INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Years Involved:

Date of Conference: March 24, 1999

LEGEND:

Corp X=
Corp Y=

State B=
Country A=
Date A=
Date B=
Date C=
Date D=
Date E=
Date F=
Date G=
Year 1=
Year 2=
Year 3=
Year 4=
Year 5=
Year 6=
A Dollars=
B Dollars=
C Dollars=
D Dollars=
E Dollars=

ISSUES :

Whether, based on the facts of this case, application of section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4, violates paragraph 3 of Article VII ("the Business Profits Article") and paragraph 6 of Article XXV ("the Non-discrimination Article") of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, Signed at Washington, D.C. on September 26, 1980, as Amended by the Protocol Signed at Ottawa on June 14, 1983 and the Protocol Signed at Washington on March 28, 1984, both effective August 16, 1984 ("the 1984 Treaty").

CONCLUSION:

The requirement in section 882(c)(2), that a foreign corporation file "a true and accurate return, in the manner prescribed in subtitle F," as a prerequisite to the allowance of deductions and credits in subtitle A, is a longstanding and established principle of U.S. domestic law. The timely filing requirement of section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4(a), is a part of the administrative framework of the United States tax system within which the provisions of the 1984 Treaty operate, and is not intended to be a substantive allocation mechanism. Had Corp X complied with the minimal timely filing requirements of section 882(c)(2), Corp X would have been entitled to the benefit of deductions allocated to Corp X's U.S. permanent establishment in accordance with the substantive allocation provisions of the Business Profits Article of the 1984 Treaty. Under the facts of this case, section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4, does not conflict with or violate paragraph 3 of the Business Profits Article of the 1984 Treaty.

With regard to the Non-discrimination Article, foreign corporations operating in the United States through permanent establishments are not similarly situated to domestic corporations with respect to the Service's ability to identify and examine noncompliant taxpayers. The timely filing requirement of section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4(a), is specifically directed at this difference in circumstances between foreign and domestic taxpayers and, accordingly, application of those provisions, per se, to foreign taxpayers is not discriminatory. Nevertheless, the Non-discrimination Article calls for careful consideration of all the facts and circumstances surrounding the application of the provisions of section 882(c)(2) in a particular case, including an evaluation of whether or not the results of applying section 882(c)(2) in the case are reasonable and whether or not the relevant treaty partner would view those results to be consistent with its understanding of the role of administrative procedures applicable to permanent establishments. The Competent Authority would be in the best position to evaluate these facts and circumstances for this purpose.

FACTS:

Corp X is a Country A corporation with operations within the United States, in State B. Corp X's fiscal year ended Date A for the years at issue. The years at issue are fiscal years ending Date A, Years 3 through 6. During an examination of Y, a domestic sister corporation to Corp X, the Service discovered that Corp X had not filed any returns for fiscal year ending Date A, Years 1 through 6**,** and informed Corp X of this fact. On or about Date B, Corp X filed U.S. federal income tax returns for its years ending Date A, Years 3 through 5, with the Internal Revenue Service Center, Philadelphia, PA. On or about Date C, Corp X filed a federal income tax return for its taxable year ending Date A, Year 6 with the Philadelphia Service Center.

On the basis of Treasury Regulation section 1.882-4(a), pursuant to section 882(c)(2), the Revenue Agent's Report proposes to disallow all of Corp X's deductions from gross income in arriving at taxable income (with the exception of charitable contribution deductions) for Corp X's taxable Years 3 through 6. For fiscal year ending Date A, Year 3, the filing deadline was Date D. For fiscal year ending Date A, Year 4, the filing deadline was Date E. For fiscal year ending Date A, Year 5, the filing deadline was Date F. For fiscal year ending Date A, Year 6, the filing deadline was Date G. The amount of proposed disallowed deductions under Treasury Regulation section 1.882-4(a)(2), pursuant to section 882(c)(2), are A Dollars (Year 3), B Dollars (Year 4), C Dollars (Year 5) and D Dollars (Year 6). Corp X maintains that the proposed disallowance of deductions is impermissible in light of the above-cited provisions of the 1984 Treaty.

It is assumed for purposes of this Technical Advice Memorandum that during the years at issue Corp X carried on business in the United States through a "permanent establishment" within the meaning of Article V (Permanent Establishment) of the 1984 Treaty. It is further assumed for purposes of this Technical Advice Memorandum that the four U.S. returns referred to above were not filed on a "timely" basis within the meaning of section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4(a)(2) and (3), and that, pursuant to Treasury Regulation section 1.882-4(a)(3)(ii), rare and unusual circumstances for a waiver of the filing deadlines set forth in section 1.882-4(a)(3)(i) do not exist.

LAW AND ANALYSIS:

Code

Section 882(c)(1) permits a foreign corporation to claim allowable deductions and credits to the extent gross income is effectively connected with the conduct of a U.S. trade or business. Section 882(c)(2) allows a foreign corporation to claim the benefit of the deductions and credits only if a true and accurate return is filed for each taxable year. Section 882(c)(2) provides:

> A foreign corporation shall receive the benefit of the deductions and credits allowed to it in this subtitle only by filing or causing to be filed with the Secretary a true and accurate

> return, in the manner prescribed in subtitle F, including therein all the information which the Secretary may deem necessary for the calculation of such deductions and credits.

Section 882(c)(2) was first enacted in the Revenue Act of 1928 as section 233, which provided:

> [a] foreign corporation shall receive the benefit of the deductions and credits allowed to it in this title only by filing or causing to be filed with the collector a true and accurate return...in the manner prescribed in this title.

Although section 233 was reenacted over the years, the substance and language of section 233 were carried forward in current section 882(c)(2).

Case Law

In interpreting section 233, the predecessor to section 882(c)(2), U.S. courts held that there is a "terminal point" after which a taxpayer could no longer claim the benefit of deductions by filing a return. See Taylor Securities, Inc. v. Commissioner, 40 B.T.A. 696, 703 (1939); Blenheim Co., Ltd. v. Commissioner, 125 F.2d 906 (4th Cir. 1942), aff'g 42 B.T.A. 1248 (1940); Georday Enterprises, Ltd. v. Commissioner, 126 F2d. 384 (4th Cir. 1942), aff'g a Memorandum Opinion of the Board of Tax Appeals dated Sept. 30, 1940. See also Espinosa v. Commissioner, 107 T.C. 146 (1996) (Upholding the Commissioner's denial of deductions to a nonresident alien individual under section 874(a) because returns were not timely filed, and finding that without a terminal point the statute would be a nullity). The language of section 874(a) is virtually identical to that of section 882(c)(2), except that section 882(c)(2) applies to foreign corporations while section 874(a) applies to nonresident alien individuals). In Taylor Securities, the Board of Tax Appeals found:

> [W]e are unable to conclude that in enacting section 233, supra, it was the intention of Congress that delinquent returns filed by a foreign corporation after the respondent's determination should constitute the returns required as a prerequisite to the allowance of the credits and deductions ordinarily allowable to the corporations....In view of such a specific prerequisite it is inconceivable that Congress contemplated by that section that taxpayers could wait indefinitely to file returns and eventually when the respondent determined deficiencies against them they could then by filing returns obtain all the benefits to which they would have been entitled if their returns had been timely filed. Such a construction would put a premium on evasion, since a taxpayer would have nothing to lose by not filing a return as required by statute.

40 B.T.A. 696, 703 (1939).

The appellate court in Blenheim stated:

> This terminal date, which the Board of Tax Appeals first adopted in Taylor Securities v. Commissioner, 1939, 40 B.T.A. 696, is directed against those foreign corporations which instead of being induced voluntarily to advise the Commissioner of their domestic operations, might find their interests best served by filing no return whatever, and then waiting until such time, if any, as the Commissioner discovers their existence and acquires sufficient information about their income on which to base a return. Unless they are precluded from then obtaining the deductions and credits under such circumstances, such foreign corporations can, if detected, come in for the first time after the Commissioner has made a return and suffer no economic loss other than the general 25% late filing penalty which applies to domestic as well as foreign corporations.

125 F.2d 906, 910.

The Blenheim court also found that:

> The situation is pregnant with possibilities of tax evasion. In express recognition of this fertile danger to the orderly administration of the income tax as applied to foreign corporations, Congress conditioned its grant of deduction on the timely filing of true, proper and complete returns. (emphasis added).

125 F.2d 906, 909.

The Blenheim court further found:

> The conclusion that the preparation of a return by the Commissioner a reasonable time after the date it was due terminates the period in which the taxpayer may enjoy the privilege of receiving deductions by filing its own return, is consistent not only with the intention of Congress as evidenced by the legislative history of Section 233, but also with consideration of sound administrative procedure....

125 F.2d 906, 910.

Regulations

Treasury Regulation section 1.882-4 interprets section 882(c)(2) with respect to the allowance of deductions and credits to foreign corporations. Since 1957, and until 1990, section 1.882-4(b) provided:

> (1) A resident foreign corporation shall receive the benefit of the deductions allowed to it with respect to the income tax, only if it files or causes to be filed with the district director, in accordance with section 6012 and the regulations thereunder, a true and accurate return of its total income received from all sources within the United States.

> (2) If a return is not so filed, the tax shall be collected on the basis of gross income, determined in accordance with Sec. 1.882-1 but without regard to any deductions otherwise allowable.
> (3) If a resident foreign corporation has various sources of income within the United States and a return of income has not been filed by it or on its behalf, the district director shall (i) cause a return of income to be made, (ii) include therein the income described in Sec. 1.882-1 of that corporation from all sources concerning which he has information, and (iii) assess the tax and collect it from one or more of those sources of income within the United States, without allowance of any deductions.

This prior version of Treasury Regulation section 1.882-4 did not have an express provision setting forth a time within which a return had to be filed in order for a foreign corporation to be entitled to deductions. However, as discussed above, U.S. courts held that there is a "terminal point" after which a return will be deemed untimely filed and, accordingly, not filed in the manner required by section 882(c)(2), resulting in the denial of deductions.

For taxable years ending after July 31, 1990, Treasury Regulation section 1.882-4 was amended to incorporate an explicit expression of the timeliness requirement. Section 1.882-4(a)(2), as amended in 1990, currently provides in part:

> A foreign corporation shall receive the benefit of the deductions and credits otherwise allowed to it with respect to the income tax, only if it timely files or causes to be filed with the Philadelphia Service Center, in the manner prescribed by subtitle F, a true and accurate return of its taxable income which is effectively connected, or treated as effectively connected, for the taxable year with the conduct of a trade or business in the United States by that corporation.

The preamble to current Treasury Regulation section 1.882-4 provides that the timely filing requirement is justified because of the different administrative and compliance concerns that are present with respect to foreign corporations that are not present with domestic corporations. 1990-2 C.B. 172. Treasury Regulation section 1.882-4(a) sets forth bright-line time limits for the timely filing of returns by foreign corporations. Under Treasury Regulation section 1.882-4(a)(3)(i), the question of whether a return has been timely filed depends on whether a return was filed for the taxable year immediately preceding the current taxable year. If a return was filed for the preceding taxable year, or if the current year is the first taxable year for which a return is required to be filed, then the current year's return must be filed within 18 months of the due date as set forth under section 6072. Treas. Reg. § 1.882-4(a)(3)(i). If, however, a return was not filed for the immediately preceding taxable year, and the current year is not the first taxable year for which a return is required to be filed, the current year's return must be filed no later than the earlier of 18 months after the due date as set forth in section 6072, or the date that the Service mails a notice to the foreign corporation advising that the current year return has not been filed and that no deductions or credits may be claimed. Id.

If a foreign corporation is engaged in a trade or business in the United States at any time

during a taxable year, it is required to file a Form 1120F even though it has no income effectively connected with the conduct of a trade or business in the United States or no income from sources within the United States. Treas. Reg. §1.6012-2(g)(1)(i). The foreign corporation would also be required to file a Form 1120-F even if its income is exempt from income tax because of a Code section or an income tax treaty. Id.

In addition to the foregoing, Treasury Regulation section 1.882-4(a)(3)(iv), as amended in 1990, provides a foreign corporation with the option of timely filing a protective return. If a foreign corporation conducts limited activities within the United States in a taxable year and determines that it has no gross income that is effectively connected with the conduct of a trade or business within the United States, it may file a protective return under that regulation. Treas. Reg. 1.882-4(a)(3)(iv). The foreign corporation need not report any amounts for gross income, deductions or credits on the protective return, it need only attach a statement that the return is being filed for protective purposes. Treas. Reg. 1.882-4(a)(3)(iv). By filing a protective return within the time limits set forth under Treasury Regulation section 1.882-4(a)(3)(i), the foreign corporation preserves its rights to allowable deductions and credits, and avoids potential disallowance of deductions and credits as a result of the application of section 882(c)(2). A foreign corporation may follow this same procedure if it determines initially that it has no U.S. tax liability under the provisions of an applicable income tax treaty. Further, even if the taxpayer fails to file a timely actual return or a timely protective return, Treasury Regulation section 1.882-4(a)(3)(ii) provides the taxpayer with another safeguard against denial of deductions by permitting the District Director to grant a waiver of the timely filing requirement in rare and unusual circumstances, if the taxpayer is able to show good cause for its failure to timely file a return.

Treaty Interpretation

In order to ensure its fair operation, a treaty must be interpreted in a manner that will give effect to the intent of the parties, as ascertained from the text, context and history of the treaty, including the course of conduct of the contracting states. Air France v. Saks, 470 U.S. 392 (1985); Sullivan v. Kidd, 254 U.S. 433 (1921). The interpretation of a treaty is a question of law, with the treaty language itself as the starting point. Eastern Air Line, Inc. v. Floyd, 499 U.S. 530, 534 (1991); Sumitomo Shoji America, Inc. v. Avagliano, 457 U.S. 176, 180 (1982). The clear language controls unless the "application of the words of the treaty according to their obvious meaning effects a result that is inconsistent with the intent or expectations of the signatories." Sumitomo Shoji, 457 U.S. at 180, quoting Maximov v. United States, 373 U.S. 49, 54 (1963).

> To alter, amend, or add to any treaty, by inserting any clause, whether small or great, important or trivial, would be on our part an usurpation of power, and not an exercise of judicial functions. It would be to make, and not to construe, a treaty. Neither can this court supply a casus omissus in a treaty, any more than in a law.

The Amiable Isabella, 19 U.S. 1, 71 (1821), quoted in Chan v. Korean Air Lines, Ltd., 490 U.S.

122, 135 (1989). "Treaties are the subject of careful consideration before they are entered into, and are drawn by persons competent to express their meaning, and to choose apt words in which to embody the purposes of the high contracting parties." Rocca v. Thompson, 223 U.S. 317, 332 (1912).

In addition to the foregoing, courts have held that when examining a provision of a tax treaty, its purpose and role within our tax structure must be examined, not just its literal language. See, e.g., Great-West Life Assurance Company v. United States, 678 F.2d 180 (Ct. Cl. 1982). Further, the meaning attributed to treaty provisions by the government agencies charged with their negotiation and enforcement is entitled to "great weight," especially if it represents a long-standing construction by the contracting states. Kolovrat v. Oregon, 366 U.S. 187, 194 (1961); Restatement (3rd) of Foreign Relations Law §326(2) 1987. The government agency charged with negotiation of the 1984 Treaty is the Department of Treasury, which is also the government agency that promulgated Treasury Regulation section 1.882-4. The "actual, reasonably harmonious practice" adopted by the contracting state may not be ignored. TWA v. Franklin Mint, 466 U.S. 243, 259 (1984).

When courts have needed additional information to construe a treaty, they have considered contemporaneous, public records, similar to a statute's legislative history. See, e.g., United States v. Stuart, 489 U.S. 353 (1989); Air France v. Saks, supra. To ascertain the treaty's meaning, courts may look beyond the written word to the history, the negotiations, and the practical construction adopted by the parties. Choctaw Nation of Indians v. United States, 318 U.S. 423, 431-432 (1943); See also Zicherman v. Korean Air Lines Co., 516 U.S. 217 (1996). In this case, the meaning attributed to the treaty by the government agency charged with its negotiation is embodied in the Treasury Department Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital Signed at Washington, D.C. on September 26, 1980, as Amended by the Protocol Signed at Ottawa on June 14, 1983 and the Protocol Signed at Washington on March 28, 1984 ("the Technical Explanation to the 1984 Treaty"). The report prepared by the Senate Foreign Relations Committee (the committee charged with approving the treaty prior to Senate ratification), the Report of the Senate Foreign Relations Committee on the Income Tax Treaty Signed with Canada on September 26, 1980, and on the Protocols Signed on June 14, 1983, and March 28, 1984 ("the Senate Report on the 1984 Treaty"), provides additional public, contemporaneous record of the 1984 Treaty's intended meaning.

Finally, it is appropriate to take into account the model treaties of the Organisation for Economic Co-operation and Development (OECD) and the official commentary thereto to discern the views of OECD member-countries on the interpretation of income tax treaties that are based on such materials. United States v. A.L. Burbank, et al., 525 F.2d 9, 15-16 (2d Cir. 1975); Taisei Fire and Marine Insurance Co., et al. v. Commissioner, 104 T.C. 535, 548-50 (1995). The United States and Canada are OECD member-countries.

Interaction Between Code and Treaty

Section 7852(d)(1) provides:

> For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or a law.

The legislative history of this provision, as reflected in the Senate Finance Committee Report, provides that this provision was intended to adopt a general rule that the later in time of a statute or a treaty controls. S. Rept. 100-445, 100th Cong., 2d Sess. at 316 (1988). However, the Senate Finance Committee Report also provides that the section 7852(d)(1) later in time rule only applies where there is a conflict between the law and the treaty. Id. Further, there is generally a presumption of harmony between earlier and later promulgations, and every attempt should be made to harmonize the application of the treaty with tax legislation. Id.; Estate of Burghardt v. Commissioner, 80 T.C. 705, 713-716 (1983); Mudry v. United States, 11 Cl.Ct. 207, 211-212 (1986). The Senate Finance Committee Report to section 7852(d)(1) provides:

> It is a proper function of the courts to carry out the process of harmonization, that is, to construe earlier and later provisions in a way that is consistent with the intent of each and that results in an absence of conflict between the two.

S. Rept. 100-445, 100th Cong., 2d Sess. at 317. The Senate Finance Committee Report further provides:

> Courts may find convincing evidence that the purpose of the later statute was completely unrelated to the earlier provision purported to be repealed, and that therefore the earlier provision continues to apply without change.

Id., citing Watt v. Alaska, 451 U.S. 259; United States v. United Continental Tuna Corp., 425 U.S. 164 (1976).

In addition, the "cardinal rule" to statutory construction "is that repeals by implication are not favored." Pasadas v. National City Bank, 296 U.S. 497, 503 (1936); see also Zenith Radio Corp. v. Matsuhita Elec. Indus. Co., 494 F. Supp. 1263, 1265 (1980); Tennessee Valley Authority v. Hill, 437 U.S. 153, 189 (1978); United States v. United Continental Tuna Corp., 425 U.S. 164, 168 (1976); Georgia v. Pennsylvania Railroad Co. et al., 324 U.S. 439, 456-457 (1945). Repeal by implication is permitted only when the earlier and later laws are irreconcilable, which requires a clear repugnancy between the two. See Georgia v. Pennsylvania Railroad Co. et al., 324 U.S. at 439; Morton v. Mancari, 417 U.S. 535 (1974); Zenith, 494 F. Supp at 1267. "The courts are not at liberty to pick and choose among congressional enactments, and when two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective." Morton v. Mancari, Id. at 551; see also Zenith, 494 F. Supp. at 1266 (finding "in order for a subsequent enactment of Congress to constitute an implied repeal of an earlier statute, the intention of the legislature to repeal must be 'clear and manifest'").

Analysis

Corp X argues that there is a conflict between section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4, and the United States' obligations under the Business Profits Article and the Non-discrimination Article of the 1984 Treaty. Specifically, Corp X argues that under paragraph 3 of Article VII (Business Profits), the United States is obliged to allow Corp X deductions for expenses it incurs with respect to the permanent establishment, and that nothing in the 1984 Treaty permits the United States to condition such deductions on the filing of a timely return. In addition, Corp X argues that paragraph 6 of Article XXV (Non-discrimination) requires that the United States tax on a permanent establishment "shall not be less favorably levied" than the tax on a United States corporation, and that the denial of deductions would be discriminatory because a United States corporation would be allowed deductions under similar circumstances.

Corp X argues that the provisions of the 1984 Treaty override the provisions of section 882(c)(2), and any regulations promulgated pursuant thereto, because the 1984 Treaty was ratified subsequent to the enactment of section 882(c)(2), and section 7852(d)(1) provides that the later in time of a statute or a treaty prevails where there is a conflict. Corp X further argues that the fact that Treasury Regulation section 1.882-4 was promulgated in 1990, subsequent to the 1984 Treaty, does not change the foregoing conclusion.

Article VII - Business Profits

Paragraph 3 of Article VII (Business Profits) of the 1984 Treaty provides:

> In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. Nothing in this paragraph shall require a Contracting State to allow the deduction of any expenditure which, by reason of its nature, is not generally allowed as a deduction under the taxation laws of that State. (Emphasis added.)

The role of the Business Profits Article is to ensure the proper allocation of the profits of a resident of a contracting state between its country of residence and the other contracting state where the resident does business through a permanent establishment; it is not intended to affect administrative provisions such as filing requirements under the domestic law of a contracting state that are necessary to ensure tax compliance. Section 882(c)(2) and Treasury Regulation section 1.882-4(a) do not provide rules for allocation of items of income and expenses between a foreign corporation and its U.S. trade or business. Section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4(a), sets forth a reasonable period of time for foreign corporations to assess whether they are engaged in a trade or business in the United States and to file either a complete return or a skeletal protective return. In order for Corp X to prevail, it must establish

that there is a "positive repugnancy" between section 882(c)(2) and the 1984 Treaty which renders them irreconcilable. Tennessee Valley Authority v. Hill, supra, at 190, quoting Wood v. United States, 41 U.S. (16 Pet.) 342, 363 (1842). In this case, it cannot be said that the provisions of section 882(c)(2) and Treasury Regulation section 1.882-4(a) are irreconcilable on their face with the provisions of the 1984 Treaty.

Section 233, the predecessor to section 882(c)(2), dates back to 1928. When the 1984 Treaty was negotiated, the United States government's position that implicit in section 882(c)(2), and its predecessor section 233, is a timeliness requirement was established. Taylor Securities, Inc. v. Commissioner, 40 B.T.A. 696 (1939); Blenheim Co., Ltd. v. Commissioner, 125 F.2d 906 (4th Cir. 1942); Geordy Enterprises, Ltd. v. Commissioner, 126 F.2d 384 (4th Cir. 1942); See also Espinosa v. Commissioner, 107 T.C. 146 (1996). The 1984 Treaty went into force on August 16, 1984. By that point in time, it was an established principle of U.S. tax law that in order to encourage compliance with, and to facilitate proper administration of, the U.S. tax system vis-a-vis foreign corporations it was necessary to have a terminal point after which deductions would not be allowed, even if a taxpayer filed a true and accurate return after that point. Taylor Securities, Inc. v. Commissioner, 40 B.T.A. 696 (1939); Blenheim Co., Ltd. v. Commissioner, 125 F.2d 906 (4th Cir. 1942); Geordy Enterprises, Ltd. v. Commissioner, 126 F.2d 384 (4th Cir. 1942).

One need only quickly peruse the entire Business Profits Article to conclude that its purpose is to define the general nature of profits to be taxable in the event of a permanent establishment, and the deductions to be allowed. There is no language to suggest that the contracting states intended to address their respective administrative filing requirements. Had it been the intention of the contracting state to override section 882(c)(2), "it would have been very easy to have declared the purpose in unmistakable terms" when paragraph 3 was drafted. Having failed to do so, long-standing principles of treaty construction mandate that there is no implied repeal of section 882(c)(2) as suggested by Corp X. Rocco v. Thompson, 223 U.S. at 332; Tennessee Valley Authority v. Hill, 437 U.S. 153 (1978) (Implied repeal).

The above analysis is supported by the Commentary to Article 7(1) of the 1977 OECD Model Tax Convention on Income and Capital, which is substantially identical to Article VII(1) of the 1984 Treaty. The allocation provisions in the Article are not intended:

> to sanction any such malpractice [i.e., the undisclosed channeling of profits away from a permanent establishment], or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. It is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion. (Emphasis added.) (paragraph 1.8).

Additionally, the commentary to Article 7(3), which is identical to the first sentence of Article VII(3) of the 1984 Treaty, confirms that its purpose is to define the general nature of profits and deductions to be considered in the taxation of a permanent establishment. Paragraph (3) "clarifies, in relation to the expenses of a permanent establishment, the general directive laid

down in paragraph 2." The entire commentary to paragraph 3 gives examples that address the nature of deductions, without reference to administrative methods to combat evasion.

In addition to the foregoing, Article I (Personal Scope) of the 1984 Treaty provides "[t]his Convention is generally applicable to persons who are residents of one or both of the Contracting States." Article 1(Personal Scope) of the 1977 OECD Model Tax Treaty provides "[t]his Convention shall apply to persons who are residents of one or both of the Contracting States." Since Article I of the 1984 Treaty in substance parallels Article 1 of the 1977 OECD Model Tax Treaty, the 1977 OECD Commentaries to Article 1 are relevant. Paragraphs 7 through 10 of the 1977 OECD Commentary to Article 1 address "improper use of the Convention." Paragraph 7 provides that tax conventions should not be used to further tax avoidance or evasion. Paragraph 7 further provides that individual states should adopt laws targeting abusive transactions and should insure that the language in bilateral income tax treaties does not nullify these domestic rules. The commentaries to Article 1 of the 1992 and 1998 OECD Conventions adopt the language of paragraphs 7 through 10 of the 1977 OECD Commentary to Article 1.

The 1992 and 1998 OECD Commentaries to Article 1, in paragraphs 11 through 26, clarify the scope of the basic rules of paragraphs 7 through 10. Paragraph 22 of the OECD Commentaries to Article 1 provides that different forms of tax treaty abuse were considered along with possible ways to deal with them such as "substance-over-form" rules and "subpart F type" provisions. Paragraph 23 specifically provides in part:

> The large majority of OECD Member countries consider that such measures are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. <u>These rules are not addressed in tax treaties and are therefore not affected by them</u>. (Emphasis added.)

Furthermore, paragraph 24 provides that "it is the view of the wide majority that such rules, and the underlying principles, <u>do not have to be confirmed in the text of the convention to be applicable</u>." (Emphasis added.)

Paragraphs 23 and 24 of the 1992 and 1998 OECD Commentaries to Article 1 are instructive regarding the proper interaction of general domestic anti-abuse rules and the 1984 Treaty. The principles adopted by these OECD commentaries, which reflect the views of the wide majority of OECD member countries, clearly indicate that domestic anti-abuse principles apply regardless of the language of bilateral treaties. This would be true in the case of the 1984 Treaty. Moreover, permitting continued application of domestic anti-abuse rules is consistent with prevention of fiscal evasion, one of the main purposes of tax conventions. Section 882(c)(2) is an anti-abuse provision. <u>See Blenheim</u>, 125 F.2d 906 (4th Cir. 1942). Thus, any alleged failure to expressly confirm the continued application of section 882(c)(2) is not meaningful.

In sum, the case law and the commentaries provide convincing evidence that the purpose of the 1984 Treaty was completely unrelated to the section 882(c)(2) timely filing requirement.

Therefore, the section 882(c)(2) timely filing requirement, as interpreted by Treasury Regulation section 1.882-4(a), continues to apply after the effective date of the 1984 Treaty. See S. Rept. 100-445, 100th Cong., 2d Sess. at 317. Moreover, the "clear repugnancy" that is required for a later legislative enactment to repeal an earlier one by implication is not present in the instant case because the two enactments do not address the same issues and are not irreconcilable. See Georgia v. Pennsylvania Railroad Co. et al., 324 U.S. at 439; Morton v. Mancari, 417 U.S. 535, 94 S.Ct. 2474, 41 L. Se. 2d 290 (1974); Zenith, 494 F. Supp. At 1267. Because there is no clearly expressed congressional intent that the provisions of the Business Profits Article of the 1984 Treaty repeal the provisions of 882(c)(2) and its timely filing requirement, and because the two enactments are capable of co-existence, both enactments are required to be regarded as effective concurrently. Morton v. Mancari, Id. at 551.

If the contracting states had intended to override this long-standing provision of U.S. tax law, they would have expressly so provided. Nowhere in the 1984 Treaty are the requirements of section 882(c)(2) expressly overridden. Further, there is no mention of any intent to override section 882(c)(2) in either the Technical Explanation to the 1984 Treaty or the Senate Report on the 1984 Treaty. Accordingly, we believe that in this case application of section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4(a) is consistent with the provisions of the Business Profits Article of the 1984 Treaty.

Article XXV - Non-discrimination

Corp X also argues that section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4, violates paragraph 6 of the Non-discrimination Article of the 1984 Treaty, and that paragraph 6 requires that deductions be allowed to permanent establishments to the same extent that resident enterprises are allowed deductions.

As a threshold matter, it is clear that section 882(c)(2) and the regulations thereunder, per se, do not violate the nondiscrimination articles of our income tax treaties. Article XXV(6) of the 1984 Treaty provides in part:

> Notwithstanding the provisions of Article XXIV (Elimination of Double Taxation), the taxation on a permanent establishment which a resident of a Contracting State has in the other Contracting State shall not be less favorably levied in the other State than the taxation levied on residents of the other State carrying on the same activities. (Emphasis added.)

The Treasury Department Technical Explanation to Article XXV(6), however, provides in part:

> Paragraph 6 protects against nondiscrimination in the case of a permanent establishment which a resident of one Contracting State has in the other Contracting State. The taxation of such a permanent establishment by the other Contracting State shall not be less favorable than the taxation of residents of that other State carrying on the same activities.

> This paragraph specifically overrides the provisions of Article XXIV(Elimination of Double Taxation), thus ensuring that permanent establishments will be entitled to relief from double taxation on a basis comparable to the relief afforded to similarly situated residents. (Emphasis added.)

This indicates that paragraph 6 is intended to prevent discrimination only to the extent that a permanent establishment is "similarly situated" to a domestic corporation carrying on the same activities. That is, comparable treatment is not required if the two are not "similarly situated."

The Commentary to paragraph 1 of the Non-discrimination Article in the OECD Model Income Tax Treaty states that the phrase:

> "in the same circumstances" refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact. (Emphasis added.)

While the Commentary specifically pertains to another paragraph of the Non-discrimination Article and thus is not directly on point, the interpretation of "in the same circumstances" provides guidance to the interpretation of "similarly situated."

U.S. domestic corporations, on the one hand, and foreign corporations conducting business in the United States through permanent establishments, on the other hand, are frequently not similarly situated. It is generally much more difficult for the Internal Revenue Service to detect a noncompliant foreign corporation doing business in the United States than a noncompliant domestic corporation. Foreign corporations are only liable for tax on income attributable to the permanent establishment and can keep records regarding their U.S. activities entirely offshore. They may also have little or no physical presence and few or no employees in the United States, particularly if they carry on their U.S. business through a dependent U.S. agent. Because of these different circumstances, the United States has a strong interest in upholding provisions designed to ensure that these business operations are detected and the appropriate amount of tax is paid. Section 882(c)(2) and Treasury Regulation section 1.882-4 are such provisions.

Congress has specifically acknowledged that unique provisions can apply to permanent establishments to ensure the collection of the appropriate tax. The legislative history of section

7852(d)(1), as reflected in the Senate Finance Committee Report, provides:

> the committee does not believe that any nondiscrimination provision of any U.S. treaty bars the application of reasonable collection mechanisms designed to ensure the collection of tax, the imposition of which is permitted by the treaty.

S. Rept. 100-45, 100th Cong., 2d Sess. at 320.

Similarly, the Treasury Department's Technical Explanation to the 1996 U.S. Model Income Tax Convention includes the following with respect to Article 24 (Non-discrimination):

> The fact that a U.S. permanent establishment of an enterprise of the other Contracting State is subject to U.S. tax only on income that is attributable to the permanent establishment, while a U.S. corporation engaged in the same activities is taxable on its worldwide income is not, in itself, a sufficient difference to deny national treatment to the permanent establishment. There are cases, however, where the two enterprises would not be similarly situated and differences in treatment may be warranted. For instance, it would not be a violation of the nondiscrimination protection of paragraph 2 [which corresponds to paragraph 6 of the 1984 Treaty] to require the foreign enterprise to provide information in a reasonable manner that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available to the Internal Revenue Service from a foreign as from a domestic enterprise. Similarly, it would not be a violation of paragraph 2 to impose penalties on persons who fail to comply with such a requirement (see, e.g., section 874(a) and 882(c)(2)).

Additionally, the Commentaries to paragraph 4 of Article 24 of the 1977 OECD Model Convention provide that:

> As regards the first sentence [of paragraph 4 of Article 24], experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in another State. <u>The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office</u>.... (Emphasis added.)

We believe these Commentaries highlight the inadvisability of interpreting the nondiscrimination articles in our income tax treaties in a manner that requires absolute consistency in treatment between permanent establishments and resident enterprises. We believe that, in general, domestic laws which impose particular requirements and penalties on foreign corporations do not violate the nondiscrimination articles of our income tax treaties if those laws are specifically designed to address reasonably the unique circumstances of foreign corporations doing business

in the United States.

Section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4(a), is narrowly targeted to assist the Service in detecting noncompliant foreign taxpayers with U.S. permanent establishments. This was specifically acknowledged in the preamble to current Treasury Regulation section 1.882-4 which provides that the timely filing requirement is justified because of unique administrative and compliance concerns that are present with respect to foreign corporations. 1990-2 C.B. 172. Section 882(c)(2) and the regulations thereunder offer strong incentives for foreign corporations with U.S. permanent establishments to file U.S. income tax returns, even if merely protective in nature, and thereby afford the Service the opportunity to identify foreign corporations that may owe U.S. tax. The fact that section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4, is specifically directed at the fertile potential of tax evasion created by the difficulty in identifying foreign corporations is clearly further from the fact that the protective return only requires that the taxpayer identify itself to the Service; no actual calculation of income, deductions or credits is required. We believe the section 882(c)(2) regime is reasonably targeted to the unique compliance concerns associated with foreign corporations doing business in the United States.

We note there is some authority within the OECD Commentaries to paragraph 4 of Article 24 of the 1977 OECD Model Convention (which is similar to paragraph 6 of the 1984 Treaty) that, in the case of deductions, no limitations can be placed on their availability without violating the nondiscrimination article. These Commentaries provide in part:

> With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:
>
> a) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise. Such deductions should be allowed without any restrictions other than those also applied on resident enterprises. (Emphasis added.)

The underlined language must, however, be read in context with the other language of the OECD Commentaries, cited above, which acknowledges that permanent establishments are different from domestic enterprises "whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office" and which identifies the main reason for the difficulty in defining the substance of the principle of equal treatment to reside in the actual nature of the permanent establishment. We believe a procedural requirement or restriction purely based on, and narrowly targeted toward, this clearly recognized difference in the nature of permanent establishments cannot be the type of restriction referenced in the underlined Commentary.

In summary, there is no "clear repugnancy" between the Non-discrimination Article of

the 1984 Treaty and the requirement of section 882(c)(2) and the regulations thereunder. Moreover, there was no "clear and manifest" intent on the part of Congress that the Non-discrimination Article of the 1984 Treaty override section 882(c)(2). Accordingly, it is clear that section 882(c)(2) and the regulations thereunder, per se, do not violate the Non-discrimination Article of the 1984 Treaty.

Notwithstanding this threshold conclusion, we note that the Non-discrimination Article of the 1984 Treaty requires careful consideration of all the facts and circumstances surrounding the application of the provisions of section 882(c)(2) and the regulations thereunder in a particular case. As indicated above, the Treasury Department's Technical Explanation to the 1996 U.S. Model Income Tax Convention provides the following:

> it would not be a violation of the nondiscrimination protection of paragraph 2 [which corresponds to paragraph 6 of the 1984 Treaty] to require the foreign enterprise to provide information in a reasonable manner that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available to the Internal Revenue Service from a foreign as from a domestic enterprise. (Emphasis added.)

Likewise, the Senate Finance Committee Report to section 7852(d)(1) provides:

> the committee does not believe that any nondiscrimination provision of any U.S. treaty bars the application of reasonable collection mechanisms designed to ensure the collection of tax, the imposition of which is permitted by the treaty. (Emphasis added.)

Thus, we believe that an evaluation under a nondiscrimination article of an income tax treaty of the potential application of a particular domestic requirement or penalty should take into account whether the results of that requirement or penalty are "reasonable." That is, a domestic requirement or penalty targeted specifically to nonresidents, albeit generally well-designed to accomplish a reasonable goal, may be found to violate the nondiscrimination article of an income tax treaty when applied in a particular case if the result places the nonresident in less favorable position vis-a-vis a similarly situated resident in an unreasonable manner.

Further, as described above, courts have generally given great weight to the government's interpretation of a treaty if it represents a long-standing construction or an "actual, reasonably harmonious practice" adopted by the contracting states. Kolovrat v. Oregon, 366 U.S. 187, 194 (1961); Restatement (3rd) of Foreign Relations Law §326(2) 1987; TWA v. Franklin Mint, 466 U.S. 243, 259 (1984); United States v. A.L. Burbank, et al., 525 F.2d 9, 15-16 (2d Cir. 1975). Therefore, the extent to which a treaty interpretation harmonizes with the views of our treaty partners can be important to the sustention of that interpretation. Accordingly, the determination of whether or not the Non-discrimination Article of the 1984 Treaty can be invoked to challenge the application of section 882(c)(2) to the facts of a particular case will depend in part upon Canada's views on the proper role for administrative requirements concerning permanent establishments, which views, in turn, may depend in part on the reasonableness of the results

flowing from the application of section 882(c)(2) in individual cases.

In summary, we believe that section 882(c)(2), as interpreted by Treasury Regulation section 1.882-4, per se, does not violate the Non-discrimination Article of the 1984 Treaty. We believe, however, that the Non-discrimination Article calls for careful consideration of all the facts and circumstances surrounding the application of the provisions of section 882(c)(2) in a particular case. This consideration should include an evaluation of whether or not the results of applying section 882(c)(2) are reasonable and whether or not Canada would view those results to be consistent with its understanding of the role of reasonable administrative procedures applicable to permanent establishments. We believe the U.S. Competent Authority would be in the best position to evaluate whether the result in this particular case is a reasonable one, taking into account its understanding the views of our treaty partners, on the proper role for administrative requirements and penalties specifically targeted to permanent establishments.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.