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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Robert Stanchik
Group Manager, OP:IN:D:C:EX:HQ

FROM: Irwin Halpern
Senior Technical Reviewer, CC:INTL:BR3

SUBJECT:

This Field Service Advice responds to your memorandum dated March 20, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Individual A =
Individual B =
c =

ISSUE

Whether the Convention between the United States of America and Canada with Respect to Taxes on Income and Capital (the "Convention") prevents application of the § 59(a)(2) alternative minimum tax ("AMT") foreign tax credit limitation to U.S. citizens who reside in Canada.

CONCLUSION

The foreign tax credit allowed by the Convention is subject to the limitations of U.S. law. Therefore, the Convention does not prevent application of the § 59(a)(2) AMT foreign tax credit limitation to U.S. citizens who reside in Canada.

FACTS

Based upon the materials submitted, we understand the facts to be as follows:

Individuals A and B are U.S. citizens who were, at all relevant times, Canadian residents. Individuals A and B filed a joint federal income tax return for 1996. During that year, Individual A sold shares in a Canadian company. As a result of the sale, Individuals A and B reported long-term capital gain and a § 1248 deemed dividend. See § 1248(b).[1]

Individuals A and B were subject to the AMT for 1996. Their original income tax return for that year reported a minimum tax liability of $c, due to the application of the § 59(a)(2) AMT foreign tax credit limitation. Individuals A and B later filed an amended return for the 1996 taxable year claiming a refund of the $c. In support of their refund claim, Individuals A and B assert a "treaty based return position" that the Convention relieves them from application of the § 59(a)(2) AMT foreign tax credit limitation. See § 6114.

[1]Your submission does not describe or inquire about Individual A and B's § 1248(b) computation.

LAW AND ANALYSIS

1. Background.

United States citizens who reside abroad are subject to U.S. income tax laws. Treas. Reg. § 1.1-1(b). These laws include the AMT provisions, §§ 55-59 of the Code. Under the AMT, certain tax benefits, including many deductions and credits, are withdrawn or subject to limitation. See, e.g., I.R.C. § 56(a) and (b).

Taxpayers are subject to the AMT if their "tentative minimum tax" ("TMT") (i.e., the tax determined in accordance with the AMT rules) exceeds their regular tax otherwise payable. A taxpayer's AMT liability is the difference between the TMT and the regular tax as calculated under the normal computational method. See § 55. The AMT is intended to prevent a taxpayer with substantial economic income from avoiding significant tax liability through the use of exemptions, deductions, and credits. S. Rept. 99-313 at 518 (1986), 1986-3 C.B. (Vol. 3) 1, 518.

United States citizens who reside or work abroad may face "double taxation" when the United States and a foreign country tax the same item of income. Under the Code, double taxation is generally alleviated by the foreign tax credit. United States income tax treaties refine the application of the Code's foreign tax credit rules.

The foreign tax credit provided under the Code is subject to limitations. For example, § 904 generally limits the allowable foreign tax credit to a taxpayer's U.S. income tax liability (before credit) on the taxpayer's foreign source taxable income and also prevents a taxpayer from crediting foreign income taxes on one type of foreign source income against U.S. income tax on other types of foreign source income. Another limitation on the foreign tax credit is imposed by § 59(a)(2).

Under § 55(b)(1)(A), noncorporate taxpayers may reduce their AMT by the AMT foreign tax credit. (A similar rule applies to corporate taxpayers under § 55(b)(1)(B).) However, § 59(a)(2) limits the amount of the AMT foreign tax credit that may be claimed in a given year to a maximum of 90 percent of the TMT. The legislative history of § 59(a)(2) addresses and explains the role of the AMT foreign tax credit limitation:

> ...[T]he minimum tax should serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits.
>
> * * *

> A further change that the committee believes is necessary relates to the use of foreign tax credits by U.S. taxpayers to avoid all U.S. tax liability. Absent a special rule, a U.S. taxpayer with substantial economic income would be able to avoid all U.S. tax liability so long as all of its income was foreign source income and it paid foreign tax at the U.S. regular tax rate or above. While allowance of the foreign tax credit for minimum tax purposes generally is appropriate, the committee believes that taxpayers should not be permitted to use the credit to avoid *all* minimum tax liability. U.S. taxpayers generally derive benefits from the protection and applicability of U.S. law, and in some cases from services (such as defense) provided by the U.S. Government, even if all of such taxpayers' income is earned abroad. Thus, it is fair to require at least a nominal tax contribution from all U.S. taxpayers with substantial economic incomes.

S. Rept. 99-313, at 518-520 (1986), 1986-3 C.B. (Vol. 3) 518-520 (emphasis in original).

2. <u>Article XXIV of the Convention</u>.

Article XXIV of the Convention provides the general rules that apply under the Convention with respect to the U.S. foreign tax credit for Canadian taxes paid or accrued. Paragraph 1 provides that:

> In the case of the United States, subject to the provisions of paragraphs 4, 5, and 6, double taxation shall be avoided as follows: <u>In accordance with the provisions and subject to the limitations of the law of the United States (as may be amended from time to time without changing the general principle hereof)</u>, the United States shall allow to a citizen or resident of the United States, or to a company electing to be treated as a domestic corporation, as a credit against the United States tax on income the amount of income tax paid or accrued to Canada; . . . [emphasis added].

The Convention thus acknowledges and applies the Code's foreign tax credit limitations. As the Department of Treasury technical explanation states: "as is generally the case under U.S. tax conventions, provisions such as Code sections 901(c), 904, 905, 907, 908, and 911 apply for purposes of computing the allowable credit under paragraph 1. In addition, the United States is not required to maintain the overall limitation currently provided by U.S. law." Treasury Department Technical Explanation of the Convention Between the United States of America and Canada with Respect to Taxes on Income and 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, 1 CCH Tax Treaties 21,061-3, at 21,087-4 ("Technical Explanation").

Accordingly, Paragraph 1 of Article XXIV of the Convention clearly authorizes the United States to impose the § 59(a)(2) AMT foreign tax credit limitation in order to limit the amount of Canadian taxes for which a U.S. foreign tax credit will be allowed. While § 59(a)(2) was not in the Code at the time the Convention entered into force, Article XXIV, paragraph 1, explicitly contemplates and incorporates amendments to U.S. law that limit the U.S. foreign tax credit.

3. Paragraph 4(b) of Article XXIV.

The applicability of the Code's foreign tax credit limitations under paragraph 1 of Article XXIV is not altered by paragraph 4(b) of Article XXIV. Paragraph 4 applies where a United States citizen is a resident of Canada (such as Individuals A and B), and provides the following rules:

> (a) Canada shall allow a deduction from the Canadian tax in respect of income tax paid or accrued to the United States in respect of profits, income or gains which arise (within the meaning of paragraph 3) in the United States, except that such deduction need not exceed the amount of the tax that would be paid to the United States if the resident were not a United States citizen; and
>
> (b) For the purposes of computing the United States tax, the United States shall allow as a credit against United States tax the income tax paid or accrued to Canada after the deduction referred to in subparagraph (a). The credit so allowed shall not reduce that portion of the United States tax that is deductible from Canadian tax in accordance with subparagraph (a).

The Technical Explanation explains paragraph 4 as follows:

> The rules of paragraph 1 are modified in certain respects by rules in paragraphs 4 and 5 for income derived by United States citizens who are residents of Canada. Paragraph 4 provides two steps for the elimination of double taxation in such a case. First, paragraph 4(a) provides that Canada shall allow a deduction from (credit against) Canadian tax in respect of income tax paid or accrued to the United States in respect of profits, income, or gains which arise in the United States (within the meaning of paragraph 3(a)); the deduction against Canadian tax need not, however, exceed the amount of income tax that would be paid or accrued to the United States if

> the individual were not a U.S. citizen, after taking into account any relief available under the Convention.
>
> The second step, as provided in paragraph 4(b), is that the United States allows as a credit against United States tax, subject to the rules of paragraph 1, the income tax paid or accrued to Canada after the Canadian credit for U.S. tax provided by paragraph 4(a). The credit so allowed by the United States is not to reduce the portion of the United States tax that is creditable against Canadian tax in accordance with paragraph 4(a).

Technical Explanation, 1 CCH Treaties at 21,087-9 (emphasis added).

Integral and necessary to the operation of paragraph 4(b) is paragraph 6 of Article XXIV. Paragraph 6 provides that "[w]here a United States citizen is a resident of Canada, items of income referred to in paragraph 4 or 5 shall, not-withstanding the provisions of paragraph 3, be deemed to arise in Canada to the extent necessary to avoid the double taxation of such income under paragraph 4(b) or paragraph 5(c)."

Paragraph 4(b) is thus properly construed as a special rule for the application of paragraph 1. This is the significance of the paragraph 1 clause "subject to the provisions of paragraphs 4, 5, and 6." Accordingly, paragraph 4(b) is subject to the limitations of U.S. law. This point is most clearly demonstrated by the resourcing rule of paragraph 6. By its terms, paragraph 6 provides that its rule applies "to avoid . . . double taxation." However, the source of income is relevant in determining the foreign tax credit only if the limitations of the Code apply. See §§ 59(a)(1) and 904(a) (limiting the AMT foreign tax credit and the regular foreign tax credit, respectively, based on the proportion that the taxpayer's foreign source AMT income or regular taxable income bears to all of the taxpayer's AMT income or regular taxable income). Sections 59(a)(1) and 904 thus clearly apply under paragraph 4, as do the other limitations of U.S. law, including § 59(a)(2). Any interpretation of paragraph 4(b) as not being subject to the limitations of U.S. law would render paragraph 6 meaningless. See also Technical Explanation, 1 CCH Treaties, at 21,087-9 to -10 (illustrating the operation of paragraphs 4 and 6) and at -11 (describing paragraph 6 as necessary to implement the objectives of paragraph 4(b)).

4. Relevant case law and the later-in-time rule.

The above analysis is consistent with the Tax Court's approach in two recent opinions: Pekar v. Commissioner, 113 T.C. 158 (1999), *appeal docketed*, No. 001382 (D.C. Cir. August 22, 2000) and Brooke v. Commissioner, T.C. Memo 2000-194, 79 T.C.M. (CCH) 2206, *appeal docketed*, No. 001482 (D.C. Cir. November 16, 2000). Both Pekar and Brooke address the interaction between the § 59(a)(2) AMT foreign tax credit limitation and the United States' tax treaty with Germany.[2] The U.S.-Germany Treaty provisions considered by the Tax Court in Pekar and Brooke are similar to the above-discussed provisions of the Convention. Compare paragraphs 3(b) and 3(c) of Article 23 of the U.S.-Germany Treaty with paragraphs 4(b) and 6, respectively, of Article 24 of the Convention.

The above analysis is also consistent with the holding of Jamieson v. Commissioner, T.C. Memo 1995-550, 70 T.C.M. 1272 aff'd without published opinion, 132 F.3d 1481 (D.C. 1997). Jamieson considered the interaction between the § 59(a)(2) AMT foreign tax credit limitation and the Convention and held that the § 59(a)(2) limit applies. However, we do not agree with Jamieson to the extent it suggests that there is a conflict between the § 59(a)(2) limitation and the Convention and, as a result, that resort must be taken to the later-in-time rule. See § 7852(d). The later-in-time rule applies only when there is a conflict between a statute and a treaty. It is a fundamental principle that a treaty and a statute must be read so as to give effect to both, if at all possible. See Whitney v. Robertson, 124 U.S. 190, 194 (1888) ("When [a treaty and statute] relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either."); see also e.g., United States v. Vetco Inc., 691 F.2d 1281, 1286 (9th Cir. 1981), cert. denied 454 U.S. 1098 (1981) ("A statute and a treaty are to be read to be consistent to the greatest possible extent") (citations omitted). As described above, the Convention and the § 59(a)(2) AMT foreign tax credit limitation do not conflict. As a result, the later-in-time rule does not apply.

5. The 1995 Protocol

Finally, we note that the above analysis is in no manner altered by the Revised Protocol Amending the Convention, signed on March 17, 1995 (the 1995 Protocol). Any argument that attempts to combine the presence of the 1995 Protocol and the later-in-time rule to negate application of the § 59(a)(2) AMT foreign tax credit limitation is fundamentally flawed because, as described above, the Convention and the § 59(a)(2) limitation do not conflict. The amendments to the Convention contained in the 1995 Protocol in no way varied Article XXIV's incorporation and application of the limitations of U.S. law. Accordingly, the later-in-time rule is inapplicable.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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[2] Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital and to Certain Other Taxes, August 21, 1991, Senate Treaty Doc. No. 101-10 (1990) (U.S. - Germany Treaty).

We are aware of two docketed cases that present the same issue addressed by this memorandum: Kappus v. Commissioner, TL-16512-99, and Robert M. and Paula Price v. Commissioner, TL-9227-00. Jennifer Nuding (312-886-9225 Ext 315) is the Chief Counsel Attorney responsible for Kappus. Leslie van der Wal (805-371-6702, Ext. 733) is the Chief Counsel Attorney responsible for Price .

Please call Rob Laudeman at (202) 622-3850 if you have any further questions.

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