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subject: Treaty benefits with respect to distributions and gains with respect to stock of a Domestic International Sales Corporation (DISC)

This memorandum should not be used or cited precedent.

ISSUE

Are foreign taxpayers permitted to claim a reduced rate of U.S. tax on their DISC distributions under Article 10[1] (Dividends) of an applicable U.S. income tax treaty by taking the position that, pursuant to Article 5 (Permanent Establishment), their DISC distributions are not attributable to a permanent establishment within the United States?

CONCLUSION

No. Claims for treaty benefits alleging that DISC distributions are not attributable to a permanent establishment within the United States should be denied because:

[1] Unless otherwise stated, all article references are to the 2006 U.S. Model Income Tax Treaty.

(1) Section 996(g)[2] requires foreign shareholders to treat DISC distributions as attributable to a permanent establishment even though they are not so attributable under an applicable U.S. income tax treaty[3]; and

(2) The well-established principle of U.S. tax treaties that the Code and treaty must be applied consistently prohibits foreign shareholders of DISCs from claiming treaty benefits applicable to income that is not attributable to a permanent establishment.

Because both the Code and U.S. income tax treaties prevent foreign shareholders of DISCs from claiming treaty benefits on DISC distributions, the "later-in-time" rule codified in section 7852(d) does not apply. Foreign taxpayers are therefore ineligible to claim treaty benefits with respect to their DISC distributions and gains, regardless of when the treaty at issue entered into force, and their treaty claims should be disallowed.

LAW & ANALYSIS

DISCs In General

The DISC regime was added to the Code in 1971[4] to promote exports of domestic goods by deferring corporate taxes on export income. Section 991 provides that a DISC is not generally subject to income tax. Section 994 permits a transfer price for "export property" between a related producer and the DISC which allows the DISC to capture up to the greater of half of the two entities' combined taxable income, or four percent of export receipts (plus 10 percent of the DISC's export promotion expenses). The income allocation may take the form of a resale price or a commission.

DISC Definition and Election Rules

To qualify as a DISC, a domestic corporation must satisfy the requirements described in section 992(a) and Treas. Reg. §1.992-1(a) (which include requirements that, in general, the corporation exclusively receive "qualified export receipts" and hold "qualified export assets"),[5] and with the consent of its shareholders, make an election under section 992(a)(1)(D) to be treated as a DISC.[6]

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[2] Unless otherwise stated, all section references are to the Internal Revenue Code of 1986 (Code), as amended.

[3] Section 996(g) also treats gains described in section 995(c) as effectively connected with the conduct of a trade or business conducted through a permanent establishment of a foreign DISC shareholder and which are derived from sources within the United States. While our analysis focuses on the availability of treaty benefits for DISC distributions, it also applies to such gain from disposition of stock in a DISC.

[4] Revenue Act of 1971, Pub. L. No. 92-178.

[5] Sec. 992(a); Treas. Reg. § 1.992-1.

[6] The election is filed on Form 4876-A. <u>See</u> Treas. Reg. § 1.921-1T(b)(1).

A corporation that qualifies as a DISC is treated as a separate corporation for Federal tax purposes, even though such corporation would not be treated (if it were not a DISC) as a corporate entity for Federal income tax purposes.[7] These requirements "constitute a relaxation of the general rules of corporate substance otherwise applicable under the Code".[8] Treas. Reg. §1.992-1(a) specifically notes that "the separate incorporation of a DISC is required under section 992(a)(1) to make it possible to keep a better record of the income which is subject to the special treatment provided by sections 991 through 996, but this does not necessitate in all other respects the separate relationships which otherwise would be required between a parent corporation and its subsidiary."

Section 992(b)(1)(B) provides that the DISC election shall be made "in such manner as the Secretary shall prescribe and shall be valid only if all persons who are shareholders in such corporation on such first day of the first taxable year for which such election is effective consent to such election." Treas. Reg. §1.992-2(a)(1)(i) provides that in general the election to be treated as a DISC shall be valid only if the consent of every person who is a shareholder of the corporation as of the beginning of the first taxable year for which such election is effective is on or attached to the Form 4876 when filed with the service center. Section 992(b)(2) and Treas. Reg. §1.992-2(d)(2) provide that a valid election by a corporation to be treated as a DISC subjects its shareholders to the provisions of section 995 (relating to the taxation of the shareholders of a DISC or former DISC) and to all other provisions of the Code relating to the shareholders of a DISC or former DISC. The regulation further states that these provisions apply to any person who is a shareholder of a DISC or former DISC whether or not such person was a shareholder at the time the corporation elected to become a DISC.

Taxation of DISC Shareholders

Section 995(a) provides that "[a] shareholder of a DISC or former DISC shall be subject to taxation on the earnings and profits of a DISC as provided in this [chapter 1], but subject to the modifications of this subpart [sections 995, 996, and 997]."[9] Amounts actually or deemed distributed to a DISC's shareholders with respect to their stock are generally treated as includible in their gross income pursuant to section 301 as described in section 995 and Treas. Reg. §§ 1.995-1(c) and 1.995-2. The DISC reports distributions, actual or deemed, made to a shareholder on Schedule K (Form 1120-IC-DISC), <u>Shareholder's Statement of IC-DISC Distributions</u>.

For DISC shareholders who are nonresident alien individuals or that are foreign corporations, trusts or estates, section 996(g) provides that "all distributions out of accumulated DISC income including deemed distributions shall be treated as gains and distributions which are effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States and which are derived from sources within the United States."

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[7] Treas. Reg. §1.992-1(a).

[8] <u>Id</u>.

[9] <u>See</u> <u>also</u> Treas. Reg. § 1.995-1(a)(2).

In H.R. Rep. 92-533, at 2024 (1971), Congress explained the purpose of section 996(g) as follows:

> Finally, a rule provides that where a nonresident alien or foreign corporation estate or trust receives a distribution out of deferred DISC income from a DISC or has gain taxed as ordinary income on the sale of stock, it is to be taxed in the same manner as if the individual were a resident or domestic corporation--otherwise, the deferred income in such cases might escape tax entirely. This is accomplished by designating this income as 'effectively connected' to the conduct of a trade or business within the United States.

In 1984, Congress amended section 996(g) to treat actual and deemed DISC distributions as "derived from sources within the United States."[10] This amendment was necessary to ensure that deemed DISC distributions which would be characterized as being from sources without the United States under section 861(a)(2)(D) of the 1954 Code, are taxable under sections 871(b) or 882 when received by certain treaty residents. The legislative history explained the amendment as follows:

> The provision that clarifies present law to make it clear that a resident of a treaty partner country cannot avoid tax (under sec. 996(g)) on DISC distributions is effective on June 22, 1984.[11]

Interaction of Treaty and Code Provisions

Section 894(a), as amended in 1988, requires that the provisions of the Code be applied with due regard to any treaty obligation of the United States that applies to the taxpayer.

U.S. income tax treaties generally provide that, with respect to dividends, the State of residence of a shareholder has the primary right to tax and not the State of source.[12] The State of source is generally limited to taxing a dividend at a reduced rate of 5% or 0% for certain corporate shareholders and 15% in all other cases.[13] Under Article 10(6), however, these benefits do not apply if "the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the payer is a resident, through a permanent establishment situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment."

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[10] Sec. 801(d)(1) of the Tax Reform Act of 1984.

[11] H.R. Rep. 98-861, at 977 (1984).

[12] See Article 10(1).

[13] See, e.g., Article 10(2) and (3) of the U.S.-U.K. Income tax treaty.

Paragraph 1 of Article 5 (Permanent Establishment) generally defines a "permanent establishment" as a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Relationship Between Treaty and Domestic Law

The Supremacy Clause of the U.S. Constitution, Article VI, section 2, states: "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land...." Tax treaties therefore have the same force as any federal law, including the Code.

According to the Supreme Court, when a treaty provision 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; but if the two are inconsistent, the one last in date will control the other...."[14] Consistent with this approach, U.S. courts generally attempt to resolve potential treaty and Code conflicts by first giving effect to both. For example, in Snap-On Tools, Inc. v. United States, 26 Cl. Ct. 1045 (1992), the U.S. Court of Federal Claims construed section 902(c)(1) of the Internal Revenue Code of 1954 and Article 23 (Elimination of Double Taxation) of the later-adopted 1975 United States-United Kingdom Income Tax Treaty as allowing a U.S. parent corporation of a wholly owned U.K. subsidiary to treat a dividend paid to it by its subsidiary within the first 60 days of 1979 as having been paid out of the subsidiary's 1978 profits. The court determined that "no language included in the United States-United Kingdom Income Tax Convention expressly overrules, or was intended to overrule, the statutory provisions of IRC section 902(c)(1)."[15]

Likewise, Congress prefers treaty and Code provisions to be construed to avoid conflicts. Before 1988, the 1954 Code provided for the priority of treaty provisions when they conflicted with Code provisions. Former section 894(a), which was added to the 1954 Code by the Foreign Investors Tax Act of 1966,[16] stated: "Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income." Section 7852(d) of the 1954 Code stated: "No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States" in effect on the date of enactment of this title. In 1988,[17] sections 894(a) and 7852 were amended to clarify that tax treaties and the Code have equal status. In

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[14] Whitney v. Robertson, 124 U.S. 190, 194 (1888).

[15] 26 Cl. Ct. 1067-68. The Court's holding relied on an analogous decision in Brown & Williamson, Ltd. v. United States, 231 Ct. Cl. 413, 420, 688 F.2d 747, 751 (1982), *acq'd*, Rev. Rul. 84-133, 1984-2 C.B. 309, 310, which allowed a previously enacted Code provision, section 6611 (Interest on overpayments), to apply a taxpayer's refund of taxes on the basis of a retroactive reduction of taxes under the 1975 United States-United Kingdom Income Tax Treaty.

[16] P.L. 89-809, §105(a).

[17] Technical and Miscellaneous Revenue Act of 1988, P.L. 100-647, §1012(aa)(1)(A) and (6).

its Description of the Technical Corrections Act of 1988,[18] the Joint Committee on Taxation stated:

> 1. Residual treaty override -- In lieu of the [original technical correction] providing for a "residual" treaty override applicable to provisions of the 1986 Act, the amendment would codify, on a permanent basis, that a statute and a treaty are to be construed in the same manner as two statutes. The amendment would require disclosure of any treaty-based return position that modifies the operation of a later-enacted statute.

The Senate Finance Committee Report[19] to the Technical Corrections Act of 1988 stated:

> In view of what the committee believes is the correct treatment of treaty-statute interactions, then, the committee finds it disturbing that some assert that a treaty prevails over later enacted conflicting legislation in the absence of an explicit statement of congressional intent to override the treaty; that it is treaties, not legislation, which will prevail in the event of a conflict absent an explicit and specific legislative override. The committee does not believe this view has any foundation in present law. [Footnote omitted] Moreover, the committee believes that it is not possible to insert an explicit statement addressing each specific conflict arising from a particular act in the act or its legislative history; for in the committee's view, it is not possible for Congress to assure itself that all conflicts, actual or potential, between existing treaties and proposed legislation have been identified during the legislative process of enacting a particular amendment to the tax laws.

In 1971, when section 996(g) was added to the Code, section 894(b) had already been enacted, and provided that, with respect to income not effectively connected with the conduct of a trade or business within the United States, a nonresident alien individual or a foreign corporation would not be deemed to have a permanent establishment in the United States at any time during the taxable year. Subsequently negotiated treaties provided that the source State is limited to the reduced rate of tax provided by the treaty unless the recipient has a permanent establishment in the State of source and the income is effectively connected with or attributable to that permanent establishment (in which case, it will be subject in the United States to tax under sections 871(b) or 882).[20] Therefore, to ensure that section 996(g) and both existing and future income tax treaties did not conflict, section 996(g) uses a treaty term, "permanent establishment" to produce the same income tax result under the treaty as if the foreign shareholder had a permanent establishment under Article 5.

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[18] Staff of Joint Comm. on Tax'n, JCX-18-88, at 13 (July 29, 1988).
[19] S. Rep. 100-445, 100th Cong., 2d Sess. (Aug. 3, 1988) to accompany S. 2238 (Technical Corrections Act of 1988), §112(aa).

[20] See, e.g., Rev. Rul. 74-63, 1974-1 C.B. 375 and G.C.M. 35472.

Restrictions on Inconsistent Treaty and Code Positions

Taxpayers may not "pick and choose" between provisions of the Code and treaty in an inconsistent manner in order to minimize tax. This limitation on treaty and Code positions is incorporated in current U.S. income tax treaties. For example, the Technical Explanation to Article 1(2)[21] states:

> Under paragraph 2, for example, if a deduction would be allowed under the U.S. Internal Revenue Code (the "Code") in computing the U.S. taxable income of a resident of the other Contracting State, the deduction also is allowed to that person in computing taxable income under the Convention. Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting States beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law.
>
> It follows that, under the principle of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax. For example, assume that a resident of the other Contracting State has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income under the Code but that do not meet the permanent establishment threshold tests of the Convention. One is profitable and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable in the United States, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B. 308.) If, however, the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.[22]

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[21] Article 1(2) provides:

> This Convention shall not restrict in any manner any benefit now or hereafter accorded:
> a) by the laws of either Contracting State; or
> b) by any other agreement to which the Contracting States are parties.

[22] See also Technical Explanation to Article 7(2) ("[A] taxpayer may choose the set of rules that results in the lowest amount of taxable income, but may not mix and match.")

Judicial precedent has adopted this limitation on treaty and Code positions. In Lehman Bros. Holdings v. United States, 2015 WL 2359256 (S.D.N.Y. May 8, 2015), the taxpayer sought to claim a treaty-based foreign tax credit with respect to substitute payments from stock-lending transactions. The taxpayer argued that the substitute payments were treated as dividends under Article 10 (Dividends) of the United States-United Kingdom Income Tax Treaty (the "1975 UK Treaty") in effect at the time, and accordingly, the taxpayer was entitled to a foreign tax credit for payments of the UK Advance Corporation Tax pursuant to Article 23 (Relief from Double Taxation) of that treaty. However, the taxpayer also argued the payments were not dividends for Code purposes, and thus not subject to the domestic law credit limitation under section 901(k) associated with dividend distributions. In denying the foreign tax credits at issue, the Court cited with approval CCA 200612013, which addressed the same legal issue, and ruled that the taxpayer was inappropriately "cherry picking" benefits in the Code and treaty in an inconsistent manner.

This limitation on treaty and Code positions has been interpreted "to prevent the taxpayer from claiming both treaty and Code treatment when the result would defeat the underlying assumptions of the two systems." A.L.I. Federal Income Tax Project: International Aspects of United States Income Taxation II: Proposals on United States Income Tax Treaties 82 (1992) ("ALI Report"). Commenting on the facts of Rev. Rul. 84-17, the ALI Report finds the ruling's holding appropriate, stating:

> In the case of business income, the statute and the treaty each sets forth a self-contained and internally consistent set of rules governing the taxation at source of business income, and these differ in important respects. The purpose of either set of rules may be carried out without allowing the taxpayer to select individual provisions most favorable to it. An interpretation of Article 1, paragraph 2, which required consistent application of one set of rules or the other adequately carries out the general policy that the treaty is for the benefit of the taxpayer, while maintaining a coherent pattern of taxation.[23]

Just as the taxpayers in Revenue Ruling 84-17 and Lehman impermissibly "cherry picked" treaty and Code benefits in an inconsistent manner, so too does a foreign DISC shareholder taking the position that, under Article 5 (Permanent Establishment) of an applicable treaty, DISC distributions are not attributable to a permanent establishment within the United States, notwithstanding section 996(g).

Lehman shows that a taxpayer cannot manipulate the Code-Treaty relationship to claim a treaty benefit while simultaneously applying the Code to circumvent limitations the treaty places on the benefit. The taxpayer in that case claimed a foreign tax credit only available under the 1975 UK Treaty. Article 10(2)(a)(iii) of that treaty required the associated income be treated as a dividend for U.S. credit purposes. The court determined that the taxpayer could not claim the treaty's foreign tax credit while also

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[23] Id., pp. 85 – 86 (footnote omitted).

applying the Code to characterize the income as non-dividends in order to circumvent a statutory credit limitation applicable to dividends. Similarly, foreign DISC shareholders cannot opt into the beneficial DISC regime by acquiring DISC shares and simultaneously claim a treaty permits the shareholder to disregard the statutory requirement to treat DISC distributions as effectively connected with a U.S. permanent establishment.

This result also follows the ALI's formulation of the limitation on inconsistent treaty and Code positions. The DISC regime sets forth an "internally consistent set of rules", which permits a broad corporate-level exemption under section 991. It correspondingly sets forth a series of shareholder-specific rules addressing the taxation of DISC distributions and gains, including section 996(g)'s requirement that they remain subject to tax under section 871(b) or 882 in the hands of a foreign shareholder even when a treaty applies. As made clear by its legislative history, section 996(g) ensures DISC income, which is already exempt at the corporate level under section 991, does not also escape U.S. taxation at the shareholder level.[24] Applying the Code to exempt corporate level tax while applying the Treaty to sidestep shareholder level tax under section 996(g) would clearly defeat the purposes of the DISC regime and simultaneously defeats the treaty assumption that dividends qualifying for a reduced rate of tax have been paid by a company that is liable to corporate tax in the United States.[25] In assessing the merits of a DISC shareholder's treaty claim, it is appropriate to consider the fact that the DISC is exempt from corporate income tax. In Donroy Ltd. v. U.S., 301 F.2d 200 (9th. Cir. 1962), for example, two Canadian resident partners in a U.S. partnership argued that, as limited partners rather than general partners, they did not have the type of agency relationship with the partnership that would cause the partnership's U.S. permanent establishment to be attributed to them under the U.S.-Canada Income Tax Treaty in effect at the time. Ruling against the partners, the court observed:

> To say that for practical purposes a limited partner in a partnership is no different from an investing shareholder in a corporation…overlooks the fact that in these latter instances the corporate entities are taxed for [sic] and pay income taxes while a partnership, whether limited or general, does not.[26]

A DISC shareholder similarly should not be falsely equated to a conventional corporate shareholder claiming treaty benefits on ordinary dividends. The fact that the corporation making the distributions at issue is exempt from tax under a regime specifically designed to facilitate a shareholder tax benefit is central to the treaty analysis where, as here, the treaty claim purports to nullify section 996(g), one of the regime's central guardrails.

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[24] See H.R. Rep. 92-533, at 2024 (1971).

[25] See Article 4(1).

[26] Id. at 207.

When foreign taxpayers participate in the DISC regime, either directly or indirectly, including upon the formation of a DISC along with a related exporting entity or a subsequent transfer of DISC shares, they also choose to take advantage of the benefits provided under the Code for the DISC regime, such as sections 991 and 994. As a condition of being a foreign DISC shareholder, these taxpayers must apply section 996(g) and treat distributions, accumulations, and gains with respect to DISC stock as though they are "effectively connected with the conduct of a trade or business conducted through a permanent establishment of such shareholder within the United States and which are derived from sources within the United States".[27] Under Treas. Reg. § 1.992-2(d)(2), this requirement applies to both founding DISC shareholders and any subsequent transferee of DISC shares.

Thus, when foreign taxpayers choose the beneficial DISC regime under the Code, either directly or indirectly, including as a founding shareholder or as a transferee of the DISC shares, they must forgo Article 10 benefits (or any other treaty benefit that does not apply to income attributable to a permanent establishment) with respect to their DISC distributions. These foreign taxpayers must therefore report their DISC distributions as taxable under section 871(b) or 882, as applicable.

Non-Applicability of Later-in-Time Rule

We understand that some taxpayers take the position that Article 5 of U.S. income tax treaties ratified after section 996(g) directly conflicts with, and thus overrides, section 996(g). The argument is that such a treaty would only allow the United States to tax business profits to the extent attributable to a treaty resident's U.S. "permanent establishment" and that term, as defined in the later treaty, does not accommodate section 996(g) taxation, creating a direct conflict that must be resolved by applying the later-in-time Rule. However, as discussed above, foreign taxpayers must report their DISC distributions as taxable under section 871(b) or 882, and may not claim benefits under Article 10, pursuant to the restriction on inconsistent Code and treaty positions. Therefore, there is no treaty-Code conflict that must be resolved under section 7852(d) and related case law.

A treaty override of a statute can only occur when the applicable statute and treaty are completely irreconcilable.[28] The legislative history to section 7852(d) similarly makes clear that, before declaring a statute repealed by implication, courts endeavor 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."[29]

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[27] Section 996(g).

[28] Johnson v. Browne, 205 U.S. 309, 321 (1907) ("[A] later treaty will not be regarded as repealing an earlier statute by implication unless the two are absolutely incompatible and the statute cannot be enforced without antagonizing the treaty").

[29] S. Rept. No. 100-445, at 317 (1988).

Courts are ordinarily reluctant to find a treaty override without extrinsic evidence suggesting affirmative intent to do so. For example, in Great-West Life Assur. Co. v. U.S., 678 F.2d 180 (Ct. Cl. 1982), a taxpayer claimed the U.S.-Canada income tax treaty in effect at the time exempted interest received from other Canadian residents that was effectively connected to its U.S. life insurance business. To obtain the exemption, the Treaty only required that the interest be paid by a Canadian resident to a non-U.S. person, and the parties agreed that those requirements had been satisfied. However, in the government's view, the Treaty's exemption was not intended to apply to interest generated by a taxpayer's U.S. business activities. Rather, the exemption was intended to provide narrow relief from a particular domestic law sourcing provision. Because the interest was effectively connected income of the taxpayer and the particular domestic law sourcing provision was inapplicable, the government denied the exemption and the court agreed. Even though the taxpayer had met all the literal treaty requirements, the court looked to extrinsic evidence including a Transmittal letter from the State Department and the Senate Report prepared in connection with the Treaty's ratification, the court held "*when understood in light of the treaty's history and explanatory provisions*, [the treaty] effected only a waiver of United States taxes imposed solely through the deemed sourcing provisions on [foreign taxpayers] not present in the United States." Id at 188.

Where, as here, both an income tax treaty (applying its restriction on inconsistent Code and treaty positions) and the Code reach the same result, there is no need to apply section 7852(d) and, moreover, doing so would contravene Congressional intent that section 7852(d) apply only to the extent necessary to resolve a dispute. This conclusion is even more salient in the case of a foreign shareholder which, alone or together with affiliated entities, has a controlling interest in a DISC and can cause a termination of the DISC election, preventing the possibility of a conflict altogether. In Rev. Rul. 79-199, 1979-1 C.B. 246, a taxpayer sought to claim a foreign tax credit under an applicable income tax treaty for income that was non-taxable pursuant to the foreign earned income exclusion, currently section 911 of the Code, even though the Code explicitly denied such credits for foreign taxes on the excluded income. The IRS determined that the taxpayer could avoid a treaty-Code conflict simply by choosing not to apply the foreign earned income exclusion if a credit under the Treaty was preferable. Similarly, a foreign shareholder with a controlling interest in a DISC and the ability to effectuate a termination of the DISC election can claim treaty benefits while avoiding any potential conflict with section 996(g).

Literal interpretations of treaty text like the ones advanced by taxpayers claiming the definition of "permanent establishment" overrides section 996(g) should be rejected when they (1) produce absurd results and (2) have no basis in the negotiating history or other extrinsic evidence. The Supreme Court so held in a unanimous decision authored by Justice Scalia, O'Connor v. United States, 479 U.S. 27, 31 (1986), holding that the phrase "any taxes" in Article XV, § 2 of Implementation Agreement of the Panama Canal Treaty referred only to Panamanian and not U.S. taxes because the taxpayer's literal reading of the phrase, which would have rendered specified U.S. citizen employees and their dependents entirely exempt from any U.S. tax whatsoever, would be "utterly implausible" and had "no foundation in the negotiations leading to the

Agreement." Allowing a claim for treaty benefits for distributions from a DISC, which is already statutorily exempt from corporate taxation, would be absurd on its face, particularly in light of the explicit Congressional intent to deny those treaty benefits.[30]

Section 996(g) is unlike most other substantive income tax provisions in the Code that apply to foreign persons and may be modified by a U.S. income tax treaty. Most such Code provisions specify how an item of income is taxed under U.S. domestic law but are silent as to the item's treatment under an applicable income tax treaty. By contrast, section 996(g) not only specifies that DISC distributions are effectively connected income under U.S. domestic law, it also requires the shareholder to *treat* DISC distributions as attributable to a U.S. permanent establishment for purposes of an applicable income tax treaty even though the distributions would not otherwise be so attributable under that treaty. The provision is therefore best understood as a coordination rule governing the interaction between the Code, specifically the DISC regime, with the overall U.S. income tax treaty network. In that regard, section 996(g) is similar to the rule in section 894(b), mentioned above, that treats a taxpayer as not having a permanent establishment for purposes of applying any income tax treaty to income that is not effectively connected with the conduct of a U.S. trade or business. As in O'Connor, it would be "utterly implausible" to rigidly construe an income tax treaty as irreconcilable with the Code by pointing to a rule like section 996(g) (or section 894(b)) that was explicitly created to govern their relationship, particularly without any supporting evidence whatsoever in any treaty's negotiation or ratification history.

Please call Richard Owens at (202) 317-6501 if you have any questions.

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[30] See e.g., H.R. Rep. 98-861, at 977 (1984).