

ACTION ON DECISION

Re: Xerox Corporation v. United States
41 F.3d 647 (Fed. Cir. 1994), reh. denied
(February 7, 1995), cert. denied 116 S.Ct.
72 (1995).

ISSUE:

Whether, under Article 23(1)(c) of the U.S.-U.K. Income Tax Treaty, a U.S. corporation is entitled to continue to treat U.K. Advance Corporation Tax (ACT) as a creditable tax paid by taxes deemed paid under section 902(a) of the Internal Revenue Code for the year in which the ACT was paid, when the subsidiary subsequently surrenders all or part of the ACT to lower-tier U.K. subsidiaries for use to satisfy their U.K. corporate tax liabilities.

DISCUSSION:

The U.K. corporate tax system partially "integrates" the taxation of corporations and their shareholders. A U.K. corporation incurs liability to pay ACT when it pays a dividend to its shareholders. A U.K. corporation paying ACT may use the ACT to satisfy (offset) its corporate tax liability for the year of the dividend distribution, or may carry over unused ACT to offset its tax liability for another year. Alternatively, the payor corporation may surrender unused ACT to a subsidiary for use as an offset against the subsidiary's corporate tax liability. A U.K. individual shareholder receiving a dividend on which ACT has been paid reports the ACT as additional dividend income and then claims a credit against its income tax liability for the ACT paid.

The U.S.-U.K. Income Tax Treaty¹ extends the benefit of the ACT credit to U.S. shareholders of U.K. corporations. Under

¹ Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed on December 31, 1975, and entered into force on April 25, 1980, 31 U.S.T. 5668, reprinted in 1980-1 C.B. 394 (hereinafter "U.S.-U.K. Treaty" or "Treaty").

Article 10 of the Treaty, one-half of the ACT paid with respect to a dividend paid by a U.K. corporation is refundable to the U.S. shareholder and treated as an additional dividend. Both the actual dividend and the ACT dividend are subject to a 5-percent withholding tax which is creditable under section 901² and Article 10(2) of the Treaty. Article 23(1)(a) and (c) provide, "in accordance with the provisions and subject to the limitations of U.S. law," that the unrefunded portion of the ACT is a creditable income tax of a U.K. corporation (Article 23(1)(a) for which a U.S. corporate shareholder may be entitled to a deemed paid credit under section 902 (Article 23(1)(c)).

The Treasury Department's Technical Explanation of the U.S.-U.K. Treaty, 1980-1 C.B. 455, and Rev. Proc. 80-18, 1980-1 C.B. 623, provide a mechanism for harmonizing the U.S. foreign tax credit rules with the U.K. integrated tax system. These authorities initially allow a U.S. shareholder of a U.K. corporation to treat all unrefunded ACT as a foreign income tax with respect to which it may compute a deemed paid credit under section 902(a) for the year in which the payor U.K. corporation pays a dividend and becomes liable for the ACT. However, if the U.K. corporation carries over unused ACT to offset its tax liability in a later year, or surrenders unused ACT to a U.K. subsidiary in a later year, these authorities require the U.S. shareholder to reduce its deemed paid taxes under section 902(a) for the original year by making an adjustment under section 905(c) as if the unused ACT were refunded to the U.K. corporation in that later year. The unused ACT is then treated as a creditable tax of the U.K. corporation in the later year to which it was carried, or, if the unused ACT was surrendered to a U.K. subsidiary, as a creditable tax of the U.K. subsidiary in the year it was applied to offset the subsidiary's U.K. corporate tax liability. The deemed ACT refund and resulting section 905(c) adjustment implement the foreign tax credit article of the U.S.-U.K. Treaty (Article 23) in a manner consistent with the provisions of section 902(a) and the other provisions of the Code related to the foreign tax credit.

On its U.S. income tax return for 1974, Xerox computed its deemed paid taxes under section 902(a) with respect to dividends paid by its U.K. subsidiary on the basis of the entire amount of unrefunded ACT the subsidiary paid in 1974. In 1980, the subsidiary surrendered most of the 1974 ACT to lower-tier subsidiaries, which applied it in satisfaction of their 1980 U.K. corporate tax liabilities. Relying on the Technical Explanation to

² All section references are to the Internal Revenue Code.

the U.S.-U.K. Treaty and Rev. Proc. 80-18, the government took the position that the ACT paid but not used was only provisionally allowed as a creditable income tax in 1974. When that unused ACT was surrendered to lower-tier U.K. subsidiaries in 1980, the government required Xerox

to recompute its 1974 foreign tax credit under section 905(c) as if the surrendered ACT had been refunded.

The Federal Circuit rejected the government's requirement of a section 905(c) adjustment based on what it viewed as the "plain meaning" of the Treaty. Article 23(1)(a) and Article 23(1)(c) of the Treaty provide that certain payments to the United Kingdom will "be treated as an income tax." The Federal Circuit's opinion erroneously regarded that phrase as equivalent to the term "allowed as a foreign tax credit." These terms, however, have vastly different meanings. In its opinion, the Court states:

Thus for dividends distributed to a United States shareholder corporation, Article 10 provides that half of the ACT paid in the United Kingdom is repaid as a tax credit by the United Kingdom, and Article 23 provides that the remainder is allowed as a United States tax credit as if the ACT were an income tax in the United Kingdom.

41 F.3d at 651 (emphasis added). Article 23, however, does not state that the portion of the ACT not repaid by the United Kingdom will be allowed as a foreign tax credit. Rather, Article 23(1)(a) and Article 23(1)(c) merely provide that certain payments to the United Kingdom will be "treated as an income tax." Confirming that a foreign levy qualifies as an income tax is a prerequisite to creditability under section 901, but does not establish when or to what extent the tax will give rise to a foreign tax credit under U.S. law. That determination is made under the "provisions and subject to the limitations of" U.S. law. Article 23(1). Nevertheless, the Federal Circuit concluded that unrefunded ACT is permanently allowed as a foreign tax credit in the year paid.

The Federal Circuit's decision is contrary to the U.S. foreign tax credit rules, which Article 23(1) of the Treaty expressly incorporates. A fundamental tenet of the section 902 deemed paid foreign tax credit is that a distribution of earnings should carry a credit only for a pro rata share of the foreign income taxes imposed on those earnings. Goodyear Tire

& Rubber Company v. United States, 493 U.S. 132 (1989); H.H. Robertson Co. v. Commissioner, 59 T.C. 53, 79 (1979), aff'd per order, 500 F.2d 1399 (3d Cir. 1974). The Federal Circuit's decision conflicts with this matching principle underlying section 902 by allowing a distribution of earnings from a U.K. subsidiary to generate a credit for foreign taxes ultimately imposed on earnings of a different entity in a different year. The decision also is contrary to section 902(b), which allows a credit for taxes paid by a lower-tier corporation only when that corporation's earnings are distributed up the chain to the U.S. shareholders. The effect of the court's decision is to allow a foreign tax credit for a tax payment ultimately used to satisfy an income tax liability on accumulated profits that may never be distributed to a U.S. shareholder, a result that is not mandated by the Treaty, was not intended by the Treaty partners, and is contrary to U.S. law.

RECOMMENDATION:

Nonacquiescence.

REVIEWERS:

/s/

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/s/

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