The TCJA and the Treaties

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In this article, the authors examine how corporate tax changes implemented by the Tax Cuts and Jobs Act interact with U.S. tax treaties.

This article addresses the interaction of U.S. income tax treaties and certain changes made by the Tax Cuts and Jobs Act (P.L. 115-97) to the international provisions of the corporate income tax.[1] The article makes four main points. First, it explains why the participation exemption, the global intangible low-taxed income regime, and the transition tax on deemed repatriations of deferred foreign earnings are compatible with provisions of the 2016 U.S. model income tax convention and existing U.S. treaties allowing for relief from international double taxation.[2] Second, it explains why the disallowance of deductions for foreign related-party interest or royalty payments (or accruals) in hybrid transactions or with hybrid entities is compatible with treaty nondiscrimination provisions. Third, the article explains why the foreign-derived intangible income regime, the (arguable) disallowance of a statutory foreign tax credit with respect to hybrid dividends not benefiting from the participation exemption, and the repeal of IRC section 902 (the statutory indirect FTC provision) are inconsistent, but not in conflict, with U.S. treaty provisions on nondiscrimination and relief from double taxation, and therefore raise no treaty override questions. Finally, it suggests that reconciling the inconsistencies means that:

- U.S. permanent establishments of foreign corporations resident in treaty partner jurisdictions may claim a treaty-based FDII deduction;
- a U.S. corporation may claim a treaty indirect FTC for both the U.S.-source portion of a dividend for which an FTC election is made and the foreign-source portion of a dividend not benefiting from the participation exemption by reason of failing to meet the one-year holding period requirement, provided the dividend is received from a foreign subsidiary that is resident in a treaty partner jurisdiction and at least 10 percent of the voting stock of that

[1] The authors previously addressed the relationship between the base erosion and antiabuse tax of IRC section 59A and the treaties; that discussion will not be repeated here. *See* H. David Rosenbloom and Fadi Shaheen, "The BEAT and the Treaties," *Tax Notes Int'l*, Oct. 1, 2018, p. 53.

[2] The 2016 U.S. model treaty is referenced because its relevant provisions are identical or similar to those in most U.S. treaties.

subsidiary is owned by the U.S. corporation; and

- if there is no statutory FTC for a hybrid dividend and tiered hybrid dividend inclusion, a U.S. corporation may claim a treaty direct FTC for withholding tax paid to a treaty partner jurisdiction on a hybrid dividend received from a controlled foreign corporation or a treaty indirect FTC for income tax paid to a treaty partner jurisdiction by the receiving CFC in the transaction triggering the tiered hybrid dividend inclusion, provided at least 10 percent of the voting stock of the CFC is owned by the U.S. corporation.

I. The Statutory Framework

The United States taxes the worldwide income of domestic corporations and allows a credit for foreign tax paid or accrued on foreign-source income.[3] For years beginning before 2018, creditable foreign taxes included, along with foreign taxes a U.S. corporation directly paid, foreign taxes paid or accrued on earnings underlying dividends paid to a U.S. corporation owning at least 10 percent of the paying subsidiary's voting stock and foreign taxes paid or accrued by a CFC on earnings underlying amounts included in income by the U.S. corporation under subpart F.[4] Thus, a U.S. corporation was allowed an indirect FTC in addition to the direct FTC allowed to all U.S. taxpayers.

The FTC is subject to a limitation equal to the product of the pre-credit tentative U.S. tax liability and the ratio of taxable foreign-source income to all taxable income. The FTC limitation is applied separately to different categories, or baskets, of foreign-source income. Associated foreign taxes in excess of the limitation in each basket are generally carried over in the same basket to other years.

For years beginning after 2017, the TCJA made important changes to the international provisions of the corporate income tax.[5] Instead of the pre-TCJA graduated corporate rate structure topping off at 35 percent, the regular corporate rate was changed to 21 percent. The grossed-up amount of GILTI — which generally is a U.S. shareholder's share of the net income of all CFCs (reduced by specified items) in excess of a 10 percent return on the CFCs' tangible assets — is now included in the gross income of an at-least-10-percent U.S. shareholder, with corporate U.S. shareholders benefiting from a deduction under section 250 for up to 50 percent (37.5 percent for years beginning after 2025) of the grossed-up GILTI inclusion. An indirect FTC is allowed for 80 percent of foreign taxes paid or accrued by CFCs on the underlying income. GILTI inclusions that are not passive category income fall in a new GILTI basket that does not allow for foreign tax credit carryovers. Foreign taxes withheld on distributions by CFCs of amounts previously included as GILTI are fully creditable in the applicable baskets[6] with limitation adjustments for timing differences between inclusions and distribution.[7] GILTI inclusions are independent of, and separate from, inclusions (with a 100 percent indirect FTC) for subpart F income of each CFC.

Under the TCJA, a U.S. corporation is allowed a deduction of up to 37.5 percent (21.875 percent for years beginning after 2025) of its FDII, which generally is income from foreign sales or services arising from domestic operations in excess of a 10 percent return on domestic tangible assets.

Further, subject to a one-year holding period requirement and an exception for hybrid instruments (along with regulatory limitations not relevant here), a U.S. corporate shareholder

[3]The foreign tax credit is elective, and taxpayers may choose to claim a foreign tax deduction instead.

[4]Sections 902 and 960 did not provide the FTC, which was the product of sections 27 and 901. Sections 902 and 960 deemed foreign taxes paid by the foreign subsidiary to have been paid by, and therefore creditable for, the U.S. corporation. The credits for deemed-paid taxes extended through six tiers of foreign subsidiaries, but beyond the third tier only for CFCs.

[5]It also enacted the BEAT and repealed the corporate alternative minimum tax. Subject to exceptions and limitations, the BEAT is imposed as a separate tax, without statutory FTCs, on each applicable taxpayer in an amount equal to the excess of 10 percent (5 percent for 2018) of a modified taxable income base (which generally is taxable income computed without regard to tax benefits for deductible payments to foreign related persons) over the pre-credit regular tax liability for the tax year, reduced by specific credits including, most importantly, the FTC. *See* Rosenbloom and Shaheen, *supra* note 1; *see also infra* note 21.

[6]The 80 percent limitation applies only to the indirect FTC under section 960(d).

[7]Proposed section 960 regulations (REG-105600-18) treat GILTI inclusions like subpart F inclusions for purposes of section 960(c). *See* prop. reg. sections 1.960-4 and 1.960-5.

now benefits from a participation exemption in the form of a deduction equal to 100 percent of the foreign-source portion of a dividend received from a foreign subsidiary of which the shareholder owns at least 10 percent.[8] Distributions from a CFC attributable to amounts a U.S. shareholder previously included in gross income under the GILTI or subpart F regimes are excluded from gross income and not treated as dividends.[9] Neither credit nor deduction is allowed for foreign taxes paid or accrued, or deemed paid or accrued, with respect to a dividend benefiting from the participation exemption.

Section 902 has been repealed, and the code no longer provides a credit for foreign taxes paid or accrued by foreign subsidiaries on earnings underlying the dividends paid to U.S. corporate shareholders.

Deductions for interest or royalty amounts paid or accrued to a foreign related party under a hybrid instrument or if either party is a hybrid entity are no longer allowed to the extent that, by reason of the hybridity, the tax laws of the related party's country of residence exclude those amounts from income or allow a deduction for them.

A transition tax at reduced rates with scaled-back FTCs was imposed on the deferred foreign earnings of U.S. corporations accumulated from 1987 through 2017 by CFCs and other foreign subsidiaries treated for this purpose as CFCs. The tax was imposed for the last tax year before the general effective dates of the international provisions in the TCJA. It combines a grossed-up subpart F inclusion for the accumulated earnings and corresponding deductions resulting in pre-credit tax rates of 15.5 percent and 8 percent on the grossed-up amounts of earnings held in cash and noncash positions, respectively, along with partial denials of FTCs.

Final, temporary, and proposed regulations issued as of the writing of this article and relevant to this discussion include the final and temporary GILTI and FTC regulations (T.D. 9866), the proposed GILTI regulations (REG-104390-18), the proposed section 250 regulations (REG-104464-18), the proposed hybrids regulations (REG-104352-18), and the proposed FTC regulations (REG-105600-18).[10]

II. The Treaty Framework

Two U.S. treaty obligations are relevant to the TCJA: one regarding nondiscrimination in article 24, and one regarding FTCs in article 23. Neither article is affected by the saving clause of article 1(4) and (5).

Article 24 bars four types of discrimination in taxation, including discrimination in the treatment of a U.S. PE of an enterprise of a taxpayer resident in a treaty partner jurisdiction and discrimination in the treatment of payments made to a resident of such a jurisdiction.

In article 23(2), the United States commits to allowing residents and citizens to claim direct and indirect FTCs for foreign taxes paid to a treaty partner. By its terms, the obligation, however, is qualified: The treaty credit must be "in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)."

The indirect FTC treaty obligation is limited to dividends a U.S. corporation receives from a first-tier subsidiary resident in the treaty partner and at least 10 percent of whose voting stock is owned by the U.S. corporation. The obligation is also limited to income taxes paid by, or on behalf of, that subsidiary to the treaty partner on the profits underlying the dividends. This raises the question whether the treaty term "dividends" is broad enough to include subpart F and GILTI inclusions

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[8] The 10 percent is tied to the section 951(b) definition of U.S. shareholder, and thus does not require voting stock. The foreign-source portion of a dividend depends on the ratio of the foreign subsidiary's pre-distribution foreign earnings to its total pre-distribution earnings. The foreign subsidiary will have foreign earnings to the extent of earnings not attributable to:

- income effectively connected to a U.S. trade or business (ECI) and not protected by treaty from U.S. tax; or
- dividends it receives (directly or indirectly through wholly owned foreign corporations) from domestic corporations that are at least 80 percent owned, directly or indirectly, by the foreign subsidiary.

Foreign earnings for this purpose are not limited to foreign-source non-ECI and could include U.S.-source non-ECI or U.S.- or foreign-source ECI exempt from U.S. tax under a treaty.

[9] *See* Notice 2019-01, 2019-03 IRB 275.

[10] The temporary participation exemption regulations (T.D. 9865) are not relevant here.

and subject them to the indirect FTC treaty obligation.[11]

As discussed below, the treaty does not define the term "dividends" for article 23(2) purposes. Article 3(2) provides that unless the context requires otherwise, an undefined treaty term takes its meaning under the domestic laws of the country applying the treaty — here, the United States. Although subpart F and GILTI inclusions generally are not dividends under U.S. domestic law, the context appears to call for an autonomous definition of the term "dividends" that would encompass those inclusions.

First, U.S. domestic tax law is inconsistent in its characterization of subpart F and GILTI inclusions, sometimes treating them as dividends.[12]

Second, even when subpart F and GILTI inclusions are not characterized as dividends under U.S. domestic tax law, they remain largely subject to the same tax treatment as dividends.[13] It is immaterial that subpart F and GILTI inclusions do not benefit from the 100 percent dividends received deduction (DRD) embodying the participation exemption and that GILTI inclusions benefit from the section 250 deduction. Subpart F and GILTI inclusions, like dividends, are included in gross income to reflect some form of participation in subsidiary profits. That is not affected by the acceleration of the subpart F and GILTI inclusions, the choice of relief from double taxation (exemption, FTC, or a combination of both), or the effective rate of taxation (the result of the section 250 deduction). Relief from double taxation is what article 23(2) requires, and a restrictive definition of the term "dividends" would run counter to the purpose of the treaty obligation.

Third, although the definition of the term "dividends" in article 10(7) is limited to article 10 (dividends), it states that for treaty purposes, dividends should include income from shares reflecting participation in profits, "as well as income that is subject to the same taxation treatment as income from shares." It may be that the definition was limited to article 10 because it refers to the source country, while article 23(2) applies to the residence country.

Fourth, a technical and restrictive interpretation of the term "dividends" would lead to an unreasonable result in which only the gross-up amounts of subpart F and GILTI inclusions (treated as dividends under section 78) — but not the inclusions themselves — would be subject to the indirect FTC treaty obligation.

Therefore, the better reading of the treaty language is that subpart F and GILTI inclusions are subject to the indirect FTC treaty obligation.

III. Treaty Compatibility

A. FTC Denials

The denial of FTCs for dividends benefiting from the participation exemption, the 80 percent limitation on indirect FTCs for GILTI inclusions, and the partial denial of FTCs for the transition tax are all compatible with article 23(2) of the U.S. model treaty.[14] Enacted by the TCJA, those limitations postdate all existing U.S. treaties. To be compatible with article 23(2), they must not change the general principle of article 23(2), which is "the allowance of a credit."[15]

As explained in a previous article:

> The general principle of allowing a credit in the meaning of Article 23(2) refers to the principle of a dollar-for-dollar reduction in the amount of U.S. tax on U.S.-taxable foreign-source income by the amount of foreign taxes paid, applied on an overall basis, item-by-item basis, or any basis in between.[16]

[11] Obviously, the term "receives" includes deemed receipts.

[12] *See* H.R. Rep. No. 104-586, at 136 (1996) ("income inclusions under subpart F have been characterized as dividends for unrelated business income tax purposes"); and Notice 2018-67, 2018-36 IRB 409 (same for GILTI).

[13] H.R. Rep. No. 87-1447, at 59 (1962) ("This subpart F income under the bill is attributed to 10-percent U.S. shareholders and taxed to them in largely the same manner as dividends"); and H.R. Rep. No. 115-446, at 641 (2017) ("Under the provision, a U.S. shareholder of any CFC must include in gross income for a taxable year its [GILTI] in a manner generally similar to inclusions of subpart F income").

[14] The failure to grant an indirect FTC to an individual U.S. shareholder for GILTI inclusions poses no treaty concerns because article 23(2) requires an indirect FTC only for corporate taxpayers.

[15] See the U.S. model technical explanation issued in connection with the 2006 U.S. model treaty.

[16] Shaheen, "How Reform Friendly Are U.S. Tax Treaties?" 41 *Brook. J. Int'l L.* 1243, 1266 (2016).

Therefore, an exemption system or "any system that is or can be expressed as an outright fixed or floating combination of exemption and credit is treaty compatible regardless of how it is actually labeled or expressed."[17] The participation exemption, the transition tax, and the GILTI regime satisfy that standard.[18] One way to rationalize this conclusion is to point to the FTC basket provisions as an integral part of the FTC.[19] Introducing a new FTC basket — say, for U.S.-exempt foreign-source income — would not change the general principle of allowing a credit, and thus would be compatible with article 23(2).[20] The denial of a credit for dividends benefiting from the participation exemption, the scaling back of credits against the reduced-rate transition tax, and the 80 percent limitation on the indirect FTC with respect to GILTI inclusions combined with the GILTI deduction are treaty compatible because none produces a result that is worse for the taxpayer than introducing a new FTC basket for exempt income.[21]

That holds even under the strictest literal reading of the treaty language.[22] Article 23(2) requires a credit, it is true, but because the treaty does not define the term "credit," article 3(2) requires that the term take its meaning under the domestic laws of the country applying the treaty — here, the United States. Fundamental to all aspects of U.S. tax law, the substance-over-form principle applies in defining the term "credit."[23] The outright disallowance of FTC for the participation exemption, the partial disallowance of FTC for the reduced-rate transition tax, and the combination of the percentage limitation for the GILTI indirect FTC and the GILTI deduction are but different forms of "what in substance is the same domestic law limitation — namely, the exemption basket limitation — that does not change the 'general principle' of allowing a credit."[24] This interpretation is supported by the reference in article 23(2) to a "general principle," which suggests a substance-over-form approach.[25] The interpretation reflects a policy judgment that the United States should not provide an FTC (intended to mitigate double taxation) for income that is exempt from U.S. taxation and thus not subject to double taxation.[26]

Consider the participation exemption first. If instead of denying an FTC for dividends benefiting from the 100 percent DRD that embodies the participation exemption the TCJA had introduced a new FTC basket for exempt income, the dividend income in question and the associated creditable foreign taxes would fall in the new basket. The 100 percent DRD would be allocated to the dividend income, reducing taxable income to zero and therefore providing zero FTC limitation in the basket. That would mean that with a treaty-compatible limitation, all associated creditable foreign taxes would be indefinitely carried over and never allowed as credits — the same outcome as denial of an FTC for dividends benefiting from the participation exemption.

Now consider the transition tax. Because it was imposed in the last tax year to which the other changes under the TCJA did not apply, the corporate tax rate was generally 35 percent. Imposition of the transition tax at reduced rates on grossed-up subpart F inclusions for deferred foreign subsidiary earnings (15.5 percent for earnings in cash and 8 percent for earnings in noncash positions) is equivalent to taxing parts of the grossed-up amounts of those earnings (44.3 percent (15.5/35) and 22.9 percent (8/35), respectively) at the full 35 percent rate and exempting the balances (55.7 percent and 77.1 percent, respectively). In fact, that is the

17. *Id.* at 1281. *See also* Mitchell Kane, "International Tax Reform, the Tragedy of the Tax Commons, and Bilateral Tax Treaties," preliminary draft presented at the New York University Tax Policy Colloquium (2018); and Daniel N. Shaviro, "The New Non-Territorial U.S. International Tax System," *Tax Notes Int'l*, July 2, 2018, p. 27.

18. *See* Shaviro, "The New Non-Territorial U.S. International Tax System, Part 2," *Tax Notes Int'l*, July 9, 2018, p. 125.

19. Shaheen, *supra* note 16, at 1256-1267.

20. Shaheen, *supra* note 16, at 1256-1267, 1271-1273.

21. This interpretation does not resolve the inconsistency between the non-allowance of FTCs under the BEAT and article 23(2) for several reasons, including that the BEAT is a separate tax and contemplates no FTC at all. *See* Rosenbloom and Shaheen, *supra* note 1, at 54 (note 4 and accompanying text).

22. Shaheen, *supra* note 16, at 1271-1273.

23. *See, e.g., PPL Corp. v. Commissioner*, 133 S. Ct. 1897, 1905 (2013) (citing *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 315 (1956) ("Tax law deals in economic realities, not legal abstractions.")).

24. Shaheen, *supra* note 16, at 1273.

25. *Id.* at 1272.

26. *Cf. Estate of Burghardt v. Commissioner*, 80 T.C. 705 (1983).

mechanism by which the tax was imposed, with the partial exemption effected through deductions. The code also disallows FTCs for 55.7 percent of the foreign taxes attributable to foreign subsidiary earnings held in cash and 77.1 percent of the foreign taxes attributable to foreign subsidiary earnings held in noncash positions. If the FTC basket for exempt income replaced the outright denial of credit, the exempt portions of the inclusions (55.7 percent and 77.1 percent for earnings held in cash and noncash positions, respectively), along with the properly apportioned foreign taxes, would fall in the exempt income basket, to which the partial deductions in the same amounts would be allocated. The result would be zero income, and therefore zero limitation, in the basket. Again, because of a treaty-compatible limitation, all creditable foreign taxes in the basket would be indefinitely carried over and never allowed as credits — the same outcome as the code's denial of partial FTCs for the transition tax.

The same analysis applies to the GILTI regime. The 50 (or 37.5) percent GILTI deduction means that 50 (or 37.5) percent of the GILTI inclusion is exempt from U.S. taxation. The deduction extends to the gross-up under section 78, so each dollar of the grossed-up GILTI inclusion is 50 (or 37.5) percent exempt and 50 (or 62.5) percent taxed.[27] This leaves room for a treaty-compatible limitation on creditability down to 50 (or 62.5) percent, because 50 (or 37.5) percent of any GILTI inclusion together with 50 (or 37.5) percent of associated foreign taxes would fall in the exempt income basket, to which the GILTI deduction would be allocated, resulting in zero taxable income and therefore zero limitation in the basket. All the foreign taxes in the basket would be carried over indefinitely without being credited — that is, up to 50 (or 37.5) percent of the foreign taxes could be simply discarded without violating the treaty commitment. The 80 percent creditability limitation results in discarding only 20 percent of the foreign taxes and is therefore both treaty compatible and generous.[28]

Other features of the GILTI regime do not raise treaty concerns. As noted, the regime operates on a global basis, generally aggregating tested income and losses of all CFCs, all their tangible assets (other than those of CFCs with losses), and all their foreign taxes (again, other than those of CFCs with losses) in determining a U.S. shareholder's GILTI inclusions and related indirect FTCs. Treaties, on the other hand, operate bilaterally. This global-bilateral inconsistency raises the question whether the global nature of the GILTI regime could reduce the FTC for current-year creditable taxes paid to a treaty partner jurisdiction when there are excess FTCs in other jurisdictions. That kind of averaging effect, if it existed, would be the result of the FTC basket limitation, however, and the operation of basket limitations on a global, not country-by-country, basis triggers no treaty concerns.

Losses and expense allocations present separate — and familiar — FTC limitation issues that are also not problematic from a treaty perspective. Applying a foreign-source loss from one jurisdiction against foreign-source income from another jurisdiction reduces the FTC limitation and may in turn reduce the amount of credit for taxes paid to the second jurisdiction. That occurs automatically if the FTC limitation is applied on a global basis or if there are specific rules providing for that result under a per-country or per-item limitation regime.[29] The U.S. FTC regime has long contained rules of that sort. The rules pose no article 23(2) concerns because they all carry out in one variation or another the purpose of the FTC limitation — namely, protecting the U.S.-source tax base from erosion by the FTC, which is an integral part of the general credit principle.[30]

Another feature not unique to the GILTI regime is allocation and apportionment of a U.S. shareholder's deductible expense to the GILTI

[27] This assumes that the section 78 gross-up amount falls in the same FTC limitation as GILTI inclusions. Prop. Treas. reg section 1.904-4(o). For the observation that the statutory language suggests separately limiting the section 78 gross-up amount, see Elizabeth J. Stevens and Rosenbloom, "GILTI Pleasures," *Tax Notes Int'l*, Feb. 12, 2018, p. 615.

[28] A reduction under section 250(a)(2) in the amount of the GILTI deduction does not change the analysis because section 250(a)(2) applies when the GILTI inclusion is reduced.

[29] Joint Committee on Taxation, "Summary of the New Provisions of the Internal Revenue Code of 1954 as Agreed to by the Conferees," at 98 (1955).

[30] Shaheen, *supra* note 16, at 1256-1267; 1265.

basket, which reduces foreign-source taxable income in the basket and thus the amount of FTCs that can be credited. That in turn could increase U.S. tax liability.[31] The same could happen if an expense is allocated to a U.S. shareholder's FTC basket that includes subpart F income.[32] Allocation and apportionment do not raise treaty compatibility concerns because they are the result of the interaction between the expense allocation and apportionment regime of sections 861(b), 862(b), and 863(a), which predates most, if not all, existing U.S. income tax treaties, and the FTC limitation, which is an integral part of both statutory and treaty FTC rules.

A unique feature of the GILTI regime is that excess FTCs in the GILTI basket cannot be carried back or forward. Article 23(2), however, does not require a carryover of credits. That is also the case under article 23B(1) of the OECD model treaty.[33] From a treaty perspective, the general carryover feature of the statutory FTC is a privilege that U.S. domestic law offers beyond the commitment in the treaties.[34] An FTC applied on a transaction-by-transaction basis would not allow for carryovers but would undoubtedly be treaty compatible.

B. Section 267A

IRC section 267A and the proposed hybrids regulations deny deductions for interest or royalty amounts paid or accrued to a related party either in a hybrid transaction or through a hybrid entity, to the extent that by reason of the hybridity the tax laws of the related party's country of residence exclude those amounts from income or allow a deduction for them. A hybrid transaction involves at least one payment treated as interest or royalties for U.S. tax purposes but not under the tax laws of the country where the recipient is a resident or subject to tax. A hybrid entity is an entity that is fiscally transparent for U.S. tax purposes but not under the tax laws of the foreign country, or vice versa.

Article 24 of the U.S. model treaty bars four types of discrimination in the taxation of nationals or residents of treaty partners as compared with comparably situated U.S. nationals or residents. The 2006 model technical explanation states that the common underlying premise of the four types of nondiscrimination protection "is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory."

Article 24(4) provides (with exceptions not relevant here) that in determining the taxable profits of an enterprise of a contracting state, interest, royalties, and other disbursements paid by that enterprise to a resident of the other contracting state will "be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State."

Even though section 267A disallows deductibility of some interest and royalty expense of a U.S. taxpayer only when paid or accrued to a foreign person, it does not raise treaty nondiscrimination concerns because, for tax-relevant reasons, the situations to which it applies cannot exist in a purely domestic setting. Deductibility on one side of a transaction and no inclusion on the other side, and deductibility on both sides of a transaction, result from inconsistent treatment of payments and accruals or inconsistent entity classifications by two tax systems.

Those inconsistencies cannot occur within the U.S. tax system. Thus, the difference in treatment between payments to foreign and domestic recipients is directly related to a tax-relevant difference in the payments, rendering the different treatment nondiscriminatory. This conclusion is consistent with the OECD's position that domestic implementation of the recommendations of action 2 of the base erosion and profit-shifting project regarding neutralization of effects of hybrid mismatch arrangements raises no nondiscrimination concerns.

[31] *See* preamble to the proposed FTC regulations; and New York State Bar Association, "Report No. 1394 on the GILTI Provisions of the Code," at 13-14, 69 (May 4, 2018).

[32] The only differences between subpart F income and GILTI in this context are that the rate of foreign tax that fully offsets U.S. tax on subpart F income is 21 percent, not 13.125 percent, and that the proposed FTC regulations generally reduce the amount of expense apportioned to the GILTI inclusion to reflect the effective partial exemption of that inclusion. *See* prop. reg. section 1.861-8(d) and the preamble to the proposed FTC regulations.

[33] Alexander Rust, *Klaus Vogel on Double Tax Conventions* 1635-1636 (4th ed. 2015); and Georg Kofler, "Article 23: Methods for Elimination of Double Taxation," IBFD Global Tax Treaties Commentaries (2019).

[34] *See, e.g.*, para. 66 of OECD commentary on articles 23A and 23B ("Some States are also considering or have already adopted the possibility of carrying over unused tax credits.").

C. FDII

IRC section 250 allows a U.S. corporation a deduction for up to 37.5 percent (21.875 percent for years beginning after 2025) of its FDII, which generally is the foreign sales or services portion of profits from domestic operations above a 10 percent return on domestic tangible assets. No code provision gives a foreign corporation an equivalent deduction against income effectively connected with the conduct of a U.S. trade or business.

As discussed below, section 250 is inconsistent with article 24(2) of the U.S. model treaty. An inconsistency between a treaty and a later-enacted statute requires an effort to reconcile the two supreme laws of the land.[35] The question whether the statute overrides the treaty becomes relevant only if the inconsistency rises to the level of an irreconcilable conflict.[36]

Article 24(2) provides that the taxation of a PE that an enterprise of one contracting state has in the other contracting state "shall not be less favorably levied in that other Contracting State than the taxation levied on enterprises of that other Contracting State carrying on the same activities." If the U.S. PE of a foreign corporation resident in a treaty partner jurisdiction earned income that would qualify for the FDII deduction, it could not claim the deduction because it is not a U.S. corporation. U.S. taxation would thus be less favorably levied on the U.S. PE than it would be on a domestic corporation carrying on the same activities.

It is clear, of course, that for article 24(2), the fact that a foreign corporation's U.S. PE is subject to U.S. tax only on income attributable to the PE while a domestic corporation engaged in the same activities is taxable on worldwide income is not a sufficient tax-relevant difference to warrant different treatment.[37]

Neither is the view that the FDII regime represents an integrated whole with the GILTI regime, intended to offset the incentive to shift assets abroad. The most this argument can come down to is drawing a distinction between U.S. corporations that are subject to the GILTI regime and foreign corporations that are not. That distinction, however, is irrelevant for three main reasons. First, if taxing U.S. corporations on a worldwide basis is not a sufficient tax-relevant difference to warrant different treatment, neither is subjecting U.S. corporations to the GILTI regime, which is a less burdensome subset of a worldwide regime with no deferral. Second, the FDII deduction is available for U.S. corporations regardless of whether they have GILTI or even CFCs. Third, the relevant distinction is between the U.S. taxation of a U.S. PE of a foreign corporation and the U.S. taxation of a U.S. corporation carrying on the same activities.

The inconsistency is not, however, a conflict between the statute and the treaties. The courts have required a "positive repugnancy" for there to be a conflict.[38] A repugnancy would have existed if, for example, the statute said a foreign corporation would not be allowed a FDII deduction — but it does not. Rather, it provides that a domestic corporation is allowed a FDII

[35] *Murray v. The Charming Betsy*, 2 Cranch 64, 118, 2 L.Ed. 208 (1804) ("an act of congress ought never to be construed to violate the law of nations, if any other possible construction remains"); *Whitney v. Robertson*, 124 U.S. 190, 194 (1888) ("By the constitution, a treaty is placed on the same footing, and made of like obligation, with an act of legislation. Both are declared by that instrument to be the supreme law of the land, and no superior efficacy is given to either over the other. When the two 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 United States v. Lee Yen Tai*, 185 U.S. 213, 221-223 (1902); *McCulloch v. Sociedad Nacional de Marineros de Honduras*, 372 U.S. 10, 20-21 (1963); *Weinberger v. Rossi*, 456 U.S. 25, 31 (1982); *Blanco v. United States*, 775 F.2d 53, 61 (2d Cir. 1985); and *Kappus v. C.I.R.*, 337 F.3d 1053 at 1056 (2003).

[36] *Id.*; *Moser v. U.S.*, 341 U.S. 41, 45 (1951) ("Not doubting that a treaty may be modified by a subsequent act of Congress, it is not necessary to invoke such authority here, for we find in this congressionally imposed limitation on citizenship nothing inconsistent with the purposes and subject matter of the Treaty."). And even when a conflict exists, without a clear expression of congressional intent to do so, a conflicting statute does not override an existing treaty simply because the statute is later in time. *Cook v. United States*, 288 U.S. 102, 119-120 (1933).

[37] Any other interpretation would render article 24(2) meaningless. The technical explanation states:

> 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 provide different treatment for the permanent establishment.

[38] *Lee Yen Tai*, 185 U.S. at 221-223 ("In the case of statutes alleged to be inconsistent with each other in whole or in part, the rule is well established that effect must be given to both, if by any reasonable interpretation that can be done; that 'there must be a positive repugnancy between the provisions of the new laws and those of the old; and even then the old law is repealed by implication only *pro tanto*, to the extent of the repugnancy;' and that 'if harmony is impossible, and only in that event, the former law is repealed, in part or wholly, as the case may be.' . . . The same rules have been applied where the claim was that an act of Congress had abrogated some of the provisions of a [treaty]."). *See also Blanco*, 775 F.2d at 61; and *In re Air Cargo Shipping Services Antitrust Litigation*, No. 06-MDL-1775 JG VVP (E.D.N.Y. 2010).

deduction and is silent on a foreign corporation's eligibility for a similar deduction. It is true that, treaties aside, the effect is the same because the statute allows a deduction only in accordance with its terms. Statutory silence, however, leaves the door open for a treaty-based deduction under article 24(2) for U.S. PEs of foreign corporations. This distinction skirts the question of treaty override.[39] Given the statutory silence, there is no statutory provision that could conflict with, or potentially override, the treaties.

Therefore, if present in a treaty, the PE nondiscrimination provision of article 24(2) should be read as providing a treaty-based FDII deduction for a U.S. PE of a foreign corporation resident in a treaty partner jurisdiction when the corporation, but for its foreign residence, would qualify for the statutory FDII deduction. This result reconciles the inconsistency between statute and treaty by giving full effect to both without violating the language of either.[40]

IV. When the Exemption Does Not Apply

A. In General

As noted, the U.S. obligation to allow an indirect FTC for foreign taxes paid by first-tier subsidiaries resident in treaty partner jurisdictions is in article 23(2). That and the direct FTC treaty obligation are satisfied with respect to the foreign-source portion of a dividend to which the participation exemption applies because, as discussed above, the participation exemption meets the requirements of article 23(2). Moreover, the code allows a direct FTC for at least some dividends to which the participation exemption does not apply — and that satisfies the direct FTC treaty obligation regarding those dividends.

There are, however, dividends and inclusions to which the participation exemption does not apply that fall within direct or indirect FTC treaty obligations and require further consideration. That happens when the dividend includes a U.S.-source portion, when the U.S. corporation does not meet the participation exemption's one-year holding period requirement, and when the dividend is a hybrid dividend or the inclusion is a tiered hybrid dividend inclusion. The next section examines each of those situations and their interaction with the direct and indirect FTC treaty obligations.

B. Limits of the Participation Exemption

1. The U.S.-Source Portion of a Dividend

Before the TCJA, U.S. corporations were deemed to have paid the foreign taxes that an at-least-10-percent-owned foreign subsidiary paid or accrued on earnings underlying dividends the U.S. corporation received from the foreign subsidiary. The effect was that a U.S. corporation was statutorily allowed an indirect FTC in addition to the direct FTC allowed to all U.S. taxpayers. Under section 245(a)(8), both direct and indirect statutory FTCs were allowed only for foreign taxes paid with respect to the non-U.S.-source portion of the dividend. The U.S.-source portion of a dividend depended on the ratio of the foreign subsidiary's undistributed U.S. earnings to its total undistributed earnings. Undistributed U.S. earnings referred to the undistributed earnings attributable to:

- income effectively connected with a U.S. trade or business and not protected by treaty from U.S. tax; or
- dividends the foreign subsidiary received (directly or indirectly through wholly owned foreign corporations) from domestic corporations that were at least 80 percent directly or indirectly owned (by vote and value) by the foreign subsidiary.

Depending on the ownership level, the U.S.-source portion of a dividend received by a domestic corporation from an at-least-10-percent-owned foreign subsidiary was entitled to a 70 or

[39] *See supra* notes 35, 36, and 38.

[40] Rev. Rul. 83-144, 1983-2 C.B. 295, discusses whether income of the U.S. office of a Philippine pension trust (which, but for its foreign situs, would have qualified under section 401(a) as U.S.-tax-exempt under section 501(a)) was exempt from U.S. taxation under the PE nondiscrimination provision in article 24(2) of the Philippines-U.S. treaty. It concludes that the pension was not entitled to the exemption because its U.S. office did not constitute a U.S. PE, so article 24(2) did not apply. Although the ruling says that was not necessarily the only reason article 24(2) did not apply, it certainly suggests that if the PE nondiscrimination provision applied, the pension fund would have been entitled to the exemption. It is immaterial that the treaty postdated the statutory provisions (sections 401(a) and 501(a)) because the later-in-time concept is pertinent to the question of treaty override, which in turn is pertinent only when there is a conflict between statute and treaty. That was not the case in the revenue ruling.

80 percent DRD under section 245(a).[41] A 100 percent DRD was not available because a foreign corporation cannot be a member of an affiliated group under section 243(b)(1)(A). However, a 100 percent DRD was available under section 245(b) in lieu of the section 245(a) DRD, but only for a domestic corporation that wholly owned the dividend-paying foreign subsidiary whose gross income from all sources was effectively connected with the conduct of a U.S. trade or business.[42]

That continues to be the law after the TCJA, with three exceptions. First, subject to a one-year holding period requirement and an exception for hybrid dividends, section 245A now provides for a 100 percent DRD for the non-U.S.-source portion — now referred to as the foreign-source portion — of a dividend received by a U.S. corporation from an at-least-10-percent-owned foreign subsidiary. Second, with the TCJA's repeal of section 902, the code no longer provides any indirect FTC for dividends a domestic corporation receives from a foreign subsidiary. Third, the 70 and 80 percent DRDs under section 245(a), like those under section 243, are now 50 and 65 percent DRDs, respectively. The conceptual difference between the section 245 DRD and the section 245A DRD is that the former, like the section 243 DRD, is designed to prevent the United States from fully taxing the same corporate income twice, while the latter, like the FTC, is designed to prevent two countries from taxing the same corporate income.[43]

The disallowance of the section 901 FTC for the U.S.-source portion of a dividend received by a domestic corporation from an at-least-10-percent-owned foreign subsidiary does not violate U.S. FTC treaty obligations even though the section 245(a) DRD is not for 100 percent of the dividend. In addition to the FTC disallowance, section 245 treats the income in question as maintaining a U.S. source, but provides that if the income is treated as foreign source under a treaty, the taxpayer may elect to benefit from an FTC in a separate basket instead of the section 245 partial DRD. Article 23(3) allows the U.S.-source portion of the dividend to be resourced as foreign. Therefore, when a treaty applies, the code allows an FTC with respect to the U.S.-source portion of a dividend from an at-least-10-percent-owned foreign subsidiary, and it is the U.S. corporate taxpayer's choice whether to elect the section 245 DRD instead. This satisfied the direct and indirect FTC treaty obligations regarding the U.S.-source portion of a dividend before the TCJA, and it satisfies the direct FTC treaty obligation now. The repeal of section 902, however, means that the indirect FTC treaty obligation is no longer satisfied. The lack of a statutory provision providing an indirect FTC is inconsistent with the principle of allowing (an indirect) credit and therefore is not a post-treaty domestic law limitation to which the treaty obligation under article 23(2) is subject.

2. The One-Year Holding Period Requirement

Under section 246, the participation exemption is available only if the U.S. corporation receiving the dividend holds the at-least-10-percent-owned foreign subsidiary's stock on which the dividend is paid for more than one continuous year during the two years that began a year before the stock became ex-dividend. Section 245A(d)(1) provides that "no credit shall be allowed under section 901 for any taxes paid or accrued (or treated as paid or accrued) with respect to any dividend for which a deduction is allowed under this section." In other words, the denial of a section 901 FTC under section 245A(d) is limited to dividends benefiting from the participation exemption.[44] When the holding

[41] That deduction was also available to a foreign corporation (receiving the dividend) that met the requirements, but the dividend had to be ECI for any deduction to be allowed. Sections 881 and 882.

[42] Because the section 245(b) DRD is in lieu of the section 245(a) DRD, the former applies only when the latter would have otherwise applied. Therefore, all the limitations of section 245(a) apply to section 245(b). For example, if the wholly owned payer foreign subsidiary's income (all ECI) is exempt from U.S. taxation under a treaty (say, because there is no PE), the 100 percent DRD under section 245(b) would be unavailable because the U.S.-source portion of the dividend would be zero, and therefore the section 245(a) DRD would also not have applied.

[43] John P. Steines, *International Aspects of U.S. Income Taxation*, Part I.2 (forthcoming 2019).

[44] Section 245A(d)(2) also denies a foreign tax deduction for dividends benefiting from the participation exemption.

period requirement is not met, there is no participation exemption and no FTC denial. The code allows a direct FTC for the foreign-source portion of that dividend, but in the absence of a section 902 deemed-paid credit, the indirect FTC treaty obligation finds no complementary rule in the statute. The lack of a statutory provision is inconsistent with the principle of article 23(2) and therefore is not a post-treaty domestic law limitation to which the obligation under article 23(2) is subject.

Allowance of an FTC with respect to dividends not benefiting from the participation exemption should not be affected by section 904(b)(4). Literally read, the section purports to disregard the foreign-source portion of any dividend (and associated deductions) in determining the FTC limitation, which could result in a zero limitation and an effective denial of credit. That reading, however, would be contrary to the provision's intended purpose of applying only to dividends benefiting from the participation exemption.[45] Although of no legal value, the heading of section 904(b)(4) ("Treatment of dividends for which deduction is allowed under section 245A") suggests the same. In any event, the proposed FTC regulations and their preamble clarify that section 904(b)(4) applies only to dividends benefiting from the participation exemption.[46]

3. Hybrid Dividends

Generally, a hybrid dividend is a dividend received from a CFC for which the CFC is allowed a deduction (or another tax benefit) under foreign law.[47] The participation exemption does not apply to a hybrid dividend received by an at-least-10-percent corporate U.S. shareholder (a direct hybrid dividend). Also, if a hybrid dividend is paid between CFCs that share the same 10 percent corporate U.S. shareholder (a tiered hybrid dividend), the dividend is treated as subpart F income in the hands of the receiving CFC, resulting in inclusion of a pro rata share of that income by the U.S. shareholder under subpart F.[48]

Section 245A(e)(3) provides that the rules of section 245A(d) (denying statutory credits and deductions for foreign taxes associated with dividends benefiting from the participation exemption) apply to any direct hybrid dividend, or to any amount a U.S. shareholder includes in income because of a tiered hybrid dividend.

The language of section 245A(e)(3) is problematic. It has been suggested, by the Joint Committee on Taxation,[49] Treasury,[50] and others that section 245A(e)(3) sweepingly denies a credit or deduction for foreign taxes attributable to any hybrid dividend or any inclusion resulting from a tiered hybrid dividend. As written, however, section 245A(e)(3) merely cross-references the rules of subsection (d), which state that foreign tax credits and deductions are denied for amounts that benefit from the participation exemption. Applying those rules to a hybrid dividend or a tiered hybrid dividend inclusion would mean that there is a denial of statutory foreign tax credits or deductions only if the dividend or inclusion benefits from the participation exemption — yet a

[45] One way to read section 904(b)(4) as applying only to dividends benefiting from the participation exemption would be to view its flush language as giving the term "any dividend" the same meaning as that in section 245A, and to view the use of the term in section 245A(a) to mean any dividend to which section 245A(a) applies.

[46] Prop. reg. section 1.904(b)-3(a)(1)(ii); preamble, at 63207.

[47] Section 245A(e)(4). *But see infra* note 48.

[48] That seems to be the intention of section 245A(e)(2), even though a literal reading of section 245A(e)(2) and (4) renders the former a nullity. The definition of a hybrid dividend includes the notion that the amount received from a CFC would, but for section 245A(e), qualify for the deduction under section 245A(a). No payment between CFCs, however, can qualify for that deduction regardless of section 245A(e). Therefore, no payment between CFCs can be a hybrid dividend under section 245A(e)(4). The proposed hybrids regulations would solve that problem by effectively broadening the language of section 245A(e)(4)(A) to include a payment between CFCs that would benefit from the participation exemption had the receiving CFC been a domestic corporation. Prop. reg. section 1.245A(e)-1(c)(2). We assume that if finalized, that regulation would be valid.

[49] JCT, "General Explanation of Public Law 115-97," JCS-1-18, at 350 (Dec. 20, 2018). Although relevant in interpreting a law, the bluebook does not constitute official legislative history. *See, e.g.*, *United States v. Woods*, 134 S. Ct. 557 (2013).

[50] The language of the proposed hybrids regulations and the preamble is curious. The proposed regulations do not say there is a denial of credit; instead, they reiterate section 245A(e)(3), saying that "the rules of section 245A(d) (denial of foreign tax credit and deduction) apply." They take a different approach when referring to the denial of the DRD, saying outright that the deduction is not allowed — for example, "The U.S. shareholder is not allowed the section 245A(a) deduction for the hybrid dividend, and the rules of section 245A(d) (denial of foreign tax credits and deductions) apply."

The preamble seems to take a mixed approach on that point. Generally, it follows the language of the proposed regulations, but in one place states: "Thus, in such a case, a U.S. shareholder that includes an amount in its gross income under the tiered hybrid dividend rule is not allowed the section 245A(a) deduction, or foreign tax credits or deductions, for the amount. See proposed section 1.245A(e)-1(c)(1) and (4)."

hybrid dividend or a tiered hybrid dividend inclusion cannot benefit from the exemption.[51]

It would not make sense to interpret section 245A(e)(3) as calling for a denial of FTCs for any hybrid dividend or tiered hybrid dividend inclusion. There are four FTC interactions with hybrid dividends, two with direct hybrid dividends and two with tiered hybrid dividend inclusions. Whereas direct hybrid dividends may be subject to foreign withholding taxes, the earnings underlying them are not subject to foreign tax at the CFC level (given the deduction or other tax benefit the CFC receives under foreign law). Thus, there is no indirect FTC question regarding direct hybrid dividends. On the other hand, once a participation exemption is denied for direct hybrid dividends, there is no sound rationale for denying direct FTCs. After all, there is no denial of FTCs for interest, royalties, and other deductible payments. Therefore, denying direct hybrid dividends a direct FTC would amount to a tax penalty, which does not appear to be the intended purpose of section 245A(e). It is also not the intended purpose of BEPS action 2 (the inspiration for section 245A(e)), which is to neutralize, not penalize, the effects of hybrid mismatch arrangements.

Tiered hybrid dividend inclusions are not subject to foreign withholding taxes potentially qualifying for direct FTCs. Therefore, there are no direct FTCs to allow or deny. In so far as indirect FTCs are concerned, though there is no foreign tax on a paying CFC's earnings underlying a tiered hybrid dividend, the receiving CFC might be subject to foreign income taxes. Although it makes sense not to extend the participation exemption to tiered hybrid dividend inclusions for the same reasons it was not extended to subpart F inclusions, there is no sound rationale for denying the indirect credit under sections 901 and 960. Again, the point was not to penalize these arrangements, but to neutralize their effects.

If, as suggested here, section 245A(e)(3) is to be read as disallowing statutory FTCs for hybrid dividends only when they benefit from the participation exemption (which is to say, never), then both the direct and indirect FTC treaty obligations would be satisfied. A direct FTC under section 901 would be allowed for foreign withholding taxes on direct hybrid dividends, and an indirect credit under sections 901 and 960 would be allowed with respect to tiered hybrid dividend inclusions for foreign taxes incurred on the underlying earnings of the receiving CFC.

If, however, section 245A(e)(3) is interpreted — contrary to its language and intended purpose — as calling for a denial of statutory FTCs with respect to any hybrid dividend or tiered hybrid dividend inclusion, then neither the direct FTC treaty obligation regarding direct hybrid dividends nor any indirect FTC treaty obligation regarding tiered hybrid dividend inclusions would be statutorily satisfied.[52]

Because there are no foreign taxes to indirectly credit for direct hybrid dividends or to directly credit for tiered hybrid dividend inclusions, the treaty FTC obligations (indirect and direct, respectively) with respect to those dividends and inclusions are meaningless and satisfied under any interpretation of section 245A(e)(3).

C. Treaty Direct and Indirect FTCs

As noted, the repeal of section 902 leaves the indirect FTC treaty obligation without a complementary rule in the statute — and therefore unsatisfied — for the U.S.-source portion of a dividend, as well as the foreign-source portion of a dividend that does not meet the one-year holding period requirement. If section 245A(e)(3) is interpreted as denying statutory FTCs for any direct hybrid dividend or tiered hybrid dividend inclusion, the direct and indirect FTC treaty obligations regarding those items respectively would also be unsatisfied. As explained below, however, these inconsistencies between statute and treaties are reconcilable and not conflicts. This distinction skirts the question of

[51] That plain reading of section 245A(e)(3) in conjunction with section 245A(d) would render the former both redundant and meaningless. But the interpretive rule against surplusage is not absolute, and the interpretive rule against a nullity is "as close to absolute as interpretive principles get," and both seem to yield to unequivocal language. *See King v. Burwell*, 135 S. Ct. 2480 (2015); *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1883); and *Marbury v. Madison*, 1 Cranch 137, 174 (1803).

[52] Such disallowance of statutory FTCs would not be a post-treaty domestic law limitation to which the treaty obligation under article 23(2) is subject because this FTC disallowance would be inconsistent with the general principle of article 23(2).

treaty override, which becomes relevant only if an inconsistency proves to be an irreconcilable conflict.[53]

1. Hybrid Dividends

If section 245A(e)(3) is interpreted as denying FTCs for any direct hybrid dividend or tiered hybrid dividend inclusion, that would refer to the denial of the section 901 credit. Section 245A(e)(3) applies the rules of section 245A(d) to direct hybrid dividends and tiered hybrid dividend inclusions, and section 245A(d) addresses the disallowance of a section 901 credit. Neither section 245A(d) nor section 245A(e)(3) contemplates a general denial of FTCs, but instead only a denial of section 901 FTCs. A denial of a section 901 credit would extend to the statutory indirect credit for tiered hybrid dividend inclusions. Those are treated as subpart F inclusions, triggering the applicability of section 960, which deems a corporate U.S. shareholder of a CFC to have paid foreign income taxes incurred by the CFC that are properly attributable to the inclusion. Section 901 would be needed for crediting those taxes.

In the absence of another statutory FTC provision, denying a section 901 credit for direct hybrid dividends and tiered hybrid dividend inclusions would be inconsistent with the U.S. direct and indirect FTC treaty obligations. Again, that disallowance of statutory FTCs would not be a post-treaty domestic law limitation to which the treaty credit obligation is subject because that disallowance of FTCs would be inconsistent with the general principle of article 23(2). The inconsistency would not be a conflict between the statute and the treaties unless a positive repugnancy existed,[54] which would occur if the statute denied FTCs in general, not just section 901 FTCs — and it does not. Thus, there is no statutory provision that could conflict with, or potentially override, the FTC treaty obligation.

Therefore, when applicable, the direct and indirect FTC treaty provisions should be read as providing a treaty-based direct FTC for direct hybrid dividends and a treaty-based indirect FTC for tiered hybrid dividend inclusions. This result reconciles the inconsistency between the statute and the treaty by giving full effect to both without violating the language of either.[55] The code has long envisioned the possibility of a treaty FTC in the absence of a section 901 FTC.[56]

It could be argued that the limitations on statutory FTCs do not apply to FTCs that are available under a treaty when section 901 does not apply. Although the argument has some appeal, it does not hold for FTC limitations that are compatible with the FTC treaty obligation. Recall that under article 23(2), the U.S. FTC treaty obligation must be "in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)." Consider, for example, the disallowance under section 901(k) of a section 901 FTC if a 15-day holding period requirement is not met. Under the language of article 23(2), FTC treaty obligations that postdate section 901(k) are subject to that section. FTC treaty obligations that predate section 901(k) are also subject to it, because section 901(k) is understood to be consistent with — and therefore does not change — the general principle of article 23(2).[57] The language of article 23(2) is broad enough to reference treaty-compatible domestic law limitations on the section 901 credit even when the statutory credit is unavailable by reason of another statutory provision that is itself incompatible with article 23(2). After all, no one would seriously argue that the basket limitations of section 904 on the section 901 credit do not apply to a treaty-based credit. The underlying reason is that a treaty-based credit could be applied in its strictest form, which would include all treaty-compatible limitations — that is, all FTC limitations that would not change the general principle of allowance of a credit.

[53] *See supra* notes 35, 36, and 38 and accompanying texts.

[54] *See supra* note 38.

[55] *See supra* note 35.

[56] *See, e.g.*, section 6511(d)(3), providing a special limitations period when an overpayment is attributable to foreign taxes "for which credit is allowed against the tax imposed by subtitle A in accordance with the provisions of section 901 or the provisions of any treaty to which the United States is a party."

[57] *See* CCA 2006122013; and *Lehman Brothers Holdings Inc. v. United States*, 115 A.F.T.R.2d 2015-1802 (S.D.N.Y. 2015) (because the 1975 treaty at issue predated the 1997 enactment of section 901(k), the court's decision that the U.S. FTC treaty obligation was subject to the limitation of section 901(k) implies that the court maintained that section 901(k) does not change the general principle of article 23(2)).

2. Other Taxable Dividends

U.S.-source portions of dividends for which an FTC election is made and foreign-source portions of dividends that do not benefit from the participation exemption because they do not meet the one-year holding period requirement pose a different question. As noted, the section 901 FTC is available for those dividends, but the repeal of section 902 has left the indirect FTC treaty obligation without a complementary statutory provision. The non-allowance of a statutory indirect FTC is incompatible with article 23(2) because it is inconsistent with the principle of allowance of an indirect credit, and therefore is not a post-treaty domestic law limitation to which the treaty obligation under article 23(2) is subject.

The consistency of the 15-day holding period requirement with the general principle of article 23(2) should not be relevant here. That requirement is consistent with, and therefore does not change, the general principle of article 23(2) because the requirement:

> was adopted to prevent taxpayers from claiming credits in two types of situations in which a credit might otherwise be claimed with respect to investments that are unlikely to produce any taxable income — i.e., where they held the investment for very short periods or while obligated to make offsetting payments.[58]

Those concerns are not compelling for a substantially longer holding period requirement of one year. Holding periods between 15 days and one year have been acceptable since the enactment of section 901(k) in 1997. Further, section 901(k) is aimed directly at the FTC, and the one-year holding period requirement for the participation exemption is not.

The incompatibility of the absence of a statutory indirect FTC with article 23(2) is a reconcilable inconsistency and not a conflict because there is no positive repugnancy between the statutory and treaty provisions.[59] A repugnancy would have existed had the statute expressly denied indirect FTCs in general — but again, it does not. As before, there is thus no statutory provision that could conflict with, or potentially override, the indirect FTC treaty obligation. The repeal of section 902 does not reflect or imply a congressional intent to deny treaty indirect FTCs because the allowance of a treaty indirect FTC does not render the repeal of section 902 meaningless. The repeal of section 902 effectively denies indirect FTCs whenever the indirect FTC treaty obligation does not apply — that is, when the U.S. corporation receiving the dividend does not own 10 percent of the voting stock of the distributing subsidiary or when a dividend is from a subsidiary resident in a jurisdiction that has not concluded a treaty with the United States.

Thus, when applicable, the indirect FTC treaty provisions should be read as providing for a treaty-based indirect FTC for the U.S.-source portion of dividends for which an FTC election under section 245(a)(10) is made and for the foreign-source portion of dividends that do not qualify for the participation exemption by reason of their failure to meet the one-year holding period requirement. Here, too, this result reconciles the inconsistency between statute and treaty by giving full effect to both without violating the language of either.[60]

V. Conclusion

The theme explored in this article is simple: The need to reconcile or harmonize self-executing treaties (such as tax treaties) and acts of Congress (such as the IRC), given that those two sources of law are equal in their constitutional status as the supreme law of the land. A facile later-in-time analysis to resolve "conflicts" runs counter to U.S. Supreme Court precedent. Moreover, it fails to address the hard questions of what exactly a conflict is and when it calls for a resolution. ■

[58] CCA 2006122013, *supra* note 57.

[59] *See supra* note 38.

[60] As noted, the code has long envisioned the possibility of a treaty FTC independent of a section 901 FTC. *See supra* note 56.