INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 901.01-04; 903.40-00
CASE MIS No.: TAM-164903-02

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =
Business Q =

Country K =
X Tax =
G Tax =
L Tax =
Taxpayer
Subsidiary =
Years 1-6 =
Taxable Years 8-10=
P% =
T% =
Z% =
Y% =
U% =
Safeharbor
Fraction =
Product =

ISSUE(S):

(1) Whether Country K's modified income tax and the X Tax applicable to Taxpayer Subsidiary in Years 1 through 6 are separate levies under Treas. Reg. §1.901-2A(a)(1);

(2) Whether the X Tax satisfies the net income requirement of Treas. Reg. §1.901-2(b) and qualifies as a creditable tax under section 901;

(3) Whether the X Tax is imposed "in substitution for" the modified Country K income tax and satisfies the substitution requirement of section 903; and

(4) What is the correct application of the safe harbor formula in this case.

CONCLUSIONS:

(1) The X Tax is imposed on a separate gross receipts tax base and is a separate levy from the modified Country K income tax;

(2) The X Tax is not a creditable tax under section 901 because it fails the net income requirement of Treas. Reg. §1.901-2(b);

(3) The X Tax is not a creditable tax under section 903 because it is "in addition to" rather than "in substitution for" the Country K income tax; and

(4) The qualifying amount derived under the safe harbor calculation is limited, pursuant to the flush language in Treas. Reg. §1.901-2A(e)(1), to the actual amount of the qualifying levy paid.

FACTS

Taxpayer is a U.S. corporation. In Year 1, Taxpayer acquired a P% voting interest in Taxpayer Subsidiary, a corporation in Country K. For Taxable Years 8 through 10, Taxpayer claimed foreign tax credits under section 902 for Country K taxes paid by Taxpayer Subsidiary, including amounts paid with respect to the X Tax during Years 1 through 6. Taxpayer made a safe harbor election with respect to those amounts under Treas. Reg. §1.901-2A(d)(1). During the years in issue, Taxpayer Subsidiary was a monopoly with an exclusive concession to provide Business Q to Country K.

The X Tax

As the sole concessionaire of the right to provide Business Q to Country K, Taxpayer

Subsidiary was subject to and paid a special X Tax. The X Tax was a temporary tax enacted in Year 1 and imposed only in Years 1 through 6.

Taxpayer Subsidiary was the only taxpayer subject to the X Tax. The X Tax was imposed at a rate of T% of gross revenue from the provision of Business Q. The X Tax also included a reinvestment credit provision, which allowed a credit against the X Tax of up to Z% of the X Tax as long as Taxpayer Subsidiary invested at least Y% (Z% of T%) of its gross revenues in fixed assets relating to the provision of Business Q. If Taxpayer Subsidiary made the requisite investment, its X Tax liability was decreased to a rate of U%. In addition, the full T% X Tax was deductible in arriving at the base for determining Taxpayer Subsidiary's Country K income tax liability even if, pursuant to the reinvestment credit provision, Taxpayer Subsidiary paid an actual X Tax liability of only U%.

The X Tax legislation also allowed Taxpayer Subsidiary to credit its X Tax liability (net of the X Tax reinvestment credit) against its G Tax liability. It also appears that distributions of income from Taxpayer Subsidiary to its shareholders relating to amounts paid or credited under the X Tax were not subject to the L Tax of Country K.

It appears that the Country K legislature designed the X Tax so that, when combined with the income tax, taxpayers subject to the X Tax would pay the same marginal tax rate as other businesses operating in Country K.

In every year that the X Tax was imposed, Taxpayer Subsidiary satisfied the reinvestment credit provision, took the Z% credit against its gross X Tax amount and deducted the full X Tax in arriving at its base for purposes of computing the Country K income tax. In Years 1 through 6, Taxpayer Subsidiary paid total taxes at the same effective rates applicable to other Country K corporate taxpayers during those years.

The Country K Income Tax

As a Country K corporation, Taxpayer Subsidiary was also subject to the general Country K income tax law, which was imposed on taxable profits. For purposes of the income tax, taxable profits are computed as gross income less authorized costs and business expenses less losses carried forward, although income taxes, asset taxes, and withholding taxes are not deductible. The X Tax legislation included a special provision rendering it deductible for purposes of determining the Country K income tax base.

LAW AND ANALYSIS

Whether a foreign levy is an income tax is determined independently for each separate levy. Treas. Reg. §1.901-2(a)(1). Where the base of the levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy is

considered, for purposes of sections 901 and 903, to impose separate levies for such classes of persons. Treas. Reg. §1.901-2(d)(1). A foreign levy that is the sum of two or more separately computed amounts, where each such amount is computed by reference to a separate base, is considered, for purposes of sections 901 and 903, to impose separate levies. Treas. Reg. §1.901-2(d)(1) and (3), *Example (3).*

Special levy rules apply in the case of a dual capacity taxpayer. A “dual capacity taxpayer” is a person who is subject to a levy of a foreign state and who also receives a specific economic benefit from the foreign state. Treas. Reg. §1.901-2(a)(2)(ii)(A). A specific economic benefit is an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country. Thus, a concession to extract government owned petroleum is a specific economic benefit. Treas. Reg. §1.901-2(a)(2)(ii)(B).

In pertinent part, Treas. Reg. §1.901-2A(a)(1) of the regulations provides that if the application of the foreign levy is different, either by its terms or in practice, for a dual capacity taxpayer from its application to other persons, then, unless the only such difference is that a lower rate (but the same base) applies to dual capacity taxpayers, such difference is a difference in kind and not merely in degree. In such a case, notwithstanding any contrary provision of Treas. Reg. §1.901-2(d), the levy as applicable to the dual capacity taxpayer is a separate levy and must be analyzed separately from the levy as applicable to other persons to determine whether it is an income tax within the meaning of Treas. Reg. §1.901-2(a)(1) or an in lieu of tax within the meaning of Treas. Reg. §1.903-1(a). Laws applicable to a dual capacity taxpayer constitute a separate levy under this provision if they differ in *any respect* (other than the imposition of a lower rate) from the rules that apply to a non-dual capacity taxpayer.

The Treas. Reg. §1.901-2A rules bifurcating a payment into tax and non-tax components apply only to a “qualifying levy,” that is, a levy that, but for the particular feature that makes it different for dual capacity taxpayers, otherwise qualifies as an income tax under section 901 or an “in lieu of” tax under section 903. Treas. Reg. §§1.901-2A(b)(1) and 1.901-2A(c)(1).

In Years 1 through 6, Taxpayer Subsidiary was potentially subject to a Country K Tax liability comprising (at least) four taxes: the income tax, the X Tax, the G Tax, and the L Tax. Each of these taxes is computed by reference to a different tax base and is considered a separate levy under the principles of Treas. Reg. §1.901-2(d)(1). Application of the general Country K income tax to Taxpayer Subsidiary was similar to other Country K corporations with the exception of the X Tax deduction. The X Tax legislation provided a special deduction for the X Tax in computing taxable income subject to the general income tax. This deduction was exclusive to Taxpayer Subsidiary. As a monopoly with an exclusive concession to provide Business Q to Country K, Taxpayer Subsidiary qualifies as a dual capacity taxpayer as defined in

Treas. Reg. §1.901-2(a)(2)(ii)(A); accordingly, the special levy rules of Treas. Reg. §1.901-2A apply, and the Country K income tax as applied to Taxpayer Subsidiary with the special deduction for the X Tax is a difference in kind and not merely in degree. As such, the Country K income tax as applied to Taxpayer Subsidiary is a separate levy from the Country K income tax as applied to all other Country K corporations. It appears that the modified income tax satisfies the realization, gross receipts, and net income requirements of Treas. Reg. §1.901-2(b) and qualifies as a creditable tax under section 901. The X Tax is computed on a different tax base (gross receipts). Therefore, it is a separate levy from the modified Country K income tax.

Whether the X Tax is a Creditable Income Tax Under Section 901

Section 901(b) allows certain taxpayers a credit against their U.S. income tax liability for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country, subject to certain limitations such as those of section 904.

Treas. Reg. §1.901-2(a)(1) provides that a foreign levy is an income tax only if it is a tax and the predominant character of the tax is that of an income tax in the U.S. sense. Treas. Reg. §1.901-2(a)(3) provides that the predominant character of a foreign tax is that of an income tax in the U.S. sense if, among other things, the foreign tax is likely to reach net gain in the normal circumstances in which it applies. A tax is likely to reach net gain if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements as provided in the regulations. It appears that the X Tax satisfies two prongs of the net gain requirement of Treas. Reg. §1.901-2(b)(1), *i.e.*, the realization requirement and the gross receipts requirement, since it is imposed on gross receipts that Taxpayer Subsidiary has realized.

The net income requirement is satisfied if the base of the foreign tax is computed by reducing gross receipts to permit (A) recovery of the significant costs and expenses attributable, under reasonable principles, to such gross receipts; or (B) recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses. Treas. Reg. §1.901-2(b)(4).

For the years at issue, the X Tax was imposed on Business Q providers in Country K. The base of the X Tax was equal to all gross revenues derived from the provision of Business Q. A taxpayer subject to the X Tax was allowed a reinvestment credit against its X Tax liability. The reinvestment credit could be as high as Z percent of Taxpayer Subsidiary's X Tax liability as long as it reinvested at least that amount in Business Q assets for the benefit of Country K. Taxpayers subject to the X Tax were permitted to credit their X Tax liability (after reduction by the X Tax reinvestment credit) against their G Tax liability. They were also permitted to deduct their full X Tax liability (without

regard to any reduction attributable to the X Tax reinvestment credit) in computing their base for purposes of determining their Country K income tax liability.

Because the X Tax was imposed on a base consisting of gross revenues and did not permit recovery of significant costs and expenses, it fails to meet the net income requirement of Treas. Reg. §1.901-2(b). Taxpayer has asserted that the reinvestment credit reduced its net X Tax liability by an amount at least equal to the recovery of significant expenses, and therefore the net income requirement is satisfied.[1] We disagree. The net income requirement of the regulations looks only to whether the base of the levy is computed by reducing gross receipts by either actual recovery of significant costs and expenses or by an amount that approximates, or is greater than, such costs and expenses. In the case of the X Tax, the credit does not affect the base on which the X Tax is computed, which remains the taxpayer's gross receipts from Business Q. The base is in no way changed by the fact that Taxpayer Subsidiary may choose to reinvest a portion of its revenues in Country K Business Q assets and thereby reap a benefit in the form of a credit against its liability for the X Tax. Accordingly, the X Tax fails the net income requirement of Treas. Reg. §1.901-2(b)(4), and is not a creditable tax under section 901.

Whether the X Tax is Creditable as an "In Lieu" of Tax Under Section 903

Section 903 provides that the term "income, war profits and excess profits tax" shall include a tax paid "in lieu" of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country. Treasury Reg. §1.903-1(a) provides that a foreign levy is a tax in lieu of an income tax only if: (1) it is a tax within the meaning of Treas. Reg. §1.901-2(a)(2); and (2) it meets the substitution requirements of Treas. Reg. §1.903-1(b). Treasury Reg. §1.903-1(b) provides that the substitution requirement is satisfied if the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed.

If there is a generally imposed income tax, a tax may qualify under section 903 of the Code so long as amounts included in the tax base are not also taxed under the generally imposed income tax. If the same income is also taxed under the generally imposed income tax, then the tax is in addition to, not in substitution for, the generally imposed income tax.

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[1] Taxpayer cites *Texasgulf, Inc. v. Commissioner*, 107 T.C. 51 (1996), *aff'd.* 172 F.3d 209 (2d Cir. 1999), and *Exxon v. Commissioner*, 113 T.C. 338 (1999) in support of its assertion that the reinvestment credit effectively compensated Taxpayer Subsidiary for its significant costs and expenses. These cases offer no support for Taxpayer's position because the manner in which the X Tax operated was dramatically different from the way in which the levies in *Texasgulf* and *Exxon* operated; in short, the X Tax permitted a credit that did not in any way affect the computation of the base of the X Tax, as opposed to deductions and/or allowances that reduced the tax bases considered in the two court cases.

Taxpayer argues that the X Tax is creditable under section 903 as a tax imposed in substitution for the Country K generally imposed income tax, which is creditable under section 901 and which does not apply to Taxpayer Subsidiary. Taxpayer asserts that the modified income tax to which Taxpayer Subsidiary is subject is creditable under section 903, without addressing its creditability under section 901. Taxpayer asserts that Treas. Reg. §1.901-2A provides that a separate levy applicable to a dual capacity taxpayer may be creditable under section 903 as long as the foreign country also has in force a general income tax for which the levy is substituted. *See e.g.,* Treas. Reg. §1.901-2A(e)(8).

We disagree. The regulations contemplate that a levy be tested for creditability first under section 901 and, secondly, if applicable, under section 903. If a levy passes muster under section 901, that is the end of the analysis. Section 903 does not apply to a tax which is creditable under section 901. To permit a choice of creditability for the modified income tax under either section 901 or 903 would vitiate the "in substitution for" requirement of section 903 as it relates to determining the creditability of other taxes such as the X Tax. Specifically, if Taxpayer could choose to credit the modified Country K income tax under section 903 despite the fact that it qualifies as a section 901 tax, Taxpayer would effectively eliminate a levy from the comparison requirement essential to analyzing the X Tax under section 903, a result that is fundamentally in conflict with the intent of section 903 and the regulations thereunder. Therefore, because the Country K modified income tax is creditable under section 901, the "in substitution for" requirement must be applied to the X Tax in comparison with the modified income tax as well as with the generally imposed corporate income tax.

Taxpayer also asserts that the X Tax and the modified Country K income tax qualify, in the aggregate, as a section 903 "in lieu of " tax imposed in substitution for the Country K income tax generally applicable to other corporate taxpayers. It is clear that more than one tax may satisfy the substitution requirement in certain circumstances. In Treas. Reg. §1.903-1(b)(3), *Example 4,* the foreign jurisdiction had a generally imposed net income tax. The tax was applicable to nonresident corporations carrying on a trade or business within that jurisdiction except for corporations engaging in contracting activities each of which was instead subject to two different taxes. The example states that the two taxes applicable to contracting activities satisfy the substitution requirement of Treas. Reg. §1.903-1(b); *See also*, Rev. Rul. 73-588, 1973-2 C.B. 268; and Treas. Reg. §1.901-2A(e)(8), *Example 8* (all the criteria of section 903 are satisfied with respect to the modified income tax and with respect to the surtax as applied to A). However, the X Tax and the modified Country K income tax will not qualify in the aggregate as an in lieu of tax unless each of the X Tax and the modified income tax is imposed in substitution for, and not in addition to, an income tax. As noted above, the X Tax cannot qualify under section 903 because the modified income tax is a creditable income tax under section 901. A tax that is not an income tax cannot be creditable under section 903 if it is imposed in addition to a creditable income tax. To permit aggregation of a creditable income tax with an otherwise noncreditable tax would violate the separate levy principle of Treas. Reg. §1.901-2(d) which mandates that taxes with

dissimilar bases be separated and independently tested for creditability.

Taxpayer further asserts that the X Tax is creditable as an in lieu of tax because, under Country K law, the X Tax is considered to operate as a tax in lieu of the generally applicable income tax as evidenced by the fact that distributions of income based on the X Tax are not subject to the L Tax and the net amount of the X Tax reduces the G Tax in the same manner as the income tax. Taxpayer also argues that because the Country K government considers the X Tax to be an "in lieu of" income tax assessment, this leads to the conclusion that it is a creditable tax for U.S. purposes. However, whether the X Tax is a creditable income tax is determined under the foregoing U.S. tax principles and is not dependent on the manner in which it is characterized by Country K. Treas. Reg. §1.901-2(a)(2)(i).

Application of the Safe Harbor Formula

Treasury Reg. §1.901-2A(e)(1) provides a safe harbor formula for purposes of determining the distinct element of a qualifying levy that is a tax and the amount paid by a dual capacity taxpayer under such levy that is a qualifying amount with respect to that levy. The qualifying amount paid with respect to a qualifying levy is an amount equal to (A-B-C) X D/1-D where:

A=the amount of gross receipts determined under paragraph (e)(2);
B= the amount of costs and expenses determined under paragraph (e)(2);
C= the total amount paid in the taxable year by the dual capacity taxpayer under the qualifying levy (the actual payment amount);
D= the tax rate as determined under paragraph (e).

Treasury Reg. §1.901-2A(e)(1) further provides that in no case shall the qualifying amount exceed the actual payment amount.

As discussed above, the X Tax is not a creditable tax under either section 901 or 903. Accordingly, the X Tax is not a qualifying levy and is not included in (C) of the safe harbor formula. Rather, the X Tax is includible in (B) of the formula as a business expense. More significantly, the qualifying amount resulting from application of the safe harbor formula ultimately is limited, pursuant to the flush language in Treas. Reg. §1.901-2A(e)(1), to the actual amount paid by Taxpayer Subsidiary pursuant to the only qualifying levy, the modified Country K income tax. Thus, Taxpayer's qualifying amount is limited to 179[2], determined as follows:

[2] Because the flush language of the regulation acts as an ultimate limitation on the qualifying amount of the amount of income taxes paid by Taxpayer Subsidiary (179), we need not address certain issues as to the exact method of determining amounts includible in (B) and (C) of the safe harbor formula since none of the possible interpretations would result in an amount that is lower than 179.

A=Gross Receipts	1,000
B=Expenses	(301)
C=Income Taxes Paid	(179)
	520
D=Tax Rate/1-Tax Rate	X Safeharbor Fraction
Qualifying Amount	Product
Cap per Actual Payment	179

Caveats

This technical advice memorandum is based on a certified translation of the X Tax statutes and on an analysis of secondary legal sources pertaining to the Country K tax laws discussed herein. Application of this technical advice memorandum is conditional on the accuracy of the translation and the secondary legal sources. The Internal Revenue Service has not independently verified the accuracy of the translated X Tax or the accuracy of the secondary legal sources.

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