INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
April 6, 2000

Number: **200030002**
Release Date: 7/28/2000
Index (UIL) No.: 901.01-05
CASE MIS No.: TAM-118929-99/CC:INTL:B3

District Director

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer =
business a =

USSub =
business b =
Country X =
Agreement C =
Certain Country X laws and
government decrees =

Generally applicable tax
laws of Country X =
Country X taxes =
Treaty =
statutory rate =
date d =
treaty rate e =
treaty rate f =
Article G =
Article H =

Article I =

ISSUE:

When applying the safe harbor method of Treas. Reg. §1.901-2A(e), should the statutory tax rate or the lower treaty rate be used in the "D" factor?

CONCLUSION:

The statutory rate should be used in the "D" factor under the regulatory safe harbor method.

FACTS:

Taxpayer is a domestic corporation engaged (with its affiliates) in business a. Taxpayer owns indirectly 100% of the stock of USSub, a domestic corporation engaged in business b through a permanent establishment in Country X.

USSub's operations are conducted under Agreement C with a controlled entity of the government of Country X. Agreement C obligates USSub to be subject to and pay Country X taxes imposed by certain Country X laws and government decrees as in effect when Agreement C was entered into. USSub's obligation under Agreement C to pay Country X taxes as provided for in these laws and government decrees is not affected by changes that may be made to Country X law. For the years under audit, the total tax imposed by these Country X laws and government decrees on USSub consisted of a tax on business profits and an additional tax on after-tax profits. During the same years, the generally applicable tax laws of Country X also imposed corporate income tax and an additional tax on the after-tax profits of non-Country X corporations that are owned by foreign shareholders and operate in Country X through a permanent establishment. The rate of additional tax under the generally applicable laws of Country X is hereinafter referred to as the statutory rate. The rate of additional tax applicable to USSub under Agreement C was the same as the statutory rate.

An income tax treaty was in effect between the U.S. and Country X during the period under audit ("Treaty"). The Treaty allows Country X to impose a tax on the business profits of U.S. corporations that operate in Country X through a permanent establishment. *See* Article G of the Treaty. In addition, under Article H of the Treaty, Country X is allowed to impose a tax at the treaty rate on the after-tax profits of U.S. corporations that operate in Country X through a permanent establishment. Prior to date d, the treaty rate of additional tax was treaty rate e. A protocol to the Treaty, which reduced the treaty rate from treaty rate e to treaty rate f, entered into force on date d. On and after date d, the treaty rate was treaty rate f. Treaty rates e and f were both lower than the statutory rate. Article I of the Treaty specifically provides, however, that the reduced treaty rates do not apply to corporations, like USSub, operating under

agreements such as Agreement C. Agreement C was entered into before, and continued to apply after, the Treaty went into effect. As a result, USSub remained subject to and paid tax to Country X on its business profits and after-tax profits at rates contractually fixed when Agreement C was entered into by USSub.

During the audit period, USSub was a dual capacity taxpayer as defined in Treas. Reg. §1.901-2(a)(2)(ii). USSub elected the safe harbor method of Treas. Reg. §1.901-2A (e)(1) to determine the portion of Country X levies that is considered to be a tax for purposes of sections 901 and 903 of the Internal Revenue Code. Under the safe harbor method, USSub's Country X tax base must be multiplied by the Country X general tax rate, the "D" factor in the formula, to determine the amount of creditable tax. USSub used the generally applicable Country X corporate tax rate on its business income and the generally applicable statutory rate on its after-tax profits in the "D" factor. USSub did not use the lower treaty rates.

LAW AND ANALYSIS:

Section 901 of the Internal Revenue Code allows a credit for the amount of income taxes paid or accrued by or on behalf of a taxpayer to a foreign country or possession of the United States. A foreign levy is creditable only if it is a tax whose predominant character is that of an income tax in the U.S. sense. A levy is a tax if it requires a compulsory payment pursuant to the foreign country's authority to levy taxes. Under Treas. Reg. §1.901-2(a)(2)(i), a payment in exchange for a specific economic benefit is not a tax. A taxpayer who is subject to a foreign levy and who also, directly or indirectly, receives a specific economic benefit from a foreign government is a dual capacity taxpayer. Treas. Reg. § 1.901-2(a)(2)(ii)(A). Under Treas. Reg. § 1.901-2 (a)(2)(i), a dual capacity taxpayer must establish the portion, if any, of the foreign levy that is a tax.

During the audit period, USSub was a dual capacity taxpayer because under Agreement C it received the right to engage in business b in Country X. Because the laws governing amounts levied pursuant to Agreement C were different than those applicable to non-dual capacity taxpayers, USSub must establish the distinct element of the levy that is a tax. Treas. Reg. §1.901-2A(b)(1) provides that a dual capacity taxpayer may use either the facts and circumstances method or the safe harbor method to establish the tax amount. Under the facts and circumstances method, not relevant here, the taxpayer must establish by all of the facts and circumstances the portion, if any, of the levy "that is not paid in exchange for a specific economic benefit." *See* Treas. Reg. §1.901-2A(c)(2)(i). The portion so established is the creditable tax. USSub elected to apply the safe harbor method, which employs a "splitting" approach to determine the portion, if any, of the payments made under the foreign levy that is a creditable tax.

Under the safe harbor method described in Treas. Reg. §1.901-2A(e), the dual capacity

taxpayer applies a formula to determine the amount of the levy that is the "qualifying amount" or the creditable tax. Treas. Reg. §1.901-2A(e)(1) provides that the formula is intended to provide a foreign tax credit for an amount "approximately equal to the amount of generally imposed income tax . . . that would have been required to be paid in the taxable year by the dual capacity taxpayer if it had not been a dual capacity taxpayer" and if the amount considered to be paid for the specific economic benefit had been deductible in determining the income tax liability.

The safe harbor formula is (A-B-C) x D/(1-D), where:

> A = the amount of gross receipts determined under foreign law;
> B = the amount of costs and expenses;
> C = the total amount paid pursuant to the levy; and
> D = the tax rate.

Treas. Reg. §1.901-2A(e)(3) provides that "the tax rate [the "D" factor] for purposes of the safe harbor formula is the tax rate . . . that is applicable in computing tax liability under the general tax." If the rate of the general tax varies with the amount of the base, the rate to be used is "the rate that applies under the general tax to a person whose base is" the same as that of the dual capacity taxpayer minus the specific economic benefit amount paid, provided that such rate applies in practice to non-dual capacity taxpayers. Id. Treas. Reg. §1.901-2A(e)(4)(i) further provides:

> If the general tax is a series of income taxes (*e.g.*, on different types of income), or if the application of the general tax differs by its terms for different classes of persons subject to the general tax (*e.g.*, for persons in different industries), then, except as otherwise provided in this paragraph (e), the qualifying amount shall be computed by reference to the income tax contained in such series of income taxes, or in the case of such different applications the application of the general tax, that by its terms and in practice imposes the highest tax burden on persons other than dual capacity taxpayers. Notwithstanding the preceding sentence, the general tax amount shall be computed by reference to the application of the general tax to entities of the same type (as determined under the general tax) as the dual capacity taxpayer and to persons of the same resident or nonresident status (as determined under the general tax) as the dual capacity taxpayer; and, if the general tax treats business income differently from non-business (*e.g.*, investment) income (as determined under the general tax), the dual capacity taxpayer's business and non-business income shall be treated as the general tax treats such income. If, for example, the dual capacity taxpayer would, under the general tax, be treated as a resident . . . and as a corporation (*i.e.*, because the rules of the general tax treat an entity like the dual capacity taxpayer as a corporation), . . . the dual capacity taxpayer . . . shall be so treated in computing the qualifying amount.

It is not disputed that USSub was actually required under Agreement C to use a rate equal to the statutory rate on its after-tax profits to compute its tax liability to Country X in the years under audit. The reduced treaty rates did not apply because USSub was a dual capacity taxpayer that entered into Agreement C. *See* Article I of the Treaty. The disputed point is whether to use the statutory rate or the U.S. treaty rate as the "general tax" rate in the safe harbor formula in determining the portion of USSub's tax payments that qualify as creditable taxes. In other words, the question is whether the dual capacity taxpayer's status as a U.S. taxpayer that would be eligible for reduced tax rates under the Treaty if it were not a dual capacity taxpayer is a factor that should be taken into account in determining the applicable rate.

Treas. Reg. §1.901-2A(e)(1) suggests that the reduced treaty rates should be used, because use of those rates would approximate the amount of tax USSub itself, as a U.S. resident eligible to be taxed at the reduced treaty rates, would have paid to Country X on its profits if it had been a non-dual capacity taxpayer. However, Treas. Reg. §1.901-2A(e)(1) provides only a general statement of what the safe harbor formula is designed to do. The specific rules for determining what tax rate is used in the D factor are contained in Treas. Reg. §1.901-2A(e)(3) and (4)(i). Treas. Reg. §1.901-2A(e)(3) indicates that the appropriate rate is the highest tax rate imposed in practice on "a person" that is a non-dual capacity taxpayer with income comparable to that of the dual capacity taxpayer. This suggests that the specific dual capacity taxpayer's eligibility for treaty benefits is not taken into account in determining the generally applicable tax rate.

Similarly, Treas. Reg. §1.901-2A(e)(4)(i) provides that if the general tax applies differently to different classes of persons, the qualifying amount is computed by reference to the application that "by its terms and in practice imposes the highest tax burden on persons other than dual capacity taxpayers." This language indicates that the higher statutory rate, rather than lower treaty rates for which some but not all classes of taxpayers are eligible, should be used. The context of the reference in Treas. Reg. §1.901-2A(e)(4)(i) to "entities of the same type" suggests that this factor refers to entity classification, such as corporation, partnership or trust, and not to all of the specific attributes of the dual capacity taxpayer. There is no dispute in this case over the application of the other rules referenced in Treas. Reg. §1.901-2A(e)(4)(i).

While the regulations are ambiguous, the better view is that the generally applicable statutory rate of additional tax, and not the lower U.S. treaty rate, should be used in computing the D factor. This reading of the regulations best furthers the underlying purpose of the safe harbor formula. As discussed above, the purpose of the safe harbor formula is to approximate the portion of the payment made by the dual capacity taxpayer that is a tax. The regulations identify the highest tax burden imposed by the foreign country on non-dual capacity taxpayers as the amount treated as a tax, so that only amounts paid in excess of this amount by the dual capacity taxpayer are considered to be paid in exchange for the specific economic benefit that it received, *i.e.*,

the deemed royalty element of the payment. If the highest rate that applies in practice to other, non-dual capacity taxpayers is not used in the safe harbor formula, an amount of tax paid by a non-dual capacity taxpayer would be treated as a royalty when paid by a dual capacity taxpayer. Accordingly, use of the statutory rate in the “D” formula reaches the correct result in this case.

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

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