RULES and REGULATIONS

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 4

[T.D. 7918; LR-100-78]

Creditability of Foreign Taxes

Wednesday, October 12, 1983

***46272** AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations setting forth the conditions that must be met in order for a levy imposed by a foreign country or a possession of the United States to qualify as an income, war profits, or excess profits tax or a tax in lieu of such a tax otherwise generally imposed. These final regulations also relate to the determination of the amount of a qualifying foreign tax that is paid or accrued and thus, subject to certain limitations, creditable against U.S. income tax liability. These final regulations supersede the temporary regulations published in the Federal Register on November 17, 1980 (45 FR 75695).

EFFECTIVE DATE: The regulations are effective for taxable years beginning after November 14, 1983. In addition, a person may elect to apply the regulations to earlier open taxable years.

FOR FURTHER INFORMATION CONTACT:Herman B. Bouma of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224 (Attention: CC:LR:T), 202-566-3289, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

On June 1, 1978, the Legislation and Regulations Division of the Office of Chief Counsel of the Internal Revenue Service opened a regulations project for the purpose of promulgating regulations that would give taxpayers greater guidance with respect to the creditability of foreign taxes under sections 901 and 903 of the Internal Revenue Code. On August 28, 1978, a notice was published in the Federal Register (43 FR 38429) inviting public comments on the creditability of foreign taxes and recommendations for the regulations. A Notice of Proposed Rulemaking was published on June 20, 1979 (44 FR 36071), and a public hearing was held on October 11, 1979. On November 17, 1980, temporary and proposed regulations were published (45 FR 75647 and 45 FR 75695, respectively) and a public hearing was held on May 28, 1981. On April 5, 1983, another Notice of Proposed Rulemaking was published (48 FR 14641) and a public hearing was held on June 23, 1983. After consideration of all comments received on the proposed regulations of April 5, 1983, the regulations, with revisions, are adopted by this Treasury Decision.

Discussion

*Section 1.901-2*

Section 901 allows a credit for the amount of income, war profits, or excess profits 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 a creditable tax only if it is a tax and its predominant character is that of an income tax in the U.S. sense.

A levy is a tax under these final regulations if it requires a compulsory payment pursuant to the foreign country's authority to levy taxes. A payment for a specific economic benefit (defined in §1.901-2(a)(2)(ii)(B)) is not a tax. A taxpayer who directly or indirectly receives a specific economic benefit from a foreign government (a “dual capacity taxpayer”) must establish under § 1.901-2A the portion, if any, of his payment to the foreign government that is a payment of tax.

Under these final regulations, the predominant character of a foreign tax is that of an income tax in the U.S. sense if the foreign tax is likely to reach net gain in the normal circumstances in which it applies. This standard, found in § 1.901-2(a)(3)(i), adopts the criterion for creditability set forth in Inland Steel Company v. U.S., 677 F.2d 72 (Ct. Cl. 1982), Bank of America National Trust and Savings Association v. U.S., 459

F.2d 513 (Ct. Cl. 1972), and Bank of America National Trust and Savings Association v. Commissioner, 61 T.C. 752 (1974). The regulations set forth three tests for determining if a foreign tax is likely to reach net gain: the realization test, the gross receipts test, and the net income test. All of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense.

Paragraph (b)(2) of § 1.901-2 states that the realization test is met if the predominant character of the foreign tax is that of tax imposed on income at the time or after the time income would be realized under the Internal Revenue Code. The test can also be satisfied even if the tax is imposed prior to a realization event if the tax recaptures a tax deduction, tax credit or other tax allowance previously accorded the taxpayer. In addition, the test can be satisfied if the foreign tax is imposed on the appreciation in value of property or on the value of certain inventory property at the time of transfer, processing, or export, but only if such amounts are not subject to foreign tax at a later time, or, if they are subject to tax, a credit is given for the earlier tax. Certain foreign taxes imposed on the deemed distribution of profits also satisfy the realization test.

Several changes were made to the realization test of the proposed regulations in response to comments made by the public. The test was expanded to cover a tax on the appreciation of any type of property and not just stock, securities, and readily marketable securities. In addition, it was clarified that the imposition of a second tax does not disqualify a tax on a prerealization event if a credit is given for the first tax. The proposed regulations had a rule pertaining to certain distributions and deemed distributions. The rule has been rewritten to apply only to deemed distributions since a tax clearly meets the realization test if it is imposed on an actual distribution of amounts that meet the realization test.

The gross receipts test set forth in paragraph (b)(3) of § 1.901-2 is satisfied if the predominant character of the foreign tax is that of a tax imposed on the basis of gross receipts. The regulations also allow a tax imposed on a base of estimated gross receipts if the method used is likely to produce an amount that is not greater than fair market value. The proposed regulations would have allowed a tax imposed on estimated gross receipts only in the case of: (1) Transactions with respect to which it is reasonable to believe that gross receipts may not otherwise be clearly reflected, or (2) certain prerealization events. In response to comments made by the public, these restrictions have been deleted.

The third test of the regulations is whether the predominant character of the foreign tax is that of a tax on net income. Paragraph (b)(4) of § 1.902-2 states that a tax imposed on a base of gross receipts reduced by significant costs and expenses (including capital expenditures) attributable to that income is a tax on net income. Certain formulary methods of computing taxable income satisfy this test. In rare cases where income is of a type (such as wages) that generally does not have significant related expenses, a foreign tax may be considered to be imposed on net income even if no deductions are allowed.

The net income test has been clarified in several respects in response to comments received. A sentence has been added at the end of paragraph (b)(4)(i) specifically stating that a tax need not give a deduction for another tax that meets the realization, gross receipts, and net income requirements. In addition, the rules concerning the consolidation of profits and losses have been clarified by the insertion of examples of separate activities within a trade or business (separate contract areas in the case of oil and gas exploration). The regulations also make clear that oil and gas extraction constitutes a separate trade or business from oil and gas refining and processing. Some persons requested that example 24 of § 4.901-2(e) of the temporary regulations be included in the final regulations. The example lists certain deductions that are not allowed by a foreign tax and concludes that the tax meets the net income test, nothwithstanding the disallowance. It was decided not to include the example in the final regulations in order to avoid the possible implication that a tax that disallowed additional deductions would not meet the net income test. Such a tax may or may not meet the net income test, depending on the additional deductions that are disallowed.

Even though a foreign tax satisfies the three tests of realization, gross receipts, and net income, the predominant character of the tax is not that of an income tax in the U.S. sense to the extent the foreign tax liability is dependent on the availability of a credit against the taxpayer's liability to another country. This rule is contained in paragraphs (a)(3)(ii) and (c) of § 1.901-2. Several comments recommended the regulations be revised to deny a credit only to the extent the foreign tax is dependent on the availability of a credit against U.S. tax liability. This recommendation was not followed.

Under the regulations, the tests for determining creditability are applied to each separate foreign levy. Paragraph (d) of § 1.901-2 provides that a levy consists of separate levies if it is imposed on a base that differs in kind, and not merely in degree, for different classes of persons subject to the levy. Taxes imposed by different levels of a government are always separate levies. A tax imposed under foreign law as modified by a contract is a separate tax imposed on those persons subject to the contractual modification. Special rules with respect to levies imposed on dual capacity taxpayers are found in § 1.901-2A(a).

Amounts of foreign income, war profits, or excess profits taxes that are creditable must be paid or accrued to the foreign country by or on behalf of the taxpayer. Paragraph (e) of § 1.901-2 contains rules with respect to the amount of a qualifying tax that is creditable, subject to limitations such as those contained in section 904. Amounts of tax paid or accrued to a foreign country do not include amounts that are: (1) Reasonably certain to be refunded, credited, rebated, abated, or forgiven, or (2) used directly or indirectly as a subsidy to the taxpayer, or (3) not compulsory payments. To the extent a taxpayer does not make reasonable efforts to minimize its foreign tax liability over time, the payment is not compulsory and is therefore not an amount of tax paid. A taxpayer is not required to change the form of a transaction in order to minimize its foreign tax liability.

The proposed regulations provided that an amount was not paid or accrued if it was reasonably likely to be refunded, credited, rebated, or forgiven. Following the recommendation of certain comments, these final regulations substitute the word “certain” for “likely”. Also in response to certain comments, the regulations give further guidance as to how far a taxpayer has to go to reduce his tax liability.

Paragraph (e) of § 1.901-2 also provides rules with respect to multiple levies. If the initial amount of one foreign liability is reduced by the amount of another levy, the amount of the first liability that is paid or accrued is the excess of the initial liability over the other levy. This is the rule of Helvering v. Queen Insurance Co., 115 F.2d 341 (2d Cir. 1940), cert. den.312 U.S. 706 (1941). The amount of the other levy that is paid or accrued is not reduced due to its use as an offset. If the taxpayer's liability is the greater or lesser of two amounts, the taxpayer is considered to pay or accrue only the levy for which he is liable for that period. Thus, if the taxpayer is liable for the greater of an income tax or an excise tax and for one period the income tax liability is larger, the taxpayer is considered to be liable only for the income tax, and not for the excise tax, for that period.

Various comments criticized the results of the two situations described above. If a person pay the greater of an income tax and an excise tax, he gets a full credit if the income tax is greater. However, if the person had been given a credit against his income tax for the amount of the excise tax, he would only get a credit for the difference between the income tax and the excise tax. It was suggested that in the latter situation the excise tax should be creditable as an in-lieu-of tax. It was decided to retain the rules of the proposed regulations, which respect foreign law in determining which levy or levies are paid.

The rules of the temporary regulations involving advance corporation taxes (§ 4.901-2(f)(4)(iv)) have been deleted because they apply to only one type of integrated tax system. The final regulations reserve a paragraph to contain more general rules for the treatment of taxes under integrated tax systems.

The final regulations also do not contain the rule of the temporary regulations regarding the accrual of contested foreign taxes (§ 4.901-2(f)(6)). No reason could be found for giving a credit when a person is contesting a tax and has not yet paid it. Thus, Revenue Rulings 58-55, 1958-1 C.B. 266; 70-290, 1970-1 C.B. 160; and 77-487, 1977-2 C.B. 479, again state the position of the Internal Revenue Service on this issue. It is anticipated that in the near future another Revenue Ruling will be issued, consolidating and expanding on the cited rulings.

Paragraph (f) of § 1.901-2 contains the general rule that a foreign income tax can be paid or accrued only by or on behalf of a taxpayer who is liable for the amount under foreign law. The final regulations, however, include an exception not found in the proposed regulations. A recipient of wages will be considered to be subject to legal liability for pension, unemployment, disability fund, and other similar payments if such amounts are deducted from the wages under provisions comparable to section 3102 (a) and (b) of the Internal Revenue Code. Paragraph (f) also contains specific rules with respect to: (1) A contractual agreement under which the income tax liability of the taxpayer is paid by another person, and (2) joint and several liability for income tax.

Paragraph (g) of § 1.901-2 contains definitions of the terms “paid,” “foreign country,” and “foreign levy” for purposes of §§ 1.901-2, 1.901-2A, and 1.903-1.

Paragraph (h) contains the effective date provision for §§ 1.901-2, 1.901-2A, and 1.903-1. Generally, the regulations are effective for taxable years beginning after November 14, 1983. However, taxpayers may elect to have the regulations apply to any open taxable year on a country-by-country basis. If the election is made with the respect to one country, it applies to all levies imposed by the country and any of its political subdivisions for the year for which the election is made and all subsequent years. The election cannot be revoked.

*Section 1.901-2A*

Under § 1.901-2 (a)(2)(i), a payment to a foreign government in exchange for a specific economic benefit is not a tax. A taxpayer who receives a specific economic benefit ("dual capacity taxpayer") must establish the portion (if any) of his payment to the foreign government that is tax. Rules pertaining to this burden are contained in § 1.901-2A.

Under paragraph (a)(1) of § 1.901-2A, no portion of a payment by a dual capacity taxpayer is considered to be compensation for a specific economic benefit if the payment is pursuant to a levy that is imposed on both dual capacity taxpayers and other taxpayers. A levy imposed on dual capacity taxpayers is also imposed on other taxpayers only if the levy is applied, by its terms and in practice, in the same manner to other taxpayers as to dual capacity taxpayers.

Paragraph (b)(2) of § 1.901-2A confirms that a dual capacity taxpayer entitled to the benefits of a tax treaty to which the United States is a party and which provides for the creditability of a foreign tax for U.S. tax purposes, may choose the benefits of the treaty, subject to any terms, conditions, and limitations contained in the treaty.

Paragraph (c) sets forth the two methods available to a dual capacity taxpayer if the taxpayer is not subject to the same levy as other taxpayers and is not claiming a credit under a treaty. The first method is to establish by all of the relevant facts and circumstances, the portion, if any, of the levy that is not paid in exchange for a specific economic benefit. Neither the methodology of the elective safe harbor method described below nor the results that would have obtained if the safe harbor method had been elected may be taken into account as relevant facts or circumstances under this method.

The second method, the elective safe harbor method, is described in paragraph (c)(3) of § 1.901-2A. A dual capacity taxpayer may elect to use this method in accordance with paragraph (d) on a country-by-country basis. A taxpayer who elects the safe harbor method applies the formula set forth in paragraph (e). The formula is intended to provide a credit under section 901 or 903 for an amount approximating the amount of generally imposed income tax that would have been paid if the taxpayer 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 foreign income tax liability. However, if a country that imposes a levy based on realized net income on a dual capacity taxpayer does not have a generally imposed income tax, the dual capacity taxpayer may use the lower of the rate specified in section 11(b)(5) of the Internal Revenue Code or the rate of the foreign levy in applying the safe harbor formula. An election to use the safe harbor method for a country is effective for the taxable year for which it is made and all subsequent years unless revoked with the consent of the Commissioner of Internal Revenue. The making of a safe harbor election constitutes a waiver of the right to use the facts and circumstances method with respect to any levy imposed by countries covered by the election.

If a payment by a dual capacity taxpayer to the foreign country is determined to have two elements—an amount that is income tax or tax in lieu of income tax and an amount that is paid in exchange for a specific economic benefit—the amount paid in exchange for the specific economic benefit is characterized (as royalty, purchase price, etc.) according to the nature of the transaction. Such characterization applies for all purposes of Chapter 1 of the Code, except that any determination by reason of the safe harbor method that an amount is not tax shall not be taken into account in determining whether or not such amount is to be characterized and treated as tax for purposes of computing an allowance for percentage depletion under sections 611 and 613.

The proposed regulations allowed a safe harbor election to be made retroactively only with respect to taxable years beginning before the general effective date of the regulations. The final regulations also allow a retroactive election if: (1) A person reasonably believed that he was not a dual capacity taxpayer or was not subject to a qualifying levy and the Commissioner consents to the retroactive election, or (2) a person originally deducted taxes for the taxable year with respect to which he now wishes to make the election. The final regulations also provide the following additional situations in which the Commissioner will normally consent to a revocation of a safe harbor election; (1) The Internal Revenue Service has issued a letter ruling to the electing person which adversely affects the person's application of the safe harbor method, and (2) a corporation that is a dual capacity taxpayer becomes a member of an affiliated group that already contains a member that is a dual capacity taxpayer with respect to the same country, and immediately prior thereto one of such dual capacity taxpayers had a safe harbor election in effect with respect to the country and the other did not.

Under the proposed regulations, a provision of the general tax (e.g., treatment of an income item, a deduction, or a rate) cannot be applied in using the safe harbor method if the provision does not apply in practice to persons other than dual capacity taxpayers. A number of comments indicated that in many cases it would be extremely burdensome for a dual capacity taxpayer to establish that a provision applies in practice to non-dual capacity taxpayers. Paragraph (e)(4)(ii) of the final regulations states that a provision (including tax rate) that by its terms applies to persons other than dual capacity taxpayers will generally be assumed to be reasonably likely to apply in practice to such other persons unless the person claiming credit knows or has reason to know otherwise.

Many comments criticized the proposed regulations for not allowing a credit under the safe harbor method if the foreign country does not have a general tax. They suggested that either the facts and circumstances method explicitly deal with this situation or the safe harbor method be modified so that the tax rate of a neighboring country or of the U.S. could be applied. The final regulations provide that if a country that does not have a general tax imposes a levy based on realized net income on a dual capacity taxpayer, the safe harbor formula may be applied using the lower of the rate of that levy or the rate specified in section 11(b)(5) of the Internal Revenue Code (currently 46%).

*Section 1.903-1*

Section 903 provides that the credit granted by section 901 shall also be available for a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by a foreign country or U.S. possession. The regulations under section 903 describe these taxes. The rules under section 901 for determining the amount of tax paid or accrued by or on behalf of a taxpayer also apply to section 903 taxes.

To qualify as a tax in lieu of a tax on income, war profits, or excess profits, a levy must satisfy the definition of a tax in § 1.901-2(a)(2). The tax must also be in substitution for, and not in addition to, a generally imposed income tax. To the extent that the amount of the foreign tax liability is contingent upon the availability of a credit against the amount of income tax owed to another country, a tax is not in substitution for an otherwise generally imposed income tax. The comparability requirement in temporary regulation § 4.903-1(c) is not contained in these final regulations.

Creditability under § 1.903-1 is not dependent on administrative difficulty in applying the generally imposed income tax. The base of the tax need not bear any relation to realized net income; a section 903 tax may be imposed on gross receipts, gross income, or a base that bears no resemblance to income. A taxpayer may be entitled to credit under section 903 for a tax with respect to certain of its activities, even though the taxpayer is also subject to a generally imposed income tax on its income from other activities. As under section 901, each separate levy is evaluated in its entirety for all persons subject to the tax, and the rules of § 1.901-2A apply to dual capacity taxpayers.

Removal of Temporary Regulations

These final regulations supersede the temporary regulations published in the Federal Register (45 FR 75647) on November 17, 1980; thus, the temporary regulations are removed from 26 CFR. The temporary regulations continue to apply, however, to taxable years ending after June 15, 1979, and beginning on or before November 14, 1983 (if a revenue ruling in effect on November 16,1980, is inconsistent with the temporary regulations, then a taxpayer may choose to apply the ruling for any taxable year ending on or before December 31, 1980).

Regulatory Flexibility Act and Executive Order 12291

The Internal Revenue Service has concluded that these regulations are interpretative and thus the notice and public comment procedural requirements of 5 U.S.C. 553 do not apply. Accordingly, these regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6). The Commissioner of Internal Revenue has determined that these regulations are not subject to Executive Order 12291.

Paperwork Reduction Act of 1980

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) in accordance with the requirements of the Paperwork Reduction Act of 1980. These requirements have been approved by OMB.

Drafting Information

The principal author of these regulations in the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service is Herman B. Bouma. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing these regulations, both on matters of substance and style.

List of Subjects

*26 CFR §§ 1.861-1 through 1.997-1*

Income taxes, Aliens, Exports, DISC, Foreign investment in U.S., Foreign tax credit, Sources of income, United States investments abroad.

*26 CFR Part 4*

Income taxes, United States investments abroad, Foreign tax credit.

Adoption of amendments to the regulations

The following amendments to 26 CFR Parts 1 and 4 are hereby adopted:

PART 1—[AMENDED]26 CFR § 1.901

Paragraph 1. A new § 1.901-2 is added immediately after § 1.901-1 to read as follows:

26 CFR § 1.901

§ 1.901-2 Income, war profits, or excess profits tax paid or accrued.

(a) Definition of income, war profits, or excess profits tax.—(a)(1) In general. Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as “income tax” for purposes of this section and §§ 1.901-2A and 1.903-1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if—

(a)(1)(i) It is a tax; and

(a)(1)(ii) The predominant character of that tax is that of an income tax in the U.S. sense.

Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms “paid by,” “foreign country,” and “foreign levy.” Paragraph (h) of this section states the effective date of this section.

(a)(2) Tax.—(a)(2)(i) In general. A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: a tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and § 1.901-2A.

(a)(2)(ii) Dual capacity taxpayers.—(a)(2)(ii)(A) In general. For purposes of this section and §§ 1.901-2A and 1.903-1, a person who is subject to a levy of a foreign state or of a possession of the United States or of a political subdivision of such a state or possession and who also, directly or indirectly (within the meaning of paragraph (a)(2)(ii)(E) of this section) receives (or will receive) a specific economic benefit from the state or possession or from a political subdivision of such state or possession or from an agency or instrumentality of any of the foregoing is referred to as a “dual capacity taxpayer.” Dual capacity taxpayers are subject to the special rules of § 1.901-2A.

(a)(2)(ii)(B) Specific economic benefit. For purposes of this section and §§ 1.901-2A and 1.903-1, the term “specific economic benefit” means 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, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general. Thus, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

(a)(2)(ii)(C) Pension, unemployment, and disability fund payments. A foreign levy imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some substantially similar purpose, is not a requirement of compulsory payment in exchange for a specific economic benefit, as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies or similar characteristics of such individuals.

(a)(2)(ii)(D) Control of property. A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property, for example, by both regulating the quantity of property that may be extracted and establishing the minimum price at which it may be disposed of.

(a)(2)(ii)(E) Indirect receipt of a benefit. A person is considered to receive a specific economic benefit indirectly if another person receives a specific economic benefit and that other person—

(1) Owns or controls, directly or indirectly, the first person or is owned or controlled, directly or indirectly, by the first person or by the same persons that own or control, directly or indirectly, the first person; or

(2) Engages in a transaction with the first person under terms and conditions such that the first person receives, directly or indirectly, all or part of the value of the specific economic benefit.

(3) Predominant character. The predominant character of a foreign tax is that of an income tax in the U.S. sense—

(a)(2)(ii)(E)(i) If, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies,

(a)(2)(ii)(E)(ii) But only to the extent that liability for the tax is not dependent, within the meaning of paragraph (c) of this section, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country.

(b) Net gain.—(b)(1) In general. A foreign tax is likely to reach net gain in the normal circumstances in which it applies 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 set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

(b)(2) Realization.—(b)(2)(i) In general. A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed—

(A) Upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code;

(B) Upon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or

(C) Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event) and—

(b)(2)(i)(1) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period; or

(b)(2)(i)(2) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).

A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph (b)(2)(i). For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code. As provided in paragraph (a)(1) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax described in the immediately preceding sentence satisfies the realization requirement even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed rental income and such stock dividends. However, a foreign tax based only or predominantly on such imputed rental income or only or predominantly on receipt of such stock dividends does not satisfy the realization requirement.

(b)(2)(ii) Certain deemed distributions. A foreign tax that does not satisfy the realization requirement under paragraph (b)(2)(i) of this section is nevertheless considered to meet the realization requirement if it is imposed with respect to a deemed distribution (e.g., by a corporation to a shareholder) of amounts that meet the realization requirement in the hands of the person that, under foreign law, is deemed to distribute such amount, but only if the foreign country does not, upon the occurrence of a later event (e.g., an actual distribution), impose tax ("second tax") with respect to the income on which tax was imposed by reason of such deemed distribution (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid with respect to the deemed distribution).

(b)(2)(iii) Readily marketable property. Property is readily marketable if—

(A) It is stock in trade or other property of a kind that property would be included in inventory if on hand at the close of the taxable year or if it is held primarily for sale to customers in the ordinary course of business, an

(B) It can be sold on the open market without further processing or it is exported from the foreign country.

(b)(2)(iv) Examples. The provisions of paragraph (b)(2) of this section may be illustrated by the following examples:

Example (1). Residents of country X are subject to a tax of 10 percent on the aggregate net appreciation in fair market value during the calendar year of all shares of stock held by them at the end of the year. In addition, all such residents are subject to a country X tax that qualifies as an income tax within the meaning of paragraph (a)(1) of this section. Included in the base of the income tax are gains and losses realized on the sale of stock, and the basis of stock for purposes of determining such gain or loss is its cost. The operation of the stock appreciation tax and the income tax as applied to sales of stock is exemplified as follows: T3A, a resident of country X, purchases stock in June, 1983 for 100u (units of country X currency) and sells it in May, 1985 for 160u. On December 31, 1983, the stock is worth 120u and on December 31, 1984, it is worth 155u. Pursuant to the stock appreciation tax, A pays 2u for 1983 (10 percent of (120u-100u)), 3.5u for 1984 (10 percent of (155u-120u)), and nothing in 1985 because no stock was held at the end of that year. For purposes of the income tax, A must include 60u (160u-100u) in his income for 1985, the year of sale. Pursuant to paragraph (b)(2)(i)(C) of this section, the stock appreciation tax does not satisfy the realization requirement because country X imposes a second tax upon the occurrence of a later event (i.e., the sale of stock) with respect to the income that was taxed by the stock appreciation tax and no credit or comparable relief is available against such second tax for the stock appreciation tax paid.

Example (2). The facts are the same as in example (1) except that if stock was held on the December 31 last preceding the date of its sale, the basis of such stock for purposes of computing gain or loss under the income tax is the value of the stock on such December 31. Thus, in 1985, A includes only 5u (160u—155u) as income from the sale for purposes of the income tax. Because the income tax imposed upon the occurrence of a later event (the sale) does not impose a tax with respect to the income that was taxed by the stock appreciation tax, the stock appreciation tax satisfies the realization requirement. The result would be the same if, instead of a basis adjustment to reflect taxation pursuant to the stock appreciation tax, the country X income tax allowed a credit (or other comparable relief) to take account of the stock appreciation tax. If a credit mechanism is used, see also paragraph (e)(4)(i) of this section.

Example (3). Country X imposes a tax on the realized net income of corporations that do business in country X. Country X also imposes a branch profits tax on corporations organized under the law of a country other than country X that do business in country X. The branch profits tax is imposed when realized net income is remitted or deemed to be remitted by branches in country X to home offices outside of country X. The branch profits tax is imposed subsequent to the occurrence of events that would result in realization of income (i.e., by corporations subject to such tax) under the income tax provisions of the Internal Revenue Code; thus, in accordance with paragraph (b)(2)(i)(A) of this section, the branch profits tax satisfies the realization requirement.

Example (4). Country X imposes a tax on the realized net income of corporations that do business in country X (the “country X corporate tax”). Country X also imposes a separate tax on shareholders of such corporations (the “country X shareholder tax”). The country X shareholder tax is imposed on the sum of the actual distributions received during the taxable year by such a shareholder from the corporation's realized net income for that year (i.e., income from past years is not taxed in a later year when it is actually distributed) plus the distributions deemed to be received by such a shareholder. Deemed distributions are defined as (A) a shareholder's pro rata share of the corporation's realized net income for the taxable year, less (B) such shareholder's pro rata share of the corporation's country X corporate tax for that year, less (C) actual distributions made by such corporation to such shareholder from such net income. A shareholder's receipt of actual distributions is a realization event within the meaning of paragraph (b)(2)(i)(A) of this section. The deemed distributions are not realization events, but they are described in paragraph (b)(2)(ii) of this section. Accordingly, the country X shareholder tax satisfies the realization requirement.

(b)(3) Gross receipts.—(b)(3)(i) In general. A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of—

(A) Gross receipts; or

(B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph (b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph (b)(3)(i).

(b)(3)(ii) Examples. The provisions of paragraph (b)(3)(i) of this section may be illustrated by the following examples:

Example (1). Country X imposes a "headquarters company tax" on country X corporations that serve as regional headquarters for affiliated nonresident corporations, and this tax is a separate tax within the meaning of paragraph (d) of this section. A headquarters company for purposes of this tax is a corporation that peforms administrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters company. It is established that this formula is likely to produce an amount that is not greater than the fair market value of arm's length gross receipts from such transactions with affiliates. Pursuant to paragraph (b)(3)(i)(B) of this section, the headquarters company tax satisfies the gross receipts requirement.

Example (2). The facts are the same as in Example (1), with the added fact that in the case of a particular taxpayer, A, the formula actually produces an amount that is substantially greater than the fair market value of arm's length gross receipts from transactions with affiliates. As provided in paragraph (a) (l) of this section, the headquarters company tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Accordingly, the result is the same as in example (1) for all persons subject to the headquarters company tax, including A.

Example (3). Country X imposes a separate tax (within the meaning of paragraph (d) of this section) on income from the extraction of petroleum. Under that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts; therefore, the tax on extraction income is not likely to produce an amount that is not greater than fair market value. Accordingly, the tax on extraction income does not satisfy the gross receipts requirement. However, if the tax satisfies the criteria of § 1.903-1(a), it is a tax in lieu of an income tax.

(b)(4) Net income.—(b)(4)(i) In general. A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts (including gross receipts as computed under paragraph (b)(3)(i(B) of this section) to permit—

(A) Recovery of the significant costs and expenses (including significant capital expenditures) 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.

A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. For example, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery, the net income requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax system and recovered either on a recurring basis over time or upon the occurrence of some future event or where the recovery of items capitalized under the Internal Revenue Code occurs less rapidly under the foreign tax system. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (e.g., principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). A foreign tax whose base, judged on the basis of its predominant character, is computed by reducing gross receipts by items described in paragraph (b)(4)(i)(A) or (B) of this section satisfied the net income requirement even if gross receipts are not reduced by some such items. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). In determining whether a foreign tax satisfied the net income requirement, it is immaterial whether gross receipts are reduced, in the base of the tax, by another tax, provided that other tax satisfies the realization, gross receipts and net income requirements.

(ii) Consolidation of profits and losses. In determining whether a foreign tax satisfies the net income requirement, one of the factors to be taken into account is whether, in computing the base of the tax, a loss incurred in one activity (e.g., a contract area in the case of oil and gas exploration) in a trade or business is allowed to offset profit earned by the same person in another activity (e.g., a separate contract area) in the same trade or business. If such an offset is allowed, it is immaterial whether the offset may be made in the taxable period in which the loss is incurred or only in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset the loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial that no such offset is allowed if a loss incurred in one such activity may be applied to offset profit earned in that activity in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset such loss

against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether a person's profits and losses from one trade or business (e.g., oil and gas extraction) are allowed to offset its profits and losses from another trade or business, (e. g., oil and gas refining and processing) or whether a person's business profits and losses and its passive investment profits and losses are allowed to offset each other in computing the base of the foreign tax. Moreover, it is immaterial whether foreign law permits or prohibits consolidation of profits and losses of related persons, unless foreign law requires separate entities to be used to carry on separate activities in the same trade or business. If foreign law requires that separate entities carry on such separate activities, the determination whether the net income requirement is satisfied is made by applying the same considerations as if such separate activities were carried on by a single entity.

(ii)(iii) Carryovers. In determining whether a foreign tax satisfies the net income requirement, it is immaterial, except as otherwise provided in paragraph (b)(4)(ii) of this section, whether losses incurred during one taxable period may be carried over to offset profits incurred in different taxable periods.

(ii)(iv) Examples. The provisions of this paragraph (b)(4) may be illustrated by the following examples:

Example (1). Country X imposes an income tax on corporations engaged in business in country X; however, that income tax is not applicable to banks. Country X also imposes a tax (the “bank tax”) of 1 percent on the gross amount of interest income derived by banks from branches in country X; no deductions are allowed. Banks doing business in country X incur very substantial costs and expenses (e.g. interest expense) attributable to their interest income. The bank tax neither provides for recovery of significant costs and expenses nor provides any allowance that significantly compensates for the lack of such recovery. Since such banks are not almost certain never to incur a loss on their interest income from branches in country X, the bank tax does not satisfy the net income requirement. However, if the tax on corporations is generally imposed, the bank tax satisfies the criteria of § 1.903-1(a) and therefore is a tax in lieu of an income tax.

Example (2). Country X law imposes an income tax on persons engaged in business in country X. The base of that tax is realized net income attributable under reasonable principles to such business. Under the tax law of country X, a bank is not considered to be engaged in business in country X unless it has a branch in country X and interest income earned by a bank from a loan to a resident of country X is not considered attributable to business conducted by the bank in country X unless a branch of the bank in country X performs certain significant enumerated activities, such as negotiating the loan. Country X also imposes a tax (the “bank tax”) of 1 percent on the gross amount of interest income earned by banks from loans to residents of country X if such banks do not engage in business in country X or if such interest income is not considered attributable to business conducted in country X. For the same reasons as are set forth in example (1), the bank tax does not satisfy the net income requirement. However, if the tax on persons engaged in business in country X is generally imposed, the bank tax satisfies the criteria of § 1.903-1(a) and therefore is a tax in lieu of an income tax.

Example (3). A foreign tax is imposed at the rate of 40 percent on the amount of gross wages realized by an employee; no deductions are allowed. Thus, the tax law neither provides for recovery of costs and expenses nor provides any allowance that effectively compensates for the lack of such recovery. Because costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized, such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that, under the circumstances, after the tax is paid, employees subject to the tax are almost certain to have net gain.

Accordingly, the tax satisfies the net income requirement.

Example (4). Country X imposes a tax at the rate of 48 percent of the “taxable income” of nonresidents of country X. “Taxable income” for purposes of the tax is defined as gross receipts received from residents of country X who furnish specified types of services to customers who are residents of country X (regardless of whether the services to which the receipts relate are performed within or outside country X) less deductions that permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X tax satisifies the net income requirement.

Example (5). Each of country X and province Y (a political subdivision of country X) imposes a tax on corporations, called the “country X income tax” and the “province Y income tax,” respectively. Each tax has an identical base, which is computed by reducing a corporation's gross receipts by deductions that, based on the predominant character of the tax, permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X income tax does not allow a deduction for the province Y income tax for which a taxpayer is liable, nor does the province Y income tax allow a deduction for the country X income tax for which a taxpayer is liable. As provided in paragraph (d)(1) of this section, each of the country X income tax and the province Y income tax is a separate levy. Both of these levies satisfy the net income requirement; the fact that neither levy's base allows a deduction for the other levy is immaterial in reaching that determination.

(c) Soak-up taxes.—(c)(1) In general. Pursuant to paragraph (a)(3)(ii) of this section, the predominant character of a foreign tax that satisfies the requirement of paragraph (a)(3)(i) of this section is that of an income tax in the U.S. sense only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country; Liability for foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only if and to the extent that the foreign tax would not be imposed on the taxpayer but for the availability of such a credit. See also § 1.903-1(b)(2).

(c)(2) Examples. The provisions of paragraph (c)(1) of this section may be illustrated by following examples:

Example (1). Country X imposes a tax on the receipt of royalties from sources in country X by nonresidents of country X. The tax is 15 percent of the gross amount of such royalties unless the recipient is a resident of the United States or of country A, B, C, or D, in which case the tax is 20 percent of the gross amount of such royalties. Like the United States, each of countries A, B, C, and D allows its residents a credit against the income tax otherwise payable to it for income taxes paid to other countries. Because the 20 percent rate applies only to residents of countries which allow a credit for taxes paid to other countries and the 15 percent rate applies to residents of countries which do not allow such a credit, one-fourth of the country X tax would not be imposed on residents of the United States but for the availability of such a credit. Accordingly, one-fourth of the country X tax imposed on residents of the United States who receive royalties from sources in country X is dependent on the availability of a credit for the country X tax against income tax liability to another country.

Example (2). Country X imposes a tax on the realized net income derived by all nonresidents from carrying on a trade or business in country X. Although country X law does not prohibit other nonresidents from carrying on business in country X, United States persons are the only nonresidents of country X that carry on business in country X in 1984. The country X tax would be imposed in its entirety on a nonresident of country X irrespective of the availability of a credit for country X tax against income tax liability to another country. Accordingly, no portion of that tax is dependent on the availability of such a credit.

Example (3). Country X imposes tax on the realized net income of all corporations incorporated in country X. Country X allows a tax holiday to qualifying corporations incorporated in country X that are owned by nonresidents of country X, pursuant to which no country X tax is imposed on the net income of a qualifying corporation for the first ten years of its operations in country X. A corporation qualifies for the tax holiday if it meets certain minimum investment criteria and if the development office of country X certifies that in its opinion the operations of the corporation will be consistent with specified development goals of country X. The development office will not so certify to any corporation owned by persons resident in countries that allow a credit (such as that available under section 902 of the Internal Revenue Code) for country X tax paid by a corporation incorporated in country X. In practice, tax holidays are granted to a large number of corporations, but country X tax is imposed on a significant number of other corporations incorporated in country X (e.g., those owned by country X persons and those which have had operations for more than 10 years) in addition to corporations denied a tax holiday because their shareholders qualify for a credit for the country X tax against income tax liability to another country. In the case of corporations denied a tax holiday because they have U.S. shareholders, no portion of the country X tax during the period of the denied 10-year tax holiday is dependent on the availability of a credit for the country X tax against income tax liability to another country.

Example (4). The facts are the same as in example (3), except that corporations owned by persons resident in countries that will allow a credit for country X tax at the time when dividends are distributed by the corporations are granted a provisional tax holiday. Under the provisional tax holiday, instead of relieving such a corporation from country X tax for 10 years, liability for such tax is deferred until the corporation distributes dividends. The result is the same as in example (3).

(d) Separate levies.—(d)(1) In general. For purposes of sections 901 and 903, whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign law imposes the levy or levies in a single or separate statutes. A levy imposed by one taxing authority (e.g., the national government of a foreign country) is always separate for purposes of sections 901 and 903 from a levy imposed by another taxing authority (e.g., a political subdivision of that foreign country). Levies are not separate merely because different rates apply to different taxpayers. For example, a foreign levy identical to the tax imposed on U.S. citizens and resident alien individuals by section 1 of the Internal Revenue Code is a single levy notwithstanding the levy has graduated rates and applies different rate schedules to unmarried individuals, married individuals who file separate returns and married individuals who file joint returns. In general, levies are not separate merely because some provisions determining the base of the levy apply, by their terms or in practice, to some, but not all, persons subject to the levy. For example, a foreign levy identical to the tax imposed by section 11 of the Internal Revenue Code is a single levy even though some provisions apply by their terms to some but not all corporations subject to the section 11 tax (e.g., section 465 is by its terms applicable to corporations described in sections 465(a)(1)(B) and 465(a)(1)(C), but not to other corporations), and even though some provisions apply in practice to some but not all corporations subject to the section 11 tax (e.g., section 611 does not, in practice, apply to any corporation that does not have a qualifying interest in the type of property described in section 611(a)). However, where the base of a 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. For example, regardless of whether they are contained in a single or separate foreign statutes, a foreign levy identical to the tax imposed by section 871(b) of the Internal Revenue Code is a separate levy from a foreign levy identical to the tax imposed by section 1 of the Internal Revenue Code as it applies to persons other than those described in section 871(b), and foreign levies identical to the taxes imposed by sections 11, 541, 881, 882, 1491 and 3111 of the Internal Revenue Code are each separate levies, because the base of each of those levies differs in kind, and not merely in degree, from the base of each of the others. Accordingly, each such levy must be analyzed separately to determine whether it is an income tax within the meaning of paragraph (a)(1) of this section and whether it is a tax in lieu of an income tax within the meaning of paragraph (a) of § 1.903-1. Where foreign law imposes a levy that is the sum of two or more separately computed amounts, and each such amount is computed by reference to a separate base, separate levies are considered, for purposes of sections 901 and 903, to be imposed. A separate base may consist, for example, of a particular type of income or of an amount unrelated to income, e.g., wages paid. Amounts are not separately computed if they are computed separately merely for purposes of a preliminary computation and are then combined as a single base. In the case of levies that apply to dual capacity taxpayers, see also § 1.901-2A(a).i11 (2) Contractual modifications. Notwithstanding paragraph (d)(1) of this section, if foreign law imposing a levy is modified for one or more persons subject to the levy by a contract entered into by such person or persons and the foreign country, then foreign law is considered for purposes of sections 901 and 903 to impose a separate levy for all persons to whom such contractual modification of the levy applies, as contrasted to the levy as applied to all persons to whom such contractual modification does not apply. In applying the provisions of paragraph (c) of this section to a tax as modified by such a contract, the provisions of § 1.903-1(b)(2) shall apply.

(d)(3) Examples. The provisions of paragraph (d)(1) of this section may be illustrated by the following examples:

Example (1). A foreign statute imposes a levy on corporations equal to the sum of 15% of the corporation's realized net income plus 3% of its net worth. As the levy is the sum of two separately computed amounts, each of which is computed by reference to a separate base, each of the portion of the levy based on income and the portion of the levy based on net worth is considered, for purposes of sections 901 and 903, to be a separate levy.

Example (2). A foreign statute imposes a levy on nonresident alien individuals analogous to the taxes imposed by section 871 of the Internal Revenue Code. For the same reasons as set forth in example (1), each of the portion of the foreign levy analogous to the tax imposed by section 871(a) and the portion of the foreign levy analogous to the tax imposed by sections 871 (b) and 1, is considered, for purposes of sections 901 and 903, to be a separate levy.

Example (3). A single foreign statute or separate foreign statutes impose a foreign levy that is the sum of the products of specified rates applied to specified bases, as follows:

In computing each such base, deductible expenditures are allocated to type of income they generate. If allocated deductible expenditures exceed the gross amount of a specified type of income, the excess may not be applied against income of a different specified type. Accordingly, the levy is the sum of several separately computed amounts, each of which is computed by reference to a separate base. Each of the levies on mining net income, manufacturing net income, technical services net income, other services net income, investment net income and other net income is, therefore considered for purposes of sections 901 and 903, to be a separate levy.

Example (4). The facts are the same as in example (3), except that excess deductible expenditures allocated to one type of income are applied against other types of income to which the same rate applies. The levies on

mining net income and other services net income together are considered, for purposes of sections 901 and 903, to be a single levy since, despite a separate preliminary computation of the bases, by reason of the permitted application of excess allocated deductible expenditures, the bases are not separately computed. For the same reason, the levies on manufacturing net income, technical services net income and other net income together are considered, for purposes of sections 901 and 903, to be a single levy. The levy on investment net income is considered, for purposes of sections 901 and 903, to be a separate levy. These results are not dependent on whether the application of excess allocated deductible expenditures to a different type of income, as described above, is permitted in the same taxable period in which the expenditures are taken into account for purposes of the preliminary computation, or only in a different (e.g., later) taxable period.

Example (5). The facts are the same as in example (3), except that excess deductible expenditures allocated to any type of income other than investment income are applied against the other types of income (including investment income) according to a specified set of priorities of application. Excess deductible expenditures allocated to investment income are not applied against any other type of income. For the reason expressed in example (4), all of the levies are together considered, for purposes of sections 901 and 903, to be a single levy.

(e) Amount of Income tax that is creditable.—In general. Credit is allowed under section 901 for the amount of income tax (within the meaning of paragraph (a)(1) of this section) that is paid to a foreign country by the taxpayer. The amount of income tax paid by the taxpayer is determined separately for each taxpayer.

(e)(2) Refunds and credits.-(e)(2)(i) In general. An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.

(e)(2)(ii) Examples. the provisions of paragraph (e)(2)(i) of this section may be illustrated by the following examples:

Example (1). The internal law of country X imposes a 25 percent tax on the gross amount of interest from sources in country X that is received by a nonresident of country X. Country X law imposes the tax on the nonresident recipient and requires any resident of country X that pays such interest to a nonresident to withhold and pay over to country X 25 percent of such interest, which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and country X overrides internal law of country X and provides that country X may not tax interest received by a resident of the United States from a resident of country X at a rate in excess of 10 percent of the gross amount of such interest. A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percent of the gross amount of interest income) after the end of the taxable year. A, a resident of the United States, receives a gross amount of 100u (units of country X currency) of interest income from a resident of country X, from source in country X in the taxable year 1984, from which 25u of country X tax is withheld. A files a timely claim for refund of the 15u excess withheld amount, 15u of the amount withheld (25u-10u) is reasonably cetrain to be refunded; therefore 15u is not considered an amount of tax paid to country X.

Example (2). A's initial income tax liability under country X law is 100u (units of country X currency). However, under country X law A's initial income tax liability is reduced in order to compute its final tax liability by an investment credit of 15u and a credit for charitable contributions of 5u. The amount of income tax paid by A is 80u.

Example (3). A computes his income tax liability in country X for the taxable year 1984 as 100u (units of country X currency), files a tax return on that basis, and pays 100u of tax. The day after A files that return, A files a claim for refund of 90u. The difference between the 100u of liability reflected in A's original return and the 10u of liability reflected in A's refund claim depends on whether a particular expenditure made by A is nondeductible or deductible, respectively. Based on an analysis of the country X tax law, A's country X tax advisors have advised A that it is not clear whether or not that expenditure is deductible. In view of the uncertainty as to the proper treatment of the item in question under country X tax law, no portion of the 100u paid by A is reasonably certain to be refunded. If A receives a refund, A must treat the refund as required by section 905(c) of the Internal Revenue Code.

Example (4). A levy of country X, which qualifies as an income tax within the meaning of paragraph (a)(1) of this section, provides that each person who makes payment to country X pursuant to the levy will receive a bond to be issued by country X with an amount payable at maturity equal to 10 percent of the amount paid pursuant to the levy. A pays 38,000u (units of country X currency) to country X and is entitled to receive a bond with an amount payable at maturity of 3800u. It is reasonably certain that a refund in the form of property (the bond) will be made. The amount of that refund is equal to the fair market value of the bond. Therefore, only the portion of the 38,000u payment in excess of the fair market value of the bond is an amount of tax paid.

(e)(3) Subsidies.—(e)(3)(i) General rule. An amount is not an amount of income tax paid by a taxpayer to a foreign country to the extent that—

(A) The amount is used, directly or indirectly, by the country to provide a subsidy by any means (such as through a refund or credit) to the taxpayer; and

(B) The subsidy is determined, directly or indirectly, by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the taxpayer.

(e)(3)(ii) Indirect subsidies. A foreign country is considered to provide a subsidy to a taxpayer if the country provides a subsidy to another person that—

(A) Owns or controls, directly or indirectly, the taxpayer or is owned or controlled, directly or indirectly, by the taxpayer or by the same persons that own or control, directly or indirectly, the taxpayer, or

(B) Engages in a transaction with the taxpayer, but only if the subsidy received by such other person is determined, directly or indirectly, by reference to the amount of income tax, or the base used to compute the income tax, imposed by the country on the taxpayer with respect to such transaction.

(e)(3)(iii) Example. The provisions of this paragraph (e)(3) may be illustrated by the following example:

Example. Country X imposes a 30-percent tax on interest received by nonresident lenders from borrowers who are residents of country X, and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903-(1)(a). Country X remits to resident borrowers an incentive payment for engaging in foreign loans, which payment is an amount equal to 20 percent of the interest paid to nonresident lenders. Because the incentive payment is based on such interest, it is determined by reference to the base used to compute the tax in lieu of an income tax that is imposed on the nonresident lender. Under paragraph (e)(3)(ii)(B) of this section, the incentive payment is considered a subsidy provided indirectly to the nonresident lender since it is provided to a person (the borrower) that engaged in a business transaction with the lender and is based on the amount of tax in lieu of an income tax that is imposed on the lender with respect to this transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by a resident borrower from interest payments to a nonresident lender is not tax in lieu of an income tax that is paid by the lender under paragraph (e)(3)(i) of this section and § 1.903-1(a).

(e)(4) Multiple levies.—(e)(4)(i) In general. If under foreign law, a taxpayer's tentative liability for one levy (the "first levy") is or can be reduced by the amount of the taxpayer's liability for a different levy (the "second levy"), then the amount considered paid by the taxpayer to the foreign country pursuant to the second levy is an amount equal to its entire liability for that levy, and the remainder of the amount paid is considered paid pursuant to the first levy. This rule applies regardless of whether it is or is not likely that liability for one such levy will always exceed liability for the other such levy. For an example of the application of this rule, see example (5) of § 1.903-1(b)(3). If, under foreign law, the amount of a taxpayer's liability is the greater or lesser of amounts computed pursuant to two levies, then the entire amount paid to the foreign country by the taxpayer is considered paid pursuant to the levy that imposes such greater or lesser amount, respectively, and no amount is considered paid pursuant to such other levy.

(e)(4)(ii) Integrated tax systems. [Reserved]

(e)(5) Noncompulsory amounts.—(e)(5)(i) In general. An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Where foreign tax law includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a payment in excess of the taxpayer's liability for foreign tax. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (e.g., a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax.

(e)(5)(ii) Examples. The provisions of paragraph (e)(5)(i) of this section may be illustrated by the following examples:

Example (1). A, a corporation organized and doing business solely in the United States, owns all of the stock of B, a corporation organized in country X. In 1984 A buys merchandise from unrelated persons for $1,000,000, shortly thereafter resells that merchandise to B for $600,000, and B later in 1984 resells the merchandise to unrelated persons for $1,200,000. Under the country X income tax, which is an income tax within the meaning of paragraph (a)(1) of this section, all corporations organized in country X are subject to a tax equal to 3 percent of their net income. In computing its 1984 country X income tax liability B reports $600,000 ($1,200,000—$600,000) of profit from the purchase and resale of the merchandise referred to above. The country X income tax law requires that transactions between related persons be reported at arm's length prices, and a reasonable interpretation of this requirement, as it has been applied in country X, would consider B's arm's length purchase price of the merchandise purchased from A to be $1,050,000. When it computes its country X tax liability B is aware that $600,000 in not an arm's length price (by country X standards). B's knowing use of a non-arm's length price (by country X standards) of $600,000, instead of a price of $1,050,000 (an arm's length price under country X's law), is not consistent with a reasonable interpretation and application of the law of country X, determined in such a way as to reduce over time B's reasonably expected liability for country X income tax. Accordingly, $13,500 (3 percent of $450,000 ($1,050,000—$600,000)), the amount of country X income tax paid by B to country X that is attributable to the purchase of the merchandise from B's parent at less than an arm's length price, is in excess of the amount of B's liability for country X tax, and thus is not an amount of tax.

Example (2). A, a corporation organized and doing business solely in the United States, owns all of the stock of B, a corporation organized in country X. Country X has in force an income tax treaty with the United States. The treaty provides that the profits of related persons shall be determined as if the persons were not related. A and B deal extensively with each other. A and B, ,with repect to a series of transactions involving both of them, treat A as having $300,000 of income and B as having $700,000 of income for purposes of A's United States income tax and B's country X income tax, respectively. B has no actual or constructive notice that its treatment of these transactions under country X law is likely to be erroneous.

Subsequently, the Internal Revenue Service reallocates $200,000 of this income from B to A under the authority of section 482 and the treaty. This reallocation constitutes actual notice to A and constructive notice to B that B's interpretation and application of country X's law and the tax treaty is likely to be erroneous. B does not exhaust all effective and practical remedies to obtain a refund of the amount of country X income tax paid by B to country X that is attributable to the reallocated $200,000 of income. This amount is in excess of the amount of B's liability for country X tax and thus is not an amount of tax.

Example (3). The facts are the same as in example (2), except that B files a claim for refund (an administrative proceeding) of country X tax and A or B invokes the competent authority procedures of the treaty, the cost of which is reasonable in view of the amount at issue and the likelihood of success, Nevertheless, B does not obtain any refund of country X tax. The cost of pursuing any judicial remedy in country X would be unreasonable in light of the amount at issue and the likelihood of B's success, and B does not pursue any such remedy. The entire amount paid by B to country X is a compulsory payment and thus is an amount of tax paid by B.

Example (4). The facts are the same as in example (2), except that, when the Internal Revenue Service makes the reallocation, the country X statute of limitations on refunds has expired; and neither the internal law of the country X nor the treaty authorizes the the country X tax authorities to pay a refund that is barred by the statute of limitations. B does not file a claim for refund, and neither A nor B invokes the competent authority procedures of the treaty. Because the country X tax paying a refund, B has no effective and practicable remedies. The entire amount paid by B to country X is a compulsory payment and thus is an amount of tax paid by B.

Example (5). A is a U.S. person doing business in the country X. In computing its income tax liability to the country X. A is permitted, at its election to recover the cost of machinery used in its business either by deducting that cost in the year of acquisition or by depreciating that cost on the straight line method over a period of 2, 4, 6 or 10 years. A elects to depreciate machinery over 10 years. This election merely shifts A's tax liability to different years (compared to the timing of A's tax liability under a different depreciation period); it does not result in a payment in excess of the amount of A's liability for the country X income tax in any year since the amount of the country X tax paid by A is consistent with a reasonable interpretation of the country X law in such a way as to reduce over time A's reasonably expected liability for the country X tax. Because the standard of paragraph (e)(5(i) of this section refers to A's reasonably expected liability, not its actual liability, events actually occurring in subsequent years (e.g, whether A has sufficient profit in such years so that such depreciation deductions actually reduce A's the country X tax liability or whether the country X tax rates change) are immaterial.

Example (6). The internal law of the country X imposes a 25 percent tax on the gross amount of interest from sources in the country X that is received by a nonresident of the country X, the country X law imposes the tax on the nonresident recipient and requires any resident of the country X that pays such interest to a nonresident to withhold and pay over to the country X 25 percent of such interest which is applied to offset the recipient's liability for the 25 percent tax. A tax treaty between the United States and the country X overrides internal law of the country X and provides that the country X may not tax interest received by a resident of the United States from a resident of the country X at a rate in excess of 10 percent of the gross amount of such interest A resident of the United States may claim the benefit of the treaty only by applying for a refund of the excess withheld amount (15 percnet of the gross amount of interest income) after the end of the taxable year, A, a resident of the United States, receives a gross amount of 100u (units of the country X currency) of interest income from a resident of country X from sources in country X in the taxable year 1984 from which 25u of country X tax is withheld. A does not file a timely claim for refund. 15u of the amount withheld (25u-10u) is not a compulsory payment and hence is not an amount of tax.

(f) Taxpayer-(f)(1) In general. The person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax even if another person (e.g., a withholding agent) remits such tax. For purposes of this section § 1.901-2A and § 1.903-1, the person on whom foreign law imposes such liability is referred to as the “taxpayer.” A foreign tax of a type described in paragraph (a)(2)(ii)(c) of this section is considered to be imposed on the recipients of wages if such tax is deducted from such wages under provisions that are comparable to section 3102 (a) and (b) of the Internal Revenue Code.

(f)(2) Party undertaking tax obligation as part of transaction.—(f)(2)(i) In general. Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability. The rules of the foregoing sentence apply notwithstanding anything to the contrary in paragraph

(e)(3) of this section. See § 1.901-2A for additional rules regarding dual capacity taxpayers.

(f)(2)(ii) Examples. The provisions of paragraphs(f)(1) and (f)(2)(i) of this section may be illustrated by the following examples:

Example (1). Under a loan agreement between A, a resident of county X, and B, a United States person, A agrees to pay B a certain amount of interest net of any tax that country X may impose on B with respect to its interest income. Country X imposes a 10 percent tax on the gross amount of interest income received by nonresidents of country X from sources in country X and it is established that this tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a). Under the law of country X this tax is imposed on the nonresident recipient, and any resident of country X that pays such interest to a nonresident is required to withhold and pay over to country X 10 percent of the amount of such interest, which is applied to offset the recipient's liability for the tax. Because legal liability for the tax is imposed on the recipient of such interest income, B is the taxpayer with respect to the country X tax imposed on B's interest income from B's loan to A. Accordingly, B's interest income for federal income tax purposes includes the amount of country X tax that is imposed on B with respect to such interest income and that is paid on B's behalf by A pursuant to the loan agreement, and, under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by B.

Example (2). The facts are the same as in example (1), except that in collecting and receiving the interest B is acting as a nominee for, or agent of, C, who is a United States person. Because C (not B) is the beneficial owner of the interest, legal liability for the tax is imposed on C, not B (C's nominee or agent). Thus, C is the taxpayer with respect to the country X tax imposed on C's interest income from C's loan to A. Accordingly, C's interest income for federal income tax purposes includes the amount of country X tax that is imposed on C with respect to such interest income and that is paid on C's behalf by A pursuant to the loan agreement. Under paragraph (f)(2)(i) of this section, such tax is considered for purposes of section 903 to be paid by C. No such tax is considered paid by B.

Example (3). Country X imposes a tax called the “country X income tax.” A, a United States person engaged in construction activities in country X, is subject to that tax. Country X has contracted with A for A to construct a naval base. A is a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) and, in accordance with paragraphs (a)(1) and (c)(1) of § 1.901-2A, A has established that the country X income tax as applied to dual capacity persons and the country X income tax as applied to persons other than dual capacity persons together constitute a single levy. A has also established that that levy is an income tax within the meaning of paragraph (a)(1) of this section. Pursuant to the terms of the contract, country X has agreed to assume any country X tax liability that A may incur with respect to A's income from the contract. For federal income tax purposes, A's income from the contract includes the amount of tax liability that is imposed by country X on A with respect to its income from the contract and that is assumed by country X; and for purposes of section 901 the amount of such tax liability assumed by country X is considered to be paid by A. By reason of paragraph (f)(2)(i) of this section, country X is not considered to provide a subsidy, within the meaning of paragraph (e)(3) of this section, to A.

(f)(3) Taxes paid on combined income. If foreign income tax is imposed on the combined income of two or more related persons (for example, a husband and wife or a corporation and one or more of its subsidiaries) and they are jointly and severally liable for the income tax under foreign law, foreign law is considered to impose legal liability on each such person for the amount of the foreign income tax that is attributable to its portion of the base of the tax, regardless of which person actually pays the tax.

(g) Definitions. For purposes of this section and §§ 1.901-2A and 1.903-1, the following definitions apply:

(g)(1) The term “paid” means “paid or accrued”; the term “payment” means “payment or accrual”; and the term “paid by” means “paid or accrued by or on behalf of.”

(g)(2) The term “foreign country” means any foreign state, any possession of the United States, and any political subdivision of any foreign state or of any possession of the United States. The term “possession of the United States” includes Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa.

(g)(3) The term “foreign levy” means a levy imposed by a foreign country.

(h) Effective date.—(h)(1) In general. This section, § 1.901-2A, and § 1.903-1 apply to taxable years beginning after November 14, 1983. In addition, a person may elect to apply the provisions of this section, § 1.901-2A, and § 1.903-1 to earlier years. See paragraph (h)(2) of this section.

(h)(2) Election to apply regulations to earlier years.—(i)(i) Scope of election. An election to apply the provisions of this section,§ 1.901-2A, and § 1.903-1 to taxable years beginning on or before November 14, 1983, is made with respect to one or more foreign states and possessions of the United States with respect to a taxable year of the person making the election beginning on or before November 14, 1983. Such election requires all of the provisions of this section, § 1.901-2A, and § 1.903-1 to be applied to such taxable year and to all subsequent taxable years of the person making the election ("elected years"). If an election applies to a foreign state or to a possession of the United States ("election country"), it applies to all taxes of the election country and to all taxes of all political subdivisions of the election country. An election does not apply to foreign taxes carried forward to any elected year from any taxable year to which the election does not apply. Such election does apply to foreign taxes carried back or forward from any elected year to any taxable year.

(ii) Effect of election. An election to apply the regulations to earlier years has no effect on the limitations on assessment and collection or on the limitations on credit or refund (see Chapter 66 of the Internal Revenue Code).

(iii) Manner of making election. An election to apply the regulations to one or more earlier taxable years is made by attaching a statement to a return, amended return, or claim for refund for the earliest taxable year to which the election relates. Such statement shall state that the election is made and, unless the election is to apply to all foreign countries, the statement shall designate the election countries. In the absence of such a designation of the election countries, all foreign countries shall be election countries.

(iv) Time for making election. An election to apply the regulations to earlier taxable years must be made by October 12, 1984, except that if a person who has deducted (instead of credited) foreign taxes in its United States income tax return for such an earlier taxable year validly makes an election to credit (instead of deduct) such taxes in a timely filed amended return for such earlier taxable year and such amended return is filed after such date, an election to apply the regulations to such earlier taxable year must be made in such amended return.

(v) Revocation of election. An election to apply the regulations to earlier taxable years may not be revoked.

(vi) Affiliated groups. A member of an affiliated group that files a consolidated United States income tax return may apply the regulations to earlier years only if an election to so apply them has been made by the common parent of such affiliated group on behalf of all members of the group.

Approved by the Office of Management and Budget under control number 1545-0746.

26 CFR § 1.901

Par. 2. A new § 1.901-2A is added immediately after § 1.901-2 to read as follows:

26 CFR § 1.901

§ 1.901-2A Dual capacity taxpayers.

(a) Application of separate levy rules as applied to dual capacity taxpayers.—(a)(1) In general. If the application of a foreign levy (as defined in § 1.901-2(g)(3)) is different, either by the terms of the levy or in practice, for dual capacity taxpayers (as defined in § 1.901-2(a)(2)(ii)(A)) 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 considered to be related to the fact that dual capacity taxpayers receive, directly or indirectly, a specific economic benefit (as defined in § 1.901-2(a)(2)(ii)(B)) from the foreign country and thus to be a difference in kind, and not merely of degree. In such a case, notwithstanding any contrary provision of § 1901-2(d), the levy as applicable to such dual capacity tax payers is a separate levy (within the meaning of § 1.901-2(d)) from the levy as applicable to such other persons, regardless of whether such difference is in the base of

the levy, in the rate of the levy, or both. In such a case, each of the levy as applied to dual capacity taxpayers and the levy as applied to other persons must be analyzed separately to determine whether it is an income tax within the meaning of § 1.901-2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of § 1.903-1(a). However, if the application of the levy is neither different by its terms nor different in practice for dual capacity taxpayers from its application to other persons, or if the only difference is that a lower rate (but the same base) applies to dual capacity taxpayers, then, in accordance with § 1.901-2(d), such foreign levy as applicable to dual capacity taxpayers and such levy as applicable to other persons together constitute a single levy. In such a case, no amount paid (as defined in § 1.901-2(g)(1)) pursuant to such levy by any such dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit, and such levy, as applicable in the aggregate to such dual capacity taxpayers and to such other persons, is analyzed to determine whether it is an income tax within the meaning of § 1.901-2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903-1(a). Application of a foreign levy to dual capacity taxpayers will be considered to be different in practice from application of that levy to other persons, even if no such difference is apparent from the terms of the levy, unless it is established that application of that levy to dual capacity taxpayers does not differ in practice from its application to other persons.

(a)(2) Examples. The provisions of paragraph (a)(1) of this section may be illustrated by the following examples:

Example (1). Under a levy of country X called the country X income tax, every corporation that does business in country X is required to pay to country X 40 percent of its income from its business in country X. Income for purposes of the country X income tax is computed by subtracting specified deductions from the corporation's gross income derived from its business in country X. The specified deductions include the corporation's expenses attributable to such gross income and allowances for recovery of the cost of capital expenditures attributable to such gross income, except that under the terms of the country X income tax a corporation engaged in the exploitation of minerals K, L or M in country X is not permitted to recover, currently or in the future, expenditures it incurs in exploring for those minerals. In practice, the only corporations that engage in exploitation of the specified minerals in country X are dual capacity taxpayers. Thus, the application of the country X income tax to dual capaacity taxpayers is different from its application to other corporations. The country X income tax as applied to corporations that engage in the exploitation of minerals K, L or M (dual capacity taxpayers) is, therefore, a separate levy from the country X income tax as applied to other corporations. Accordingly, each of (i) the country X income tax as applied to such dual capacity taxpayers and (ii) the country X income tax as applied to such other persons, must be analyzed separately to determine whether it is an income tax within the meaning of § 1.901-2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of § 1.903-1(a).

Example (2). The facts are the same as in example (1), except that it is demonstrated that corporations that engage in exploitation of the specified minerals in country X and that are subject to the levy include both dual capacity taxpayers and other persons. The country X income tax as applied to all corporations is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X income tax by a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X income tax is an income tax within the meaning of § 1.901-2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903-1(a), it will be so considered in its entirely for all corporations subject to it.

Example (3). Under a levy of country Y called the country Y income tax, each corporation incorporated in country Y is required to pay to country Y a percentage of its worldwide income. The applicable percentage is greater for such corporations that earn more than a specified amount of income than for some corporations that earn less than that amount. Income for purposes of the levy is computed by deducting from gross income specified types of expenses and specified allowances for capital expenditures. The expenses for which deductions are permitted differ depending on the type of business in which the corporation subject to the levy is engaged, e.g., a deduction for interest paid to a related party is not allowed for corporations engaged in enumerated types of activities. In addition, carryover of losses from one taxable period to another is permitted for corporations engaged in specified types of activities, but not for corporations engaged in other activities. By its terms, the foreign levy makes no distinction between dual capacity taxpayers and other persons. It is established that in practice the higher rate of the country Y income tax applies to both dual capacity taxpayers and other persons and that in practice the differences in the base of the country Y income tax (e.g., the lack of a deduction for interest paid to related parties for some corporations subject to the levy and the lack of a carryover provision for some corporations subject to the levy) apply to both dual capacity taxpayers and other persons. The country Y income tax as applied to all corporations incorporated in country Y is therefore a single levy. Accordingly, no amount paid pursuant to the country Y income tax by a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and if the country Y income tax is an income tax within the meaning of § 1.901-2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903-1(a), it will be so considered in its entirety for all persons subject to it.

Example (4). The facts are the same as in example (3), except that it is not established that in practice the higher rate does not apply only to dual capacity taxpayers. By reason of such higher rate, application of the country Y income tax to dual capacity taxpayers is different in practice from application of the country Y income tax to other persons subject to it. The country Y income tax as supplied to dual capacity taxpayers is therefore a separate levy from the country Y income tax as applied to other corporations incorporated in country Y. Accordingly, each of (i) the country Y income tax as applied to dual capacity taxpayers and (ii) the country Y income tax as applied to other corporations incorporated in country Y, must be analyzed separately to determine whether it is an income tax within the meaning of § 1.901-2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of § 1.903-1(a).

Example (5). Under a levy of country X called the country X tax, all persons who do not engage in business in country X and who receive interest income from residents of country X are required to pay to country X 25 percent of the gross amount of such interest income. It is established that the country X tax applies by its terms and in practice to certain banks that are dual capacity taxpayers and to persons who are not dual capacity taxpayers and that application to such dual capacity taxpayers does not differ by its terms or in practice from application to such other persons. The country X tax as applied to all such persons (both the dual capacity taxpayers and the other persons) is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X tax by such a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a), it will be so considered in its entirety for all persons subject to it.

Example (6). Under a levy of country X called the country X tax, every corporation incorporated outside of country X ("foreign corporation") that maintains a branch in country X is required annually to pay to country X 52 percent of its net income attributable to that branch. It is established that the application of the country X tax is neither different by its terms nor different in practice for certain banks that are dual capacity taxpayers from its application to persons (which may, but do not necessarily, include other banks) that are not dual capacity taxpayers. The country X tax as applied to all foreign corporations with branches in country X (i.e., both those banks that are dual capacity taxpayers and the foreign corporations that are not dual capacity taxpayers) is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X tax by a bank that is a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X tax is an income tax within the meaning of § 1.901-2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903-1(a), it will be so considered in its entirety for all persons subject to it.

Example (7). Under a levy of country H called the country H tax, all corporations that are organized outside country H and that do not engage in business in country H are required to pay to country H a percentage of the gross amount of interest income derived from residents of country H. The percentage is 30 percent, except that it is 15 percent for a specified category of corporations. All corporations in that category are dual capacity taxpayers. It is established that the country H tax applies by its terms and in practice to dual capacity taxpayers and to persons that are not dual capacity taxpayers and that the only difference in application between such dual capacity taxpayers and such other persons is that a lower rate (but the same base) applies to such dual capacity taxpayers. The country H tax as applied to all such persons (both the dual capacity taxpayers and the other persons) is, therefore, a single levy. Accordingly, no amount paid pursuant to the country H tax by such a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit, and if the country H tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a), it will be so considered in its entirety for all persons subject to it.

(b) Burden of proof for dual capacity taxpayers.—(b)(1) In general. For credit to be allowable under section 901 or 903, the person claiming credit must establish that the foreign levy with respect to which credit is claimed is an income tax within the meaning of § 1.901-2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903-1(a), respectively. Thus, such person must establish, among other things, that such levy is a tax. See § 1.901-2(a)(2)(i) and § 1.903-1(a). Where a person claims credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to a foreign levy, § 1.901-2(a)(2)(i) and § 1.903-1(a), respectively, require such person to establish the amount, if any, that is paid pursuant to the distinct element of the levy that is a tax. If, pursuant to paragraph (a)(1) of this section and § 1.901-2(d), such levy as applicable to dual capacity taxpayers and such levy as applicable to other persons together constitute a single levy, then no amount paid pursuant to that levy by any such dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit. Accordingly, such levy has only one distinct element, and the levy either is or is not, in its entirety, a tax. If, however, such levy as applicable to dual capacity taxpayers is a separate levy from such levy as applicable to other persons, then a person claiming credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to such separate levy may establish the amount, if any, that is paid pursuant to the distinct element of the levy that is a tax only by the facts and circumstances method or the safe harbor method described in paragraph (c) of this section. If such person fails to so establish such amount, no portion of the amount that is paid pursuant to the separate levy by the dual capacity

taxpayer to such foreign country shall be treated as an amount of tax. Any amount that, either by reason of application of the methods of paragraph (c) of this section or by reason of the immediately preceding sentence, is not treated as an amount of tax shall (i) be considered to have been paid in exchange for a specific economic benefit; (ii) be characterized (e.g., as royalty, purchase price, cost of sales, reduction of the proceeds of a sale, or reduction of interest income) according to the nature of the transaction and of the specific economic benefit received; and (iii) be treated according to such characterization for all purposes of Chapter 1 of the Internal Revenue Code, except that any determination that an amount is not tax for purposes of section 901 or 903 by reason of application of the safe harbor method shall not be taken into account in determining whether or not such an amount is to be characterized and treated as tax for purposes of computing an allowance for percentage depletion under sections 611 and 613.

(b)(2) Effect of certain treaties. If, irrespective of whether such credit would be allowable under section 901 or 903 in the absence of a treaty, the United States has in force a treaty with a foreign country that treats a foreign levy as an income tax for purposes of allowing credit for United States tax and if the person claiming credit is entitled to the benefit of such treaty, then, unless such person claims credit not under the treaty but under section 901 or 903, and except to the extent the treaty provides otherwise and subject to all terms, conditions and limitations provided in the treaty, no portion of an amount paid with respect to such levy by a dual capacity taxpayer shall be considered to be paid in exchange for a specific economic benefit. If, however, such person claims credit not under such treaty but rather under section 901 or 903 (e.g., so as not to be subject to a limitation contained in such treaty), the provisions of this section apply to such levy.

(c) Satisfaction of burden of proof.—(c)(1) In general. This paragraph (c) sets out the methods by which a person who claims credit under section 901 or 903 for an amount paid by a dual capacity taxpayer pursuant to a foreign levy that satisfies all of the criteria of section 901 or 903 other than the determination of the distinct element of the levy that is a tax and of the amount that is paid pursuant to that distinct element (a “qualifying levy”) may establish such distinct element and amount. Such person must establish the amount paid pursuant to a qualifying levy that is paid pursuant to the distinct element of the levy that is a tax (which amount therefore is an amount of income tax within the meaning of § 1.901-2(a)(1) or an amount of tax in lieu of income tax within the meaning of § 1.903-1(a) (a “qualifying amount”)) only by the facts and circumstances method set forth in paragraph (c)(2) of this section or the safe harbor method set forth in paragraph (c)(3) of this section. A levy is not a qualifying levy, and neither the facts and circumstances method nor the safe harbor method applies to an amount paid by a dual capacity taxpayer pursuant to a foreign levy, if it has been established pursuant to § 1.901-2(d) and paragraph (a)(1) of this section that that levy as applied to that dual capacity taxpayer and that levy as applied to persons other than dual capacity taxpayers together constitute a single levy, or if it has been established in accordance with the first sentence of paragraph (b)(2) of this section that credit is allowable by reason of a treaty for an amount paid with respect to such levy.

(c)(2) Facts and circumstances method.—(c)(2)(i) In general. If the person claiming credit establishes, based on all of the relevant facts and circumstances, the amount, if any, paid by the dual capacity taxpayer pursuant to the qualifying levy that is not paid in exchange for a specific economic benefit, such amount is the qualifying amount with respect to such qualifying levy. In determining the qualifying amount with respect to a qualifying levy under the facts and circumstances method, neither the methodology nor the results that would have obtained if a person had elected to apply the safe harbor method to such qualifying levy is a relevant fact or circumstance. Accordingly, neither such methodology nor such results shall be taken into account in applying the facts and circumstances method.

(c)(2)(ii) Examples. The application of the facts and circumstances method is illustrated by the following examples:

Example (1). Country A which does not have a generally imposed income tax, imposes a levy called the country A income tax, on corporations that carry on the banking business through a branch in country A. All such corporations lend money to the government of country A, and the consideration (interest) paid by the government of country A for the loans is not made available by the government on substantially the same terms to the population of country A in general. Thus, the country A income tax is imposed only on dual capacity taxpayers. L, a corporation that carries on the banking business through a branch in country A and that is a dual capacity taxpayer, establishes that all of the criteria of section 901 are satisfied by the country A income tax, except for the determination of the distinct element of the levy that is a tax and of L's qualifying amount with respect thereto. The country A income tax is, therefore a qualifying levy. L establishes that, although all persons subject to the country A income tax are dual capacity taxpayers, the country A income tax applies in the same manner to income from such persons' transactions with the government of country A as it does to income from their transactions with private persons; that there are significant transactions (either in volume or in amount) with private persons; and that the portion of such persons' income that is derived from transactions with the government of country A on the one hand or private persons on the other varies greatly among persons subject to the country A income tax. By making this showing, L has demonstrated that no portion of the amount paid by it to country A pursuant to the levy is paid in exchange for a specific economic benefit (the interest income). Accordingly, L has demonstrated under the facts and circumstances method that the entire amount it has paid pursuant to the country A income tax is a qualifying amount.

Example (2). A, a domestic corporation that is a dual capacity taxpayer subject to a qualifying levy of country X, pays 1000u (units of country X currency) to country X in 1986 pursuant to the qualifying levy. A does not elect to apply the safe harbor method to country X, but if had so elected, 800u would have been A's qualifying amount with respoect to the levy. Based on all of the relevant facts and circumstances (which do not include either the methodology of the safe harbor method or the qualifying amount that would have obtained under that method), A establishes that 628u of such 1000u is not paid in exchange for a specific economic benefit. A has demonstrated under the facts and circumstances method that 628u is a qualifying amount. Pursuant to paragraph (b)(1) of this section, 372u (1000u-628u) is considered to have been paid by A in exchange for a specific economic benefit. That amount is characterized and treated as provided in paragraph (b)(1) of this section.

Example (3). The facts are the same as in example (2) except that under the safe harbor method 580u would have been A's qualifying amount with respect to the levy. That amount is not a relevant fact or circumstance and the result is the same as in example (2).

(c)(3) Safe harbor method. Under the safe harbor method, the person claiming credit makes an election as provided in paragraph (d) of this section and, pursuant to such election, applies the safe harbor formula described in paragraph (e) of this section to the qualifying levy or levies to which the election applies.

(d) Election to use the safe harbor method.—(d)(1) Scope of election. An election to use the safe harbor method is made with respect to one or more foreign states and possessions of the United States with respect to a taxable year of the person making the election (the “electing person”). Such election applies to such taxable year and to all subsequent taxable years of the electing person (“election years”), unless the election is revoked in accordance with paragraph (d)(4) of this section. If an election applies to a foreign state or possession of the United States

(“elected country”), it applies to all qualifying levies of the elected country and to all qualifying levies of all political subdivisions of the elected country with respect to which the electing person claims credit for amounts paid (or deemed to be paid) by any dual capacity taxpayer. A member of an affiliated group that files a consolidated United States income tax return may use the safe harbor method for a foreign state or U.S. possession only if an election to use the safe harbor method for that state or possession has been made by the common parent of such affiliated group on behalf of all members of the group. Similarly, a member of an affiliated group that does not file a consolidated United States income tax return may elect to use the safe harbor method for a foreign state or U.S. possession only if an election to use the safe harbor method for that state or possession is made by each member of the affiliated group which claims credit for taxes paid to such state or possession or to any political subdivision thereof. An election to use the safe harbor method for an elected country does not apply to foreign taxes carried back or forward to any election year from any taxable year to which the election does not apply. Such election does apply to foreign taxes carried back or forward from any election year to any taxable year. A person who elects to use the safe harbor method for one or more foreign countries may, in a later taxable year, also elect to use that method for other foreign countries.

(d)(2) Effect of election. An election to use the safe harbor method described in paragraph (c)(3) of this section requires the electing persons to apply the safe harbor formula of paragraph (e) of this section to all qualifying levies of all elected countries and their political subdivisions, and constitutes a specific waiver by such person of the right to use the facts and circumstances method described in paragraph (c)(2) of this section with respect to any levy of any elected country or any political subdivision thereof.

(d)(3) Time and manner of making election.—(d)(3)(i) In general. To elect to use the safe harbor method, an electing person must attach a statement to its United States income tax return for the taxable year for which the election is made and must file such return by the due date (including extensions) for the filing thereof. Such statement shall state—

(A) That the electing person elects to use the safe harbor method for the foreign states and the possessions of the United States designated in the statement and their political subdivisions, and

(B) That the electing person waives the right, for any election year, to use the facts and circumstances method for any levy of the designated states, possessions and political subdivisions. Notwithstanding the foregoing, a person may, with the consent of the Commissioner, elect to use the safe harbor method for a taxable year for one or more foreign states or possessions of the United States, at a date later than that specified in the first sentence of this paragraph (d)(3)(i) e.g., upon audit of such person's United States income tax return for such taxable year. The Commissioner will normally consent to such a later election if such person demonstrates that it failed to make a timely election for such a foreign state or possession for such taxable year because such person reasonably believed either that it was not a dual capacity taxpayer with respect to such state or possession or any political subdivisin thereof was possession or any political subdivision thereof was a qualifying levy (for example, because it reasonably, but incorrectly, believed that the levy it paid was not a separate levy from that applicable to persons other than dual capacity taxpayers). The Commissioner will not, however, consent to such a later election with respect to any state or possession for a taxable year if such person (or any other member of an affiliated group of which such person is a member) applied the facts and circumstances method to any levy of such state or possession or any political subdivision thereof for such taxable year.

(d)(3)(ii) Certain retroactive elections. Not withstanding the requirements of paragraph (d)(3)(i) of this section relating to the time and manner of making an election, an election may be made for a taxable year beginning on or before November 14, 1983, provided the electing person elects in accordance with § 1.901-2(h) to apply all of the provisions of this section, § 1.901-2 and § 1.903-1 to such taxable year and provided all of the requirements set forth in this paragraph (d)(3)(ii) are satisfied. Such an election shall be made by timely (including extensions) filing a federal income tax return or an amended federal income tax return for such taxable year; by attaching to such return a statement containing the statements and information set forth in paragraph (d)(3)(i) of this section; and by filing amended income tax returns for all subsequent election years for which income tax returns have previously been filed in which credit is claimed under section 901 or 903 and applying the safe harbor method in such amended returns. All amended returns referred to in the immediately preceding sentence must be filed on or before October 12, 1984, (unless the Commissioner consents to a later filing in circumstances similar to those provided in paragraph (d)(3)(i)) and at a time when neither assessment of a deficiency for any of such election years nor the filing of a claim for any refund claimed in any such amended return is barred.

(d)(3)(iii) Election to credit taxes made in amended return. If a person has filed a United States income tax return for a taxable year to which this § 1.901-2A applies (including application by reason of the election provided in § 1.901-2(h)(2)) in which such person has deducted (instead of credited) qualifying foreign taxes and such person validly makes an election to credit (instead of deduct) such taxes in a timely filed amended return for such taxable year, an election to use the safe harbor method may be made in such amended return provided all of the requirements of paragraph (d)(3)(ii) of this section are satisfied other than the requirement that such amended return and the other amended returns referred to in that paragraph be filed on or before October 12, 1984.

(d)(4) Revocation of election. An election to use the safe harbor method described in paragraph (c)(3) of this section may not be revoked without the consent of the Commissioner. An application for consent to revoke such election with respect to one or more elected countries shall be made to the Commissioner of Internal Revenue, Washington, D.C. 20224. Such application shall be made not later than the 30th day before the due date (including extensions) for the filing of the income tax return for the first taxable year for which the revocation is sought to be effective, except in the case of an event described in (i), (ii), (iii), or (iv) below, in which case an application for revocation with retroactive effect may be made within a reasonable time after such event. The Commissioner may make his consent to any revocation conditioned upon adjustments being made in one or more taxable years so as to prevent the revocation from resulting in a distortion of the amount of any item relating to tax liability in any taxable year. The Commissioner will normally consent to a revocation (including, in the case of (i), (ii), (iii) or (iv) below, one with retroactive effect), if—

(d)(4)(i) An amendment to the Internal Revenue Code or the regulations thereunder is made which applies to the taxable year for which the revocation is to be effective and the amendment substantially affects the taxation of income from sources outside the United States under subchapter N of Chapter 1 of the Internal Revenue Code; or

(d)(4)(ii) After a safe harbor election is made with respect to a foreign state, a tax treaty between the United States and that state enters into force; that treaty covers a foreign tax to which the safe harbor election applies; and that treaty applies to the taxable year for which the revocation is to be effective; or

(d)(4)(iii) After a safe harbor election is made with respect to a foreign state or possession of the United States, a material change is made in the tax law of that state or possession or of a political subdivision of that state or possession; and the changed law applies to the taxable year for which the revocation is to be effective and has a material effect on the taxpayer; or (d)(4)(iv) With respect to a foreign country to which a safe harbor election applies, the Internal Revenue Service issues a letter ruling to the electing person and that letter ruling (A) relates to the availability or application of the safe harbor method to one or more levies of such foreign country; (B) does not relate to the facts and circumstances method described in paragraph (c)(2) of this section; and (C) fails to include a ruling requested by the electing person or includes a ruling contrary to one requested by such person (in either case, other than one relating to the facts and circumstances method) and such failure or inclusion has a material adverse effect on the amount of such electing person's credit for taxes paid to such foreign country for the taxable year for which the revocation is to be effective; or

(d)(4)(v) A corporation ("new member") becomes a member of an affiliated group; the new member and one or more pre-existing members of such group are dual capacity taxpayers with respect to the same foreign country; and, with respect to such country, either the new member or the pre-existing members (but not both) have made a safe harbor election; and the Commissioner in his discretion determines that obtaining the benefit of the right to revoke the safe harbor election with respect to such foreign country was not the principal purpose of the affiliation between such new member and such group; or

(d)(4)(vi) The election has been in effect with respect to at least three taxable years prior to the taxable year for which the revocation is to be effective. The Commissioner may, in his discretion, consent to a revocation even if none of the foregoing subdivisions (i) through (vi) is applicable. if an election has been revoked with respect to an elected country, a subsequent election to apply the safe harbor method with respect to such elected country may be made only with the consent of the Commissioner and upon such terms and conditions as the Commissioner in his discretion may require.

(e) Safe harbor formula.—(e)(1) In general. The safe harbor formula applies to determine the distinct element of a qualifying levy that is a tax and the amount paid by a dual capacity taxpayer pursuant to such qualifying levy that is the qualifying amount with respect to such levy. Under the safe harbor formula the amount paid in a taxable year pursuant to a qualifying levy that is the qualifying amount with respect to such levy is an amount equal to:

$(A-B-C)xD/(1-D)$

where: (except as otherwise provided in paragraph (e)(5) of this section)

A=the amount of gross receipts as determined under paragraph (e)(2) of this section

B=the amount of costs and expenses as determined under paragraph (e)(2) of this section

C=the total amount paid in the taxable year by the dual capacity taxpayer pursuant to the qualifying levy (the "actual payment amount")

D=the tax rate as determined under paragraph (e)(3) of this section

In no case, however, shall the qualifying amount exceed the actual payment amount; and the qualifying amount is zero if the safe harbor formula yields a qualifying amount less than zero. The safe harbor formula is intended to yield a qualifying amount equal to the amount of generally imposed income tax within the meaning of paragraphs (a) and (b)(1) of § 1.903-1 ("general tax") of the foreign country that would have been required to be paid in the taxable year by the dual capacity taxpayer if it has not been a dual capacity taxpayer and if the base of the general tax had allowed a deduction in such year for the amount ("specific economic benefit amount") by which the actual payment amount exceeds the qualifying amount. See, however, paragraph (e)(5) of this section if an elected country has no general tax. The specific economic benefit amount is considered to be the portion of the actual payment amount that is paid pursuant to the distinct portion of the qualifying levy that imposes an obligation in exchange for a specific economic benefit. The specific economic benefit amount is therefore considered to be an amount paid by the dual capacity taxpayer in exchange for such specific economic benefit, which amount must be treated for purposes of chapter 1 of the Internal Revenue Code as provided in paragrpah (b)(1) of this section.

(e)(2) Determination of gross receipts and costs and expenses. For purposes of the safe harbor formula, gross receipts and costs and expenses are, except as otherwise provided in this paragraph (e), the gross receipts and the deductions for costs and expenses, respectively, as determined under the foreign law applicable in computing the actual payment amount of the qualifying levy to which the safe harbor formula applies. However, except as otherwise provided in this paragraph (e), if provisions of the qualifying levy increase or decrease the liability imposed on dual capacity taxpayers compared to the general tax liability of persons other than dual capacity taxpayers by reason of the determination or treatment of gross receipts or of costs or expenses, the provisions generally applicable in computing such other persons' tax base under the general tax shall apply to determine gross receipts and costs and expenses for purposes of computing the

qualifying amount. If provisions of the qualifying levy relating to gross receipts meet the requirements of § 1.901-2(b) (3)(i), such provisions shall apply to determine gross receipts for purposes of computing the qualifying amount. If neither the general tax nor the qualifying levy permits recovery of one or more costs or expenses, and by reason of the failure to permit such recovery the qualifying levy does not satisfy the net income requirement of § 1.901-2(b)(4) (even though the general tax does satisfy that requirement), then such cost or expense shall be considered a cost or expense for purposes of computing the qualifying amount. If the qualifying levy does not permit recovery of one or more significant costs or expenses, but provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, then, for purposes of computing the qualifying amount, costs and expenses shall not include the costs and expenses under the general tax whose nonrecovery under the qualifying levy is compensated for by such allowances but shall instead include such allowances. In determining costs and expenses for purposes of computing the qualifying amount with respect to a qualifying levy, the actual payment amount with respect to such levy shall not be considered a cost or expense. For purposes of this paragraph, the following differences in gross receipts and costs and expenses between the qualifying levy and the general tax shall not be considered to increase the liability imposed on dual capacity taxpayers compared to the general tax liability of persons other than dual capacity taxpayers, but only if the general tax would be an income tax within the meaning of § 1.901-2(a)(1) if such different treatment under the qualifying levy had also applied under the general tax:

(e)(2)(i) Differences in the time of realization or recognition of one or more items of income or in the time when recovery of one or more costs and expenses is allowed (unless the period of recovery of such costs and expenses pursuant to the qualifying levy is such that it effectively is a denial of recovery of such costs and expenses, as described in § 1.901-2(b)(4)(i)); and

(e)(2)(ii) Differences in consolidation or carryover provisions of the types described in paragraphs (b)(4)(ii) and (b)(4)(iii) of § 1.901-2.

(e)(3) Determination of tax rate. The tax rate for purposes of the safe harbor formula is the tax rate (expressed as a decimal) that is applicable in computing tax liability under the general tax. If the rate of the general tax varies according to the amount of the base of that tax, the rate to be applied in computing the qualifying amount is the rate that applies under the general tax to a person whose base is, using the terminology of paragraph (e)(1) of this section, "A" minus "B" minus the specific economic benefit amount paid by the dual capacity taxpayer pursuant to the qualifying levy, provided such rate applies in practice to persons other than dual capacity taxpayers, or, if such rate does not so apply in practice, the next lowest rate of the general tax that does so apply in practice.

(e)(4) Determination of applicable provisions of general tax.—(e)(4)(i) In general. 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 small 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 (e.g., because the general tax treats an entity that is organized in the foreign country or managed or controlled there 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), and if some of the dual capacity taxpayer's income would, under the general tax, be treated as business income and some as non-business income, the dual capacity taxpayer and its income shall be so treated in computing the qualifying amount.

(e)(4)(ii) Establishing that provisions apply in practice. For purposes of the safe harbor formula a provision (including tax rate) shall be considered a provision of the general tax only if it is reasonably likely that that provision applies by its terms and in practice to persons other than dual capaciaty taxpayers. In general, it will be assumed that a provision (including tax rate) that by its terms applies to persons other than dual capacity taxpayers is reasonably likely to apply in practice to such other persons, unless the person claiming credit knows or has reason to know otherwise. However, in cases of doubt, the person claiming credit may be required to demonstrate that such provision is reasonably likely so to apply in practice.

(e)(5) No general tax. If a foreign country does not impose a general tax (and thus a levy, in order to be a qualifying levy must satisfy all of the criteria of section 901 (because section 903 cannot apply), other than the determination of the distinct element of the levy that is a tax and of the amount that is paid pursuant to that distinct element), paragraphs (e)(2), (3) and (4) of this section do not apply to a qualifying levy of such country, and the terms of the safe harbor formula set forth in paragraph (e)(1) of this section are defined with respect to such levy as follows:

A=the amount of gross receipts as determined under the qualifying levy;

B=the amount of deductions for costs and expenses as determined under the qualifying levy;

C=the actual payment amount; and

D=the lower of the rate of the qualifying levy, or the rate of tax specified in section 11(b)(5) (or predecessor or successor section, as the case may be) of the Internal Revenue Code as applicable to the taxable year in which the actual payment amount is paid.

(e)(6) Certain taxes in lieu of an income tax. To the extent a tax in lieu of an income tax (within the meaning of § 1.903-1(a)) that applies in practice to persons other than dual capacity taxpayers would actually have been required to be paid in the taxable year by a dual capacity taxpayer if it had not been a dual capacity taxpayer (e.g., in substitution for the general tax with respect to a type of income, such as interest income, dividend income, royalty income, insurance income), such tax in lieu of an income tax shall be treated as if it were an application of the general tax for purposes of applying the safe harbor formula of this paragraph (e) to such dual capacity taxpayer, and such formula shall be applied to yield a qualifying amount that is approximately equal to the general tax (so defined) that would have been required to be paid in the taxable year by such dual capacity taxpayer if the base of such general tax had allowed a deduction in such year for the specific economic benefit amount.

(e)(7) Multiple levies. If, in any election year of an electing person, with respect to any elected country and all of its political subdivisions,

(e)(7)(i) Amounts are paid by a dual capacity taxpayer pursuant to more than one qualifying levy or pursuant to one or more levies that are qualifying levies and one or more levies that are not qualifying levies by reason of the last sentence of paragraph (c)(1) of this section but with respect to which credit is allowable, or

(e)(7)(ii) More than one general tax (including a tax treated as if it were an application of the general tax under paragraph (e)(6)) would have been required to be paid by a dual capacity taxpayer (or taxpayers) if it (or they) had not been a dual capacity taxpayer (or taxpayers), or

(e)(7)(iii) Credit is claimed with respect to amounts paid by more than one dual capacity taxpayer, the provisions of this paragraph (e) shall be applied such that the aggregate qualifying amount with respect to such qualifying levy or levies plus the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies shall be the aggregate amount that would have been required to be paid in the taxable year by such dual capacity taxpayer (or taxpayers) pursuant to such general tax or taxes if it (or they) had not been a dual capacity taxpayer (or taxpayers) and if the base of such general tax or taxes had allowed a deduction in such year for the aggregate specific economic benefit amount (except that, if paragraph (e)(5) applies to any levy of such elected country or any political subdivision thereof, the aggregate qualifying amount for qualifying levies of such elected country and all of its political subdivisions plus the aggregate amount paid with respect to levies referred to the paragraph (e)(7)(i) that are not qualifying levies shall not exceed the greater of the aggregate amount paid with respect to levies referred to in paragraph (e)(7)(i) that are not qualifying levies and the amount determined in accordance with paragraph (e)(5) where "D" is the rate of tax specified in section 11(b)(5) (or predecessor or successor section, as the case may be) of the Internal Revenue Code as applicable to the taxable year in which the actual payment amount is paid). However, in no event shall such aggregate amount exceed the aggregate actual payment amount plus the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies, nor be less than the aggregate amount paid with respect to levies referred to in (e)(7)(i) that are not qualifying levies. In applying (e)(7)(ii) a person who is not subject to a levy but who is considered to receive a specific economic benefit by reason of § 1.901-2(a)(2)(ii)(E) shall be treated as a dual capacity taxpayer. See example (12) in paragraph (e)(8) of this section.

(e)(8)Examples. The provisions of this paragraph (e) may be illustrated by the following examples:

Example (1). Under a levy of country X called the country X income tax, every corporation that does business in country X is required to pay to country X 40% of its income from its business in country X. Income for purposes of the country X income tax is computed by subtracting specified deductions from the corporation's gross income derived from its business in country X. The specified deductions include the corporation's expenses attributable to such gross income and allowances for recovery of the cost of capital expenditures attributable to such gross income, except that under the terms of the country X income tax a corporation engaged in the exploitation of minerals K, L or M in country X is not permitted to recover, currently or in the future, expenditures it incurs in exploring for those minerals. Under the terms of the country X income tax interest is not deductible to the extent it exceeds an arm's length amount (e.g., if the loan to which the interest relates is not in accordance with normal commercial practice or to the extent the interest rate exceeds an arm's length rate). In practice, the only corporations that engage in exploitation of the specified minerals in country X are dual capacity taxpayers. Because no other persons subject to the levy engage in exploitation of minerals K, L or M, in country X, the application of the country X income tas to dual capacity taxpayers is different from its application to other corporations. The country X income tax as applied to corporations that engage in the exploitation of minerals K, L, or M (dual capacity taxpayers) is, therefore, a separate levy from the country X income tax as applied to other corporations.

A is a U.S. corporation that is engaged in country X in exploitation of mineral K. Natural deposits of mineral K in country X are owned by country X, and A has been allowed to extract mineral K in consideration of payment of a bonus and of royalties to an instrumentality of country X. Therefore, A is a dual capacity taxpayer. In 1984, A does business in country X within the meaning of the levy. A has validly elected the safe harbor method for country X for 1984. In 1984, as determined in accordance with the country X income tax as applied to A, A has gross receipts of 120u (units of country X currency), deducts 20u of costs and expenses, and pays 40u (40% of (120u-20u)) to country X

pursuant to the levy. A also incurs in 1984, 10u of nondeductible expenditures for exploration for mineral K and 2u of nondeductible interest costs attributable to an advance of funds from a related party to finance an undertaking relating to the exploration for mineral K for which normal commercial financing was unavailable because of the substantial risk inherent in the undertaking. A establishes that the country X income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901-2(a)(1), that it is the generally imposed income tax of country X and hence the general tax, and that all of the criteria of section 903 are satisfied with respect to the country X income tax as applied to dual capacity taxpayers, except for the determination of the distinct element of the levy that is a tax and of A's qualifying amount with respect thereto. (No conclusion is reached whether the country X income tax as applied to dual capacity taxpayers is an income tax within the meaning of § 1.901-2(a)(1). Such a determination would require, among other things, that the country X income tax as so applied, judged on the basis of its predominant character, meets the net income requirement of § 1.901-2(b)(4) notwithstanding its failure to permit recovery of exploration expenses.) A has therefore demonstrated that the country X income tax as applied to dual capacity taxpayers is a qualifying levy.

In applying the safe harbor formula, in accordance with paragraph (e)(2), the amount of A's costs and expenses includes the 10u of nondeductible exploration expenses. The failure to permit recovery of interest in excess of arm's length amounts, a provision of both the general tax and the qualifying levy, does not cause the qualifying levy to fail to satisfy the net income requirement of § 1.901-2(b)(4); therefore, the amount of A's cost and expenses does not include the 2u of nondeductible interest costs. Thus, under the safe harbor method, A's qualifying amount with respect to the levy is 33.33u ((120u-30u-40u) x .40/ (1-.40)). A's specific economic benefit amount is 6.67u (A's actual payment amount (40u) less A's qualifying amount (33.33u)). Under paragraph (a) of this section, this 6.67u is considered to be consideration paid by A for the right to extract mineral K. Pursuant to paragraph (b) of this section, this amount is characterized according to the nature of A's transactions with country X and its instrumentality and of the specific economic benefit received (the right to extract mineral K), as an additional royalty or other business expesnse paid or accrued by A and is so treated for all purposes of Chapter 1 of the Internal Revenue Code, except that if an allowance for percentage depletion is allowable to A under sections 611 and 613 with respect to A's interest in mineral K, the determination whether this 6.67u is tax or royalty for purposes of computing the amount of such allowance shall be made under sections 611 and 613 without regard to the determination that under the safe harbor formula such 6.67u is not tax for purposes of section 901 or 903.

Example (2). Under a levy of country Y called the country Y income tax, each corporation incorporated in country Y is required to pay to country Y a percentage of its worldwide income. The applicable percentage is 40 percent of the first 1,000u (units of country Y currency) of income and 50 percent of income in excess of 1,000u. Income for purposes of the levy is computed by deducting from gross income specified types of expenses and specified allowances for capital expenditures. The expenses for which deductions are permitted differ depending on the type of business in which the corporation subject to the levy is engaged, e.g., a deduction for interest paid to a related party is not allowed for corporations engaged in enumerated types of activities. In addition, carryover of losses from one taxable period to another is permitted for corporations engaged in specified types of activities, but not for corporations engaged in other activities. By its terms, the foreign levy makes no distinction between dual capacity taxpayers and other persons. In practice the differences in the base of the country Y income tax (e.g., the lack of a deduction for interest paid to related parties for some corporations subject to the levy and the lack of a carryover provision for some corporations subject to the levy) apply to both dual capacity taxpayers and other persons, but the 50 percent rate applies only to dual capacity taxpayers. By reason of such higher rate, application of the country Y income tax to dual capacity taxpayers is different in practice from application of the country Y income tax to other persons subject to it. The country Y income tax as applied to dual capacity taxpayers is therefore a separate levy from the country Y income tax as applied to other corporations incorporated in country Y.

B is a corporation incorporated in country Y that is engaged in construction activities in country Y. B has a contract with the government of country Y to build a hospital in country Y for a fee that is not made available on substantially the same terms to substantially all persons who are subject to the general tax of country X. Accordingly, B is a dual capacity taxpayer. B has validly elected the safe harbor method for country Y for 1985. In 1985, as determined in accordance with the country Y income tax as applied to B, B has gross receipts of 10,000u, deducts 6,000u of costs and expenses, and pays 1900u ((1,000ux40%) + (3,000ux50%)) to country Y pursuant to the levy.

It is asssumed that B has established that the country Y income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901-2(a)(1) and is the general tax. It is further assumed that B has demonstrated that all of the criteria of section 901 are satisfied with respect to the country Y income tax as applied to dual capacity taxpayers, except for the determination of the distinct element of such levy that is a tax and of B's qualifying amount with respect to that levy, and therefore that the country Y income tax as applied to dual capacity taxpayers is a qualifying levy.

In applying the safe harbor formula, in accordance with paragraph (e)(3), the 50 percent rate is not used because it does not apply in practice to persons other than dual capacity taxpayers. The next lowest rate of the general tax that does apply in practice to such persons, 40 percent, is used. Accordingly, under the safe harbor formula, B's qualifying amount with respect to the levy is 1400u ((10,000u-6000u-1900u) x .40/(1-40)). B's specific economic benefit amount is 500u (B's actual payment amount (1900u) less B's qualifying amount (1400u)). Pursuant to paragraph (b) of this section, B's specific economic benefit amount is characterized according to the nature of B's transactions with country Y and of the specific economic benefit received, as a reduction of B's proceeds of its contract with country Y; and this amount is so treated for all purposes of Chapter 1 of the Code, including the computation of B's accumulated profits for purposes of section 902.

Example (3). The facts are the same as in example (2), with the following additional facts: The contract between B and country Y is a cost plus contract. One of the costs of the contract which country Y is required to pay or for which it is required to reimburse B is any tax of country Y on B's income or receipts from the contract. Instead of reimbursing B therefor, country Y agrees with B to assume any such tax liability. Under country Y tax law, B is not considered to have additional income or receipts by reason of country Y's assumption of B's country Y tax liability. In 1985, B's gross receipts of 10,000u include 3000u from the contract, and its costs and expenses of 6000u include 2000u attributable to the contact. B's other gross receipts and expenses do not relate to any transaction in which B receives a specific economic benefit. In accordance with the contract, country Y, and not B, is required to bear the amount of B's country Y income tax liability on B's 1000u (3000u-2000u) income from the contract. In accordance with the contract B computes its country Y income tax without taking this 1000u into account and therefore pays 1400u ((1000u x 40%) + (2000u x 50%)) to country Y pursuant to the levy.

In accordance with § 1.901-2(f)(2)(i), the country Y income tax which country Y is, under the contract, required to bear is considered to be paid by country Y on behalf of B. B's proceeds of its contract, for all purposes of Chapter 1 of the Code (including the computation of B's accumulated profits for purposes of section 902), therefore, are increased by the additional 500u (1900u computed as in example (2) less 1400u as computed above) of B's liability under the country Y income tax that is assumed by country Y and such 500u is considered to be paid pursuant to the levy by country Y on behalf of B. In applying the safe harbor formula, therefore, the computation is exactly as in example (2) and the results are the same as in example (2).

Example (4). Country L issues a decree (the “April 11 decree.”), in which it states it is exercising its tax authority to impose a tax on all corporations on their “net income” from country L. “Net income” is defined as actual gross receipts less all expenses attributable thereto, except that in the case of income from extraction of petroleum, gross receipts are defined as 105 percent of actual gross receipts, and no deduction is allowed for interest incurred on loans whose proceeds are used for exploration for petroleum. Under the April 11 decree, wages paid by corporations subject to the decree are deductible in the year of payment, except that corporations engaged in the extraction of petroleum may deduct such wages only by amortization over a 5-year period and, to the extent such wages are paid to officers, they may be deducted only by amortization over a period of 50 years. The April 11 decreee permits related corporations subject to the decree to file consolidated returns in which net income and net losses of related corporations offset each other in computing net income for purposes of the April 11 decree, except that corporations engaged in petroleum exploration or extraction activities are not eligible for inclusion in such a consolidated return. The law of country L does not require separate entities to carry on separate activities in connection with exploring for or extracting petroleum. Net losses of a taxable year may be carried over for 10 years to offset income, except that no more than 25% of net income (before deducting the loss carryover) in any such future year may be offset by a carryover of net loss, and, in the case of any corporation engaged in exploration or extraction of petroleum, losses incurred prior to such a corporation's having net income from production may be carried forward for only 8 years and no more than 15% of net income in any such future year may be offset by such a net loss. The rate to be paid under the April 11 decree is 50% of net income (as defined in the levy), except that if net income exceeds 10,000u (units of country L currency), the rate is 75% of the corporation's net income (including the first 10,000u thereof). In practice, no corporations other than corporations engaged in extraction of petroleum have net income in excess of 10,000u. All petroleum resources of country L are owned by the government of country L, whose petroleum ministry licenses corporations to explore for and extract petroleum in consideration for payment of royalties as petroleum is produced.

J is a U.S. corporation that is engaged in country L in the exploration and extraction of petroleum and therefore is a dual capacity taxpayer. J has validly elected the safe harbor method for country L for the year 1986, the year that J commenced activities in country L, and has not revoked such election. For the years 1983 through 1988, J's gross receipts, deductions and net income before application of the carryover provisions, determined in accordance with the April 11 decree, are as follows:

After application of the carryover provisions, J's net income and actual payment amounts pursuant to the April 11 levy are as follows:

Pursuant to paragraph (a)(1) of this section, the April 11 decree as applied to corporations engaged in the exploration or extraction of petroleum in country L is a separate levy from the April 11 decree as applied to all other corporations. J establishes that the April 11 decree, as applied to such other corporations, is an income tax within the meaning of § 1.901-2(a)(1) and that the decree as so applied is the general tax.

The April 11 decree as applied to corporations engaged in the exploration or extraction of petroleum in country L does not meet the gross receipts requirement of § 1.901-2(b)(3); therefore, irrespective of whether it meets the other requirements of § 1.901-2(b)(1), it is not an income tax within the meaning of § 1.901-2(a)(1). However, the April 11 decree as applied to such corporations is a qualifying levy because J has demonstrated that all of the criteria of section 903 are satisfied with respect to the April 11 decree as applied to such corporations, except for the determination of the distinct element of such levy that imposes a tax and of J's qualifying amount with respect thereto.

In applying the safe harbor formula, in accordance with paragraph (e)(2), gross receipts are computed by reference to the general levy, and thus are 100%, not 105%, of actual gross receipts. Similarly, costs and expenses include exploration interest expense. In accordance with paragraph (e)(2)(i) of this section the difference between the general tax and the qualifying levy in the timing of the deduction for wages, other than wages of officers, is not considered to increase the liability of dual capacity taxpayers because the general tax would not have failed to be an income tax within the meaning of § 1.901-2(a)(1) if it had provided for 5-year amortization of such wages instead of for current deduction. See § 1.901-2(b)(4)(i). However, amortization of wages paid to officers over a 50-year period is such

A deferred recovery of such wages that it effectively is a denial of the deduction of the excess of such wages paid in any year over the amortization of such cumulative wages permitted in such year. See § 1.901-2(b)(4)(i). The different treatment of wages paid to officers under the general tax and the qualifying levy is thus not merely a difference in timing within the meaning of paragraph(e)(2)(i) of this section. Accordingly, the difference between the amount of wages paid by J to officers in any year and J's deduction (in computing the actual payment amount) for amortization of such cummulative wages allowed in such year is, pursuant to paragraph (e)(2) of this section, treated as a cost and expense in computing J's qualifying amount for such year with respect to the

April 11 decree. The differences in the consolidation and carryover provisions between the general tax and the qualifying levy are of the types described in paragraph (e)(2)(ii) of this section and pursuant to paragraphs (b)(4)(ii) and (b)(4)(iii) of § 1.901-2, the general tax would not fail to be an income tax within the meaning of § 1.901-2(a)(i) even if it contained the consolidation and carryover provisions of the qualifying levy. Thus such differences are not considered to increase the liability of dual capacity taxpayers pursuant to the qualifying levy as compared to the general tax liability of persons other than dual capacity taxpayers.

Accordingly, in applying the safe harbor formula to the qualifying levy for 1985 and 1986, gross receipts and costs and expenses are computed as follows:

*Gross receipts*

1985: 42,000u x (100/105=40,000u

1986: 105,000u x (100/105=100,000u

In years after 1986, costs and expenses for purposes of determining the qualifying amount would reflect net loss carryforward deductions based on the recomputed losses carried forward from 1983 and 1984 (14,070u and 19,890u, respectively) less the amounts thereof that were utilized in determining costs and expenses for 1985 and 1986 (3,314u and 11,561u, respectively). The 1983 and 1984 loss carryforwards would be considered utilized in accordance with the order of priority in which such losses are utilized under the terms of the qualifying levy.

In applying the safe harbor formula, the tax rate to be used, in accordance with paragraph (e)(3) of this section, is. 50.

Accordingly, under the safe harbor method. J's qualifying amounts with respect to the April 11 decree for 1985 and 1986 are computed as follows:

1985: (40,000u-21,224u-17,172u) x .50/(1-.50)=1604u

1986: (100,000u-34,491u-54,134u) x .50/(1-.50)=11,375u

Under the safe harbor method J's qualifying amounts with respect to the April 11 decree for 1985 and 1986 are thus 1604u and 11,375u, respectively; and its specific economic benefit amounts are 15,568u (17,172u-1604u) and 42,759uc, 54.134u-11,375u), respectively. Pursuant to paragraph (b) of this section J's specific economic benefit amounts are characterized according to the nature of J's transactions with country L and of the specific economic benefit received by L as additional royalties paid to country L with respect to the petroleum extacted by J in country L in 1985 and 1986, and these amounts are so treated for all purposes of Chapter 1 of the Code.

Example (5). Country E, which has no generally imposed income tax, imposes a levy called the country E income tax only on corporations carrying on the banking a business through a branch in country E and on corporations engaged in the extraction of petroleum in country E. All of the petroleum resources of country E are owned by the government of country E, whose petroleum ministry licenses corporations to explore for petroleum and extract petroleum in consideration of payment of royalties as petroleum is extracted. The base of the country E income tax is a corporation's actual gross receipts from sources in country E less all expenses attributable, on reasonable principles, to such gross receipts; the rate of tax is 29 percent.

A is a U.S corporation that carries on the banking business through a branch in country E, B is a U.S. corporation (unrelated to A) that is engaged in the extraction of petroleum in country E. In 1984 A receives interest on loans it has made to 160 borrowers in country E, seven of which are agencies and instrumentalities of the government of country E. The economic benefits received by A and B (i.e., the interest received by A from the government and B's license to extract petroleum owned by the government) are not made available on substantially the same terms to the population of country E in general.

A and B are dual capacity taxpayers. Each of them has validly elected the safe harbor method for country E for 1984. A demonstrates that the country E income tax, as applied to it (a dual capacity taxpayer) is not different by its terms or in practice from the country E income tax as applied to persons (in this case other banks) that are not dual capacity taxpayers. A has therefore established pursuant to paragraph (a)(1) of this section and § 1.901-2(d) that the country E income tax as applied to it and the country E income tax as applied to persons other than dual capacity taxpayers are together a single levy. A establishes that such levy is an income tax within the meaning of § 1.901-2(a)(1). In accordance with paragraph (a)(1) of this section, no portion of the amount paid by A pursuant to such levy is considered to be paid in exchange for a specific economic benefit. Thus, the entire amount paid by A pursuant to this levy is an amount of income tax paid.

B does not demonstrate that the country E income tax as applied to corporations engaged in the extraction of petroleum in country E (dual capacity taxpayers) is not different by its terms or in practice from the country E income tax as applied to persons other than dual capacity taxpayers (i.e., banks that are not dual capacity taxpayers). Accordingly, pursuant to paragraph (a)(1) of this section and § 1.901-2(d), the country E income tax as applied to corporations engaged in the extraction of petroleum in country E is a separate levy from the country E income tax as applied to other persons.

B demonstrates that all of the criteria of section 901 are satisfied with respect to the country E income tax as applied to corporations engaged in the exploration of petroleum in country E, except for the determination of the distinct element of such levy that imposes a tax and of B's qualifying amount with respect to the levy. Pursuant to paragraph (e)(5) of this section, in applying the safe harbor formula to B, “A” is the amount of B's gross receipts as determined under the country E income tax as applied to B; “B” is the amount of B's costs and expenses as determined thereunder; “C” is B's actual payment amount; and “D” is .29, the lower of the rate (29 percent) of the qualifying levy (the country E income tax as applied to corporations engaged in the extraction of petroleum in country E) or the rate (46 percent) of tax specified for 1984 in section 11(b)(5) of the Internal Revenue Code. Thus, B's qualifying amount is equal to its actual payment amount.

Example (6). The facts are the same as in example (5), except that the rate of the country E income tax is 55 percent. For the reasons stated in example (5), the results with respect to A are the same as in example (5). In applying the safe harbor formula to B, “A,” “B,” and “C” are the same as in example (5), but “D” is .46, as that rate is less than .55. Thus, B's qualifying amount is less than B's actual payment amount, and the difference is B's specific economic benefit amount.

Example (7). Country E imposes a tax (called the country E income tax) on the realized net income derived by corporations from sources in country E, except that, with respect to interest income received from sources in country E and certain insurance income, nonresident corporations are instead subject to other levies. With respect to such interest income a levy (called the country E interest tax) requires nonresident corporations to pay to country E 20 percent of such gross interest income unless the nonresident corporation falls within a specified category of corporations (“special corporations”), all of which are dual capacity taxpayers, in which case the rate is instead 25 percent. With respect to such insurance income nonresident corporations are subject to a levy (called the country E insurance tax), which is not an income tax within the meaning of § 1.901-2(a)(1).

The country E interest tax applies at the 20 percent rate by its terms and in practice to persons other than dual capacity taxpayers. The country E interest tax as applied at the 25 percent rate to special corporations applies only to dual capacity taxpayers; therefore, the country E interest tax as applied to special corporations is a separate levy from the country E interest tax as applied at the 20 percent rate.

A is a U.S. corporation which is a special corporation subject to the 25 percent rate of the country E interest tax. A does not have any insurance income that is subject to the country E insurance tax. A, a dual capacity taxpayer, has validly elected the safe harbor formula for 1984. In 1984 A receives 100u (units of country E currency) of gross interest income subject to the country E interest tax and pays 25u to country E.

A establishes that the country E income tax is the generally imposed income tax of country E; that all of the criteria of section 903 are satisfied with respect to the country E interest tax as applied to special corporations except for the determination of the distinct element of the levy that is a tax and of A's qualifying amount with respect thereto. A has therefore demonstrated that the country E interest tax as applied to speical corporations is a qualifying levy. A establishes that the country E interest tax at the 20 percent rate is a tax in lieu of an income tax within the meaning of § 1.903-1(a). Pursuant to paragraph (e)(6) of this section the country E interest tax at the 20 percent rate is treated as if it were an application of the general tax for purposes of the safe harbor formula of this paragraph (e), since that tax would actually have been required to have been paid by A with respect to its interest income had A not been a dual capacity taxpayer (special corporation) instead subject to the qualifying levy (the country E interest tax at the 25 percent rate).

Even if the country E insurance tax is a tax in lieu of an income tax within the meaning of § 1.903-1(a), that tax is not treated as if it were an application of the general tax for purposes of applying the safe harbor formula to A since A had no insurance income in 1984 and hence such tax would not actually have been required to be paid by A had A not been a dual capacity taxpayer.

Example (8). Under a levy of country S called the country S income tax, each corporation operating in country S is required to pay country S 50 percent of its income from operations in country S. Income for purposes of the country S income tax is computed by subtracting all attributable costs and expenses from a corporation's gross receipts derived from its business in country S. Among corporations on which the country S income tax is imposed are corporations engaged in the owned by country S, and all corporations engaged in the exploitation of mineral K in country S. Natural deposits of mineral K in country S are exploitation thereof do so under concession agreements with an instrumentality of country S. Such corporations, in addition to the 50 percent country S income tax, are also subject to a levy called a surtax, which is equal to 60 percent of posted price net income less the amount of the contry S income tax. The surtax is not deductible in computing the country S income tax of corporations engaged in the exploitation of mineral K in country S.

A is a U.S. corporation engaged in country S in the exploitation of mineral K, and A has been allowed to extract mineral K under a concession agreement with an instrumentality of country S. Therefore, A is a dual capacity taxpayer. In accordance with a term of the concession agreement, certain of A's income (net of expenses attributable thereto) is exempted from the income tax and surtax.

The results for A in 1984 are as follows:

Because of the difference (nondeductibility of the surtax) in the country S income tax as applied to dual capacity taxpayers from its application to other persons, the country S income tax as applied to dual capacity taxpayers and the country S income tax as applied to persons other than dual capacity taxpayers are separate levies. Moreover, because A's concession agreement provides for a modification (exemption of certain income) of the country S income tax and surtax as they otherwise apply to other persons engaged in the exploitation of mineral K in country S, those levies (contractual levies) as applied to A are separate levies from those levies as applied to other persons engaged in the exploitation of mineral K in country S.

A establishes that the country S income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901-2(a)(1) and is the general tax. A demonstrates that all the criteria of section 903 are satisfied with respect to the country S income tax as applied to A and with respect to the surtax as applied to A, except for the determination of the distinct elements of such levies that are taxes and of A's qualifying amounts with respect to such levies. Therefore, both the country S income tax as applied to A and the surtax as applied to A are qualifying levies.

In applying the safe harbor formula, in accordance with paragraph (e)(2), the amount of A's gross receipts includes the exempt realized income, and the amount of A's costs and expenses includes the costs attributable to such exempt income. In accordance with paragraph (e)(7)(i), the amount of the qualifying levy for purposes of the formula is the sum of A's liability for the country S income tax and A's liability for the surtax. Accordingly, under the safe harbor formula, A's qualifying amount with respect to the country S income tax and the surtax is 35u ((135u-25u-75u)x.50/(1-.50)). A's specific economic benefit amount is 40u (A's actual payment amount (75u) less A's qualifying amount (35u)).

Example (9). Country T imposes a levy on corporations, called the country T income tax. The country T income tax is imposed at a rate of 50 percent on gross receipts less all costs and expenses, and affiliated corporations are allowed to consolidate their results in applying the country T income tax. Corporations engaged in the exploitation of mineral L in country T are subject to a levy that is identical to the country T income tax except that no consolidation among affiliated corporations is allowed. The levy allows unlimited loss carryforwards.

C and D are affiliated U.S. corporations engaged in country T in the exploitation of mineral L. Natural deposits of mineral L in country T are owned by country T, and C and D have been allowed to extract mineral L in consideration of certain payments to an instrumentality of country T. Therefore, C and D are dual capacity taxpayers.

The results for C and D in 1984 and 1985 are as follows:

C and D establish that the country T income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901-2(a)(1) and is the general tax. C and D demonstrate that all of the criteria of section 901 are satisfied with respect to the country T income tax as applied to dual capacity taxpayers, except for the determination of the distinct element of such levy that is a tax and of C and D's qualifying amounts with respect to that levy. Therefore, the country T income tax as applied to dual capacity taxpayers is a qualifying levy.

In applying the safe harbor formula, in accordance with paragraphs (e)(2)(ii) and (e)(7)(iii), the gross receipts, costs and expenses, and actual payment amounts of C and D are aggregated, except that in D's loss year (1984) its gross receipts and costs and expenses are disregarded. The results of any loss year are disregarded since the country T income tax as applied to dual capacity taxpayers does not allow consolidation, and, pursuant to paragraph (e)(2)(ii), differences in consolidation provisions between such levy and the country T income tax as applied to persons that are not dual capacity taxpayers are not considered. Accordingly, in 1984 the qualifying amount with respect to the country T income tax is 50u ((120u-20u-50u)x.50/(1-.50)), all of which is considered paid by C. In 1985 the qualifying amount is 75u ((120u+120u-20u-20u-50u (loss carry forward)—50u—25u)x.50/(1-.50)), of which 50u is considered to be paid by C and 25u by D.

Example (10). Country W imposes a levy called the country W income tax on corporations doing business in country W. The country W income tax is imposed at a 50 percent rate on gross receipts less all costs and expenses. Corporations engaged in the exploitation of mineral M in country W are subject to a levy that is identical in all respects to the country W income tax except that it is imposed at a rate of 80 percent (the “80 percent levy”).

A is a U.S. corporation engaged in country W in exploitation of mineral M and is subject to the 80 percent levy. Natural deposits of mineral M in country W are owned by country W, and A has been allowed to extract mineral M in consideration of certain payments to an instrumentality of country W. Therefore, A is a dual capacity taxpayer. B, a U.S. corporation affiliated with A, also is engaged in business in country W, but has no transactions with country W. B is subject to the country W income tax. B is a dual capacity taxpayer within the meaning of § 1.901-2(a)(2)(ii)(A) by virtue of its affiliation with A.

The results for A and B in 1984 are as follows:

A and B establish that the country W income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901-2(a)(1) and is the general tax. It is assumed that B has demonstrated that the country W income tax as applied to B does not differ by its terms or in practice from the country W income tax as applied to persons other than dual capacity taxpayers and hence that the country W income tax as applied to B, a dual capacity taxpayer, and the country W income tax as applied to such other persons is a single levy. Thus, with respect to B, the country W income tax is not a qualifying levy by reason of the last sentence of paragraph (c)(1) of this section. A demonstrates that all the criteria of section 901 are satisfied with respect to the 80 percent levy, except for the determination of the distinct element of such levy that is a tax and of A's qualifying amount with respect thereto. Accordingly, the 80 percent levy as applied to A is a qualifying levy.

In applying the safe harbor formula in accordance with paragraphs (e)(7)(i) and (e)(7)(iii) in the instant case, it is not necessary to incorporate B's results in the safe harbor formula because B's taxation in country W is identical to the taxation of persons other than dual capacity taxpayers and because neither A's and B's results nor their taxation in country W interact in any way to change A's taxation. All of the amount paid by B, 30u, is an amount of income tax paid by B within the meaning of § 1.901-2(a)(1). Accordingly, under the safe harbor formula, the qualifying amount for A with respect to the 80 percent levy is 20u ((120u - 20u - 80u) x .50/(1 - .50)). The remaining 60u paid by A (80u - 20u) is A's specific economic benefit amount.

Example (11). The facts are the same as in example (10), except that it is assumed that B has not demonstrated that the country W income tax as applied to B does not differ by its terms or in practice from the country W income tax as applied to persons other than dual capacity taxpayers. In addition, A and B demonstrate that all the criteria of section 901 are satisfied with respect to each of the country W income tax and the 80 percent levy as applied to dual capacity taxpayers, except for the determination of the distinct elements of such levies that are taxes of A and B's qualifying amounts with respect to such levies. Therefore, the country W income tax and 80 percent levy as applied to dual capacity taxpayers are qualifying levies.

In applying the safe harbor formula in accordance with paragraphs (e)(7)(i) and (e)(7)(iii), the results of A and B are aggregated. Accordingly, under the safe harbor formula, the aggregate qualifying amount for A and B with respect to the country W income tax and 80 percent levy is 50u ([(120u + 100u) - (20u + 40u) - (80u + 30u)] x .50/(1- .50)).

Example (12). Country Y imposes a levy on corporations operating in country Y, called the country Y income tax. Income for purposes of the country Y income tax is computed by subtracting all costs and expenses from a corporation's gross receipts derived from its business in country Y. The rate of the country Y income tax is 50 percent. Country Y also imposes a 20 percent tax (the “withholding tax”) on the gross amount of certain income, including dividends, received by persons who are not residents of country Y from persons who are residents of country Y and from corporations that operate there. Corporations engaged in the exploitation of mineral K in country Y are subject to a levy (the “75 percent levy”) that is identical in all respects to the country Y income tax except that it is imposed at a rate of 75 percent. Dividends received from such corporations are not subject to the withholding tax.

C, a wholly-owned country Y subsidiary of D, a U.S. corporation, is engaged in country Y in the exploitation of mineral K. Natural deposits of mineral K in country Y are owned by country Y, and C has been allowed to extract mineral K in consideration of certain payments to an instrumentality of country Y. Therefore, C is a dual capacity taxpayer. D has elected the safe harbor method for country Y for 1984. In 1984, C's gross receipts are 120u (units of country Y currency), its costs and expenses are 20u, and its liability under the 75 percent levy is 75u. C distributes the amount that remains, 25u, as a dividend to D.

D establishes that the country Y income tax as applied to persons other than dual capacity taxpayers is an income tax within the meaning of § 1.901-2(a)(1) and the general tax, and that all the criteria of section 901 are satisfied with respect to the 75 percent levy, except for the determination of the distinct element of such levy that is tax and of C's qualifying amount with respect thereto. Accordingly, the 75 percent levy is a qualifying levy.

Pursuant to paragraph (e)(7), D (which is not subject to a levy of country Y but is considered to receive a specific economic benefit by reason of § 1.901-2(a)(2)(ii)(E)) is treated as a dual capacity taxpayer in applying paragraph (e)(7)(ii). D demonstrates that the withholding tax is a tax in lieu of an income tax within the meaning of § 1.903-1, which tax applies in practice to persons other than dual capacity taxpayers, and that such tax actually would have applied to D had D not been a dual capacity taxpayer (i.e., had C not been a dual capacity taxpayer, in which case D also would not have been one). Accordingly, the withholding tax is treated for purposes of the safe harbor formula as if it were an application of the general tax.

In applying the safe harbor formula to this situation in accordance with paragraph (e)(7)(ii), the rates of the country Y income tax and the withholding tax are aggregated into a single effective general tax rate. In this case, the rate is .60 (.50+[(1-.50)x.20]). Accordingly, under the safe harbor formula, C's qualifying amount with respect to the 75 percent levy is 37.5u [(120u-20u-75u) x.60/(1-.60)], the aggregate amount that C and D would have paid if C had been subject to the country Y income tax and had distributed to D as a dividend subject to the withholding tax the entire amount that remained for the year after payment of the country Y income tax. Because C is in fact the only taxpayer, the entire qualifying amount is paid by C.

Example (13). The facts are the same as in example (12), except that dividends received from corporations engaged in the exploitation of mineral K in country Y are subject to the withholding tax. Thus, C's liability under the 75 percent tax on the 75u, and D's liability under the withholding tax on the 25u distribution is 5u

D, which is a dual capacity taxpayer, demonstrates that the withholding tax as applied to D does not differ by its terms or in practice from the withholding tax as applied to persons other than dual capacity taxpayers and hence that the withholding tax as applied to D and that levy as applied to such other persons is a single levy. D demonstrates that all of the criteria of section 903 are satisfied with respect to the withholding tax. The withholding tax is not a qualifying levy by reason of the last sentence of paragraph (c)(1) of this section.

Paragraphs (e)(7)(i), (e)(7)(ii) and (e)(7)(iii) all apply in this situation. As in example (10), it is not necessary to incorporate the withholding tax into the safe harbor formula. All of the amount paid by D, 5u, is an amount of tax paid by D in lieu of an income tax. In applying the safe harbor formula to C, therefore, with respect to the 75 percent levy, "A" is 120, "B" is "20", "C" is 75 and "D" is .50. Accordingly, C's qualifying amount with respect to the 75 percent levy is 25u; the remaining 50u that it paid is its specific economic benefit amount.

Example (14). The facts are the same as in example (12), except that dividends received from corporations engaged in the exploitation of mineral K in country Y are subject to a 10 percent withholding tax (the "10 percent withholding tax"). Thus, C's liability under the 75 percent levy is 75u, and D's liability under the 10 percent withholding tax on the 25u distribution is 2.5u.

The only difference between the withholding tax and the 10 percent withholding tax applicable only to dual capacity taxpayers (including D) is that a lower rate (but the same base) applies to dual capacity taxpayers. Although the withholding tax and the 10 percent withholding tax are together a single levy, this difference makes it necessary, when dealing with multiple levies, to incorporate the withholding tax and D's payment pursuant to the 10 percent withholding tax in the safe harbor formula. Accordingly, as in example (12), the safe harbor formula is applied by aggregation.

The aggregate effective rate of the general taxes for purposes of the safe harbor formula is .60 (.50+[(1-.50)x.20]). Pursuant to paragraph (e)(7), the aggregate actual payment amount of the qualifying levies for purposes of the formula is the sum of C and D's liability for the 75 percent levy and the 10 percent withholding tax. Accordingly, under the safe harbor formula, the aggregate qualifying amount with respect to the 75 percent levy on C and the 10 percent withholding tax on D is 33.75u ((120u-20u-[75u+2.5u])x.60/(1-.60)), which is the aggregate amount of tax that C and D would have paid if C had been subject to the country Y income tax and had paid out its entire amount remaining after payment of that tax to D as a dividend subject to the withholding tax.

Example (15). The facts are the same as in example (5), except that the rate of the country E income tax is 45 percent and a political subdivision of country E also imposes a levy, called the "local tax," on all corporations subject to the country E income tax. The base of the local tax is the same as the base of the country E income tax; the rate is 10 percent.

The reasoning of example (5) with regard to the country E income tax as applied to A and B, respectively, applies equally with regard to the local tax as applied to A and B, respectively. Accordingly, the entire amount paid by A pursuant to each of the country E income tax and the local tax is an amount of income tax paid, and both the country E income tax as applied to B and the local tax as applied to B are qualifying levies.

Pursuant to paragraph (e)(7), in applying the safe harbor formula to B, "A" is the amount of B's gross receipts as determined under the (identical) country E income tax and local tax as applied to B; "B" is the amount of B's costs and expenses thereunder; and "C" is the sum of B's actual payment amounts with respect to the two levies. Pursuant to paragraph (e)(7), in applying the safe harbor formula to B, B's aggregate qualifying amount with respect to the two levies is limited to the amount determined in accordance with paragraph (e)(5) where "D" is the rate of tax specified in section 11(b)(5) of the Internal Revenue Code. Accordingly, "D" is .46, which is the lower of the aggregate rate (55 percent) of the qualifying levies or the section 11(b)(5) rate (46 percent). B's aggregate qualifying amount is, therefore, identical to B's qualifying amount in example (6), which is less than its aggregate actual payment amount, and the difference is B's specific economic benefit amount.

(f) Effective date. The effective date of this section is as provided in § 1.901-2(h).

Approved by the office of Management and Budget under control number 1545-0746.

26 CFR § 1.903

26 CFR § 1.902

Par. 3. A new § 1.903-1 is added immediately after § 1.902-2 to read as follows:

26 CFR § 1.903

§ 1.903-1 Taxes in lieu of income taxes.

(a) In general. Section 903 provides that the term "income, war profits, and excess profits taxes', shall include a tax paid in lieu of a tax on income, war profits, or excess profits ("income tax") otherwise generally imposed by any foreign country. For purposes of this section and §§ 1.901-2 and 1.901-2A, such a tax is referred to as a "tax in lieu of an income tax"; and the terms "paid" and "foreign country" are defined in § 1.901-2(g). A foreign levy (within the meaning of § 1.901-2(g)(3)) is a tax in lieu of an income tax if and only if—

(a)(1) It is a tax within the meaning of § 1.901-2(a)(2): and

(a)(2) It meets the substitution requirement as set forth in paragraph (b) of this section.

The foreign country's purpose in imposing the foreign tax (e.g., whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is immaterial. It is also immaterial whether the base of the foreign tax bears any relation to realized net income. The base of the tax may, for example, be gross income, gross receipts or sales, or the number of units produced or exported. Determinations of the amount of a tax in lieu of an income tax that is paid by a person and determinations of the person by whom such tax is paid are made under § 1.901-2 (e) and (f), respectively, substituting the phrase "tax in lieu of an income tax" for the phrase "income tax" wherever the latter appears in those sections. Section 1.901-2A contains additional rules applicable to dual capacity taxpayers (as defined in § 1.901-2(a)(2)(ii) (A)). The rules of this section are applied independently to each separate levy (within the meaning of §§ 1.901-2(d) and 1.901-2A (a)) imposed by the foreign country. Except as otherwise provided in paragraph (b)(2) of this section, a foreign tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax.

(b) Substitution.—(b)(1) In general. A foreign tax satisfies the substitution requirement 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. However, not all income derived by persons subject to the foreign tax need be exempt from the income tax. If, for example, a taxpayer is subject to a generally imposed income tax except that, pursuant to an agreement with the foreign country, the taxpayer's income from insurance is subject to a gross receipts tax and not to the income tax, then the gross receipts tax meets the substitution requirement notwithstanding the fact that the taxpayer's income from other activities, such as the operation of a hotel, is subject to the generally imposed income tax. A comparison between the tax burden of this insurance gross receipts tax and the tax burden that would have obtained under the generally imposed income tax is irrelevant to this determination.

(b)(2) Soak-up taxes. A foreign tax satisfies the substitution requirement only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the foreign tax against income tax liability to another country. If, without regard to this paragraph (b)(2), a foreign tax satisfies the requirement of paragraph (b)(1) of this section (including for this purpose any foreign tax that both satisfies such requirement an also is and income tax within the meaning of § 1.901-2(a)(1)), liability for the foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only to the extent of the lesser of—

(b)(2)(i) The amount of foreign tax that would not be imposed on the taxpayer but for the availability of such a credit to the taxpayer (within the meaning of § 1.901-2(c)), or

(b)(2)(ii) The amount, if any, by which the foreign tax paid by the taxpayer exceeds the amount of foreign income tax that would have been paid by the taxpayer if it had instead been subject to the generally imposed income tax of the foreign country.

(b)(3) Examples. The provisions of this paragraph (b) may be illustrated by the following examples:

Example (1). Country X has a tax on realized net income that is generally imposed except that nonresidents are not subject to that tax. Nonresidents are subject to a gross income tax on income from country X that is not attributable to a trade or business carried on in country X. The gross income tax

Imposed on nonresidents satisfies the substitution requirement set forth in this paragraph (b). See also examples (1) and (2) of § 1.901-2(b)(4)(iv).

Example (2). The facts are the same as in example (1), with the additional fact that payors located in country X are required by country X law to withhold the gross income tax from payments they make to nonresidents, and to remit such withheld tax to the government of country X. The result is the same as in example (1).

Example (3). The facts are the same as in example (2), with the additional fact that the gross income tax on nonresidents applies to payments for technical services performed by them outside of country X. The result is the same as in example (2).

Example (4). Country X has a tax that is generally imposed on the realized net income of nonresident corporations that is attributable to trade or business carried on in country X. The tax applies to all nonresident corporations that engage in business in country X except for such corporations that engage in contracting activities, each of which is instead subject to two different taxes. The taxes applicable to nonresident corporations that engage in contracting activities satisfy the substitution requirement set forth in this paragraph (b).

Example (5). Country X imposes both an exise tax and an income tax. The excise tax, which is payable independently of the income tax,is allowed as a credit against the income tax. For 1983 A has a tentative income tax liability of 100u (units of country X currency) but is allowed a credit for 30u of excise tax that it has paid. Pursuant to paragraph (e)(4)(i) of § 1.901-2, the amount of excise tax A has paid to country X is 30u and the amount of income tax A has paid to country X is 70u. The excise tax paid by A does not satisfy the substitution requirement set forth in this paragraph (b) because the excise tax is imposed on A in addition to, and not insubstitution for, the generally imposed income tax.

Example (6). Pursuant to a contract with country X, A, a domestic corporation engaged in manufacturing activities in country X, must pay tax to country X equal to the greater of (i) 5u (units of country X currency) per item produced, or (ii) the maximum amount creditable by A against its U.S. income tax liability for that year with respect to income from its country X operation. Also pursuant to the contract, A is exempted from otherwise generally imposed income tax. A produces 16 items in 1984 and the maximum amount creditable by A against its U.S. income tax liability for 1984 is 125u. If A had been subject to country X's otherwise generally imposed income tax it would have paid a tax of 150u. Pursuant to paragraph (b)(2) of this section, the amount of tax paid by A that is dependent on the availability of a credit against income tax of another country is 0 (lesser of (i) 45u, the amount that would not be imposed but for the availability of a credit (125u-80u) or (ii) 0, the amount by which the contractual tax (125u) exceeds the generally imposed income tax (150u)).

Example (7). The facts are the same as in example (6) except that, of the 150u A would have paid if it had been subject to the otherwise generally imposed income tax, 60u is dependent on the availability of a credit against income tax of another country. The amount of tax actually paid by A (i.e., 125u) that is dependent on the availability of a credit against income tax of another country is 35u (lesser of (i) 45u, computed as in example (6), or (ii) 35u, the amount by which the contractual tax (125u) exceeds the amount A would have paid as income tax if it had been subject to the otherwise generally imposed income tax (90u, i.e., 150u-60u).

(c) Effective date. The effective date of this section is as provided in § 1.901-2(h).

PART 4—[AMENDED]26 CFR § 4.901

26 CFR § 4.903

§§ 4.901-2 and 4.903-1 [Removed]

26 CFR § 4.901

Par. 4. Sections 4.901-2 and 4.903-1 of 26 CFR Part 4 are removed.

This Treasury Decision is issued under the authority contained in section 7805 of the Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

Roscoe L. Egger, Jr.,

Commissioner of Internal Revenue.

Approved: September 28, 1983.

John E. Chapoton,

Assistant Secretary of the Treasury.

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