

861(a)(2)(D) as income from sources without the United States.

(j) *Effective/applicability date.* Paragraph (g) of this section applies to taxable years ending after April 9, 2008. Paragraphs (a) and (b) of this section apply to taxable years ending after July 13, 2011.

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EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.901-1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at www.fdsys.gov.

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

(a) *Definition of income, war profits, or excess profits tax—(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—

- (i) It is a tax; and
- (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.

(2) *Tax—(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.

(ii) *Dual capacity taxpayers—(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.

(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.

(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.

(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 prop-

erty that may be extracted and establishing the minimum price at which it may be disposed of.

(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—

(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,

(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*—(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.

(2) *Realization*—(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—

(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

(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. How-

ever, 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.

(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).

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

(A) It is stock in trade or other property of a kind that properly 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, and

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

(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: A, 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.

(3) *Gross receipts*—(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).

(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 performs 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)(1) 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.

(4) *Net income*—(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 satisfies 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 satisfies 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.

(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.

(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 who furnish specified types of services to customers who are residents of country X. “Taxable income” for purposes of the tax is defined as gross receipts received from 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 satisfies 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*—(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 de-

pendent 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).

(2) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the 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*—(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 pro-

visions 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,

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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).

(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.

(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:

Base	Rate (per- cent)
Net income from mining	45
Net income from manufacturing	50
Net income from technical services	50

Base	Rate (per- cent)
Net income from other services	45
Net income from investments	15
All other net income	50

In computing each such base, deductible expenditures are allocated to the 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—(1) 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.

(2) *Refunds and credits*—(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.

(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 sources 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 certain 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.

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

(A) The amount is used, directly or indirectly, by the foreign country imposing the tax to provide a subsidy by any means (including, but not limited to, a rebate, a refund, a credit, a deduction, a payment, a discharge of an obligation, or any other method) to the taxpayer, to a related person (within the meaning of section 482), to any party to the transaction, or to any party to a related transaction; and

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

(ii) *Subsidy*. The term “subsidy” includes any benefit conferred, directly or indirectly, by a foreign country to

one of the parties enumerated in paragraph (e)(3)(i)(A) of this section. Substance and not form shall govern in determining whether a subsidy exists. The fact that the U.S. taxpayer may derive no demonstrable benefit from the subsidy is irrelevant in determining whether a subsidy exists.

(iii) *Official exchange rate.* A subsidy described in paragraph (e)(3)(i)(B) of this section does not include the actual use of an official foreign government exchange rate converting foreign currency into dollars where a free exchange rate also exists if—

(A) The economic benefit represented by the use of the official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit;

(B) The economic benefit of the official exchange rate applies to a broad range of international transactions, in all cases based on the total payment to be made without regard to whether the payment is a return of principal, gross income, or net income, and without regard to whether it is subject to tax; and

(C) Any reduction in the overall cost of the transaction is merely coincidental to the broad structure and operation of the official exchange rate.

In regard to foreign taxes paid or accrued in taxable years beginning before January 1, 1987, to which the Mexican Exchange Control Decree, effective as of December 20, 1982, applies, see Rev. Rul. 84-143, 1984-2 C.B. 127.

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

Example 1. (i) Country X imposes a 30 percent tax on nonresident lenders with respect to interest which the nonresident lenders receive 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 provides the nonresident lenders with receipts upon their payment of the 30 percent tax. 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.

(ii) Because the incentive payment is based on the interest paid, it is determined by reference to the base used to compute the tax that is imposed on the nonresident lender. The incentive payment is considered a subsidy under this paragraph (e)(3) since it is

provided to a party (the borrower) to the transaction and is based on the amount of tax that is imposed on the lender with respect to the transaction. Therefore, two-thirds (20 percent/30 percent) of the amount withheld by the resident borrower from interest payments to the nonresident lender is not an amount of income tax paid or accrued for purposes of section 901(b).

Example 2. (i) A U.S. bank lends money to a development bank in Country X. The development bank relends the money to companies resident in Country X. A withholding tax is imposed by Country X on the U.S. bank with respect to the interest that the development bank pays to the U.S. bank, and appropriate receipts are provided. On the date that the tax is withheld, fifty percent of the tax is credited by Country X to an account of the development bank. Country X requires the development bank to transfer the amount credited to the borrowing companies.

(ii) The amount successively credited to the account of the development bank and then to the account of the borrowing companies is determined by reference to the amount of the tax and the tax base. Since the amount credited to the borrowing companies is a subsidy provided to a party (the borrowing companies) to a related transaction and is based on the amount of tax and the tax base, it is not an amount paid or accrued as an income tax for purposes of section 901(b).

Example 3. (i) A U.S. bank lends dollars to a Country X borrower. Country X imposes a withholding tax on the lender with respect to the interest. The tax is to be paid in Country X currency, although the interest is payable in dollars. Country X has a dual exchange rate system, comprised of a controlled official exchange rate and a free exchange rate. Priority transactions such as exports of merchandise, imports of merchandise, and payments of principal and interest on foreign currency loans payable abroad to foreign lenders are governed by the official exchange rate which yields more dollars per unit of Country X currency than the free exchange rate. The Country X borrower remits the net amount of dollar interest due to the U.S. bank (interest due less withholding tax), pays the tax withheld in Country X currency to the Country X government, and provides to the U.S. bank a receipt for payment of the Country X taxes.

(ii) The use of the official exchange rate by the U.S. bank to determine foreign taxes with respect to interest is not a subsidy described in paragraph (e)(3)(i)(B) of this section. The official exchange rate is not targeted to or tied to transactions that give rise to a claim for a foreign tax credit. The use of the official exchange rate applies to the interest paid and to the principal paid. Any benefit derived by the U.S. bank through the

use of the official exchange rate is merely coincidental to the broad structure and operation of the official exchange rate.

Example 4. (i) B, a U.S. corporation, is engaged in the production of oil and gas in Country X pursuant to a production sharing agreement between B, Country X, and the state petroleum authority of Country X. The agreement is approved and enacted into law by the Legislature of Country X. Both B and the petroleum authority are subject to the Country X income tax. Each entity files an annual income tax return and pays, to the tax authority of Country X, the amount of income tax due on its annual income. B is a dual capacity taxpayer as defined in § 1.901-2(a)(2)(ii)(A). Country X has agreed to return to the petroleum authority one-half of the income taxes paid by B by allowing it a credit in calculating its own tax liability to Country X.

(ii) The petroleum authority is a party to a transaction with B and the amount returned by Country X to the petroleum authority is determined by reference to the amount of the tax imposed on B. Therefore, the amount returned is a subsidy as described in this paragraph (e)(3) and one-half the tax imposed on B is not an amount of income tax paid or accrued.

Example 5. Assume the same facts as in *Example 4*, except that the state petroleum authority of Country X does not receive amounts from Country X related to tax paid by B. Instead, the authority of Country X receives a general appropriation from Country X which is not calculated with reference to the amount of tax paid by B. The general appropriation is therefore not a subsidy described in this paragraph (e)(3).

(v) *Effective Date.* This paragraph (e)(3) shall apply to foreign taxes paid or accrued in taxable years beginning after December 31, 1986.

(4) *Multiple levies*—(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.

(ii) *Integrated tax systems.* [Reserved]

(5) *Noncompulsory amounts*—(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.

(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 is 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 respect 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 country X nor the treaty authorizes 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 authorities would be barred by the statute of limitations from 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 country X. In computing its income tax liability to 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

country X income tax in any year since the amount of country X tax paid by A is consistent with a reasonable interpretation of country X law in such a way as to reduce over time A's reasonably expected liability for 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 country X tax liability or whether the country X tax rates change) are immaterial.

Example 6. 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 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.

(iii) [Reserved]

(iv) *Structured passive investment arrangements—(A) In general.* Notwithstanding paragraph (e)(5)(i) of this section, an amount paid to a foreign country (a “foreign payment”) is not a compulsory payment, and thus is not an amount of tax paid, if the foreign payment is attributable (within the meaning of paragraph (e)(5)(iv)(B)(I)(ii) of this section) to a structured passive investment arrangement (as described in paragraph (e)(5)(iv)(B) of this section).

(B) *Conditions.* An arrangement is a structured passive investment arrangement if all of the following conditions are satisfied:

(1) *Special purpose vehicle (SPV).* An entity that is part of the arrangement meets the following requirements:

(i) Substantially all of the gross income (for U.S. tax purposes) of the entity, if any, is passive investment income, and substantially all of the assets of the entity are assets held to produce such passive investment income.

(ii) There is a foreign payment attributable to income of the entity (as determined under the laws of the foreign country to which such foreign payment is made), including the entity's share of income of a lower-tier entity that is a branch or pass-through entity under the laws of such foreign country, that, if the foreign payment were an amount of tax paid, would be paid or accrued in a U.S. taxable year in which the entity meets the requirements of paragraph (e)(5)(iv)(B)(I)(i) of this section. A foreign payment attributable to income of an entity includes a foreign payment attributable to income that is required to be taken into account by an owner of the entity, if the entity is a branch or pass-through entity under the laws of such foreign country. A foreign payment attributable to income of the entity also includes a withholding tax (within the meaning of section 901(k)(1)(B)) imposed on a dividend or other distribution (including distributions made by a pass-through entity or an entity that is disregarded as an entity separate from its owner for U.S. tax purposes) with respect to the equity of the entity.

(2) *U.S. party.* A person would be eligible to claim a credit under section 901(a) (including a credit for foreign taxes deemed paid under section 902 or 960) for all or a portion of the foreign payment described in paragraph (e)(5)(iv)(B)(I)(ii) of this section if the foreign payment were an amount of tax paid.

(3) *Direct investment.* The U.S. party's proportionate share of the foreign payment or payments described in paragraph (e)(5)(iv)(B)(I)(ii) of this section is (or is expected to be) substantially greater than the amount of credits, if any, that the U.S. party reasonably would expect to be eligible to claim under section 901(a) for foreign taxes attributable to income generated by

the U.S. party's proportionate share of the assets owned by the SPV if the U.S. party directly owned such assets. For this purpose, direct ownership shall not include ownership through a branch, a permanent establishment or any other arrangement (such as an agency arrangement or dual resident status) that would result in the income generated by the U.S. party's proportionate share of the assets being subject to tax on a net basis in the foreign country to which the payment is made. A U.S. party's proportionate share of the assets of the SPV shall be determined by reference to such U.S. party's proportionate share of the total value of all of the outstanding interests in the SPV that are held by its equity owners and creditors. A U.S. party's proportionate share of the assets of the SPV, however, shall not include any assets that produce income subject to gross basis withholding tax.

(4) *Foreign tax benefit.* The arrangement is reasonably expected to result in a credit, deduction, loss, exemption, exclusion or other tax benefit under the laws of a foreign country that is available to a counterparty or to a person that is related to the counterparty (determined under the principles of paragraph (e)(5)(iv)(C)(7) of this section by applying the tax laws of a foreign country in which the counterparty is subject to tax on a net basis). However, a foreign tax benefit in the form of a credit is described in this paragraph (e)(5)(iv)(B)(4) only if the amount of any such credit corresponds to 10 percent or more of the amount of the U.S. party's share (for U.S. tax purposes) of the foreign payment referred to in paragraph (e)(5)(iv)(B)(1)(ii) of this section. In addition, a foreign tax benefit in the form of a deduction, loss, exemption, exclusion or other tax benefit is described in this paragraph (e)(5)(iv)(B)(4) only if such amount corresponds to 10 percent or more of the foreign base with respect to which the U.S. party's share (for U.S. tax purposes) of the foreign payment is imposed. For purposes of the preceding two sentences, if an arrangement involves more than one U.S. party or more than one counterparty or both, the aggregate amount of foreign tax benefits available to all of the counter-

parties and persons related to such counterparties is compared to the aggregate amount of all of the U.S. parties' shares of the foreign payment or foreign base, as the case may be. Where a U.S. party indirectly owns interests in an SPV that are treated as equity interests for both U.S. and foreign tax purposes, a foreign tax benefit available to a foreign entity in the chain of ownership that begins with the SPV and ends with the first-tier entity in the chain does not correspond to the U.S. party's share of the foreign payment attributable to income of the SPV to the extent that such benefit relates to earnings of the SPV that are distributed with respect to equity interests in the SPV that are owned directly or indirectly by the U.S. party for purposes of both U.S. and foreign tax law.

(5) *Counterparty.* The arrangement involves a counterparty. A counterparty is a person that, under the tax laws of a foreign country in which the person is subject to tax on the basis of place of management, place of incorporation or similar criterion or otherwise subject to a net basis tax, directly or indirectly owns or acquires equity interests in, or assets of, the SPV. However, a counterparty does not include the SPV or a person with respect to which for U.S. tax purposes the same domestic corporation, U.S. citizen or resident alien individual directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests) of each of the U.S. party and such person. A counterparty also does not include a person with respect to which for U.S. tax purposes the U.S. party directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests), but only if the U.S. party is a domestic corporation, a U.S. citizen or a resident alien individual. In addition, a counterparty does not include an individual who is a U.S. citizen or resident alien.

(6) *Inconsistent treatment.* The United States and an applicable foreign country treat one or more of the aspects of the arrangement listed in paragraph (e)(5)(iv)(B)(6)(i) through (e)(5)(iv)(B)(6)(iv) of this section differently under their respective tax systems, and for one or more tax years

when the arrangement is in effect one or both of the following two conditions applies; either the amount of income attributable to the SPV that is recognized for U.S. tax purposes by the SPV, the U.S. party or parties, and persons related to a U.S. party or parties is materially less than the amount of income that would be recognized if the foreign tax treatment controlled for U.S. tax purposes; or the amount of credits claimed by the U.S. party or parties (if the foreign payment described in paragraph (e)(5)(iv)(B)(1)(ii) of this section were an amount of tax paid) is materially greater than it would be if the foreign tax treatment controlled for U.S. tax purposes:

(i) The classification of the SPV (or an entity that has a direct or indirect ownership interest in the SPV) as a corporation or other entity subject to an entity-level tax, a partnership or other flow-through entity or an entity that is disregarded for tax purposes.

(ii) The characterization as debt, equity or an instrument that is disregarded for tax purposes of an instrument issued by the SPV (or an entity that has a direct or indirect ownership interest in the SPV) to a U.S. party, a counterparty or a person related to a U.S. party or a counterparty.

(iii) The proportion of the equity of the SPV (or an entity that directly or indirectly owns the SPV) that is considered to be owned directly or indirectly by a U.S. party and a counterparty.

(iv) The amount of taxable income that is attributable to the SPV for one or more tax years during which the arrangement is in effect.

(C) *Definitions.* The following definitions apply for purposes of paragraph (e)(5)(iv) of this section.

(1) *Applicable foreign country.* An *applicable foreign country* means each foreign country to which a foreign payment described in paragraph (e)(5)(iv)(B)(1)(ii) of this section is made or which confers a foreign tax benefit described in paragraph (e)(5)(iv)(B)(4) of this section.

(2) *Counterparty.* The term *counterparty* means a person described in paragraph (e)(5)(iv)(B)(5) of this section.

(3) *Entity.* The term *entity* includes a corporation, trust, partnership or disregarded entity described in § 301.7701-2(c)(2)(i).

(4) *Indirect ownership.* Indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of section 958(a)(2), regardless of whether the interest is owned by a U.S. or foreign entity.

(5) *Passive investment income*—(i) *In general.* The term *passive investment income* means income described in section 954(c), as modified by this paragraph (e)(5)(iv)(C)(5)(i) and paragraph (e)(5)(iv)(C)(5)(ii) of this section. In determining whether income is described in section 954(c), paragraphs (c)(1)(H), (c)(3), and (c)(6) of that section shall be disregarded. Sections 954(c), 954(h), and 954(i) shall be applied at the entity level as if the entity (as defined in paragraph (e)(5)(iv)(C)(3) of this section) were a controlled foreign corporation (as defined in section 957(a)). For purposes of determining if sections 954(h) and 954(i) apply for purposes of this paragraph (e)(5)(iv)(C)(5)(i) and paragraph (e)(5)(iv)(C)(5)(ii) of this section, any income of an entity attributable to transactions that, assuming the entity is an SPV, are with a person that is a counterparty, or with persons that are related to a counterparty within the meaning of paragraph (e)(5)(iv)(B)(4) of this section, shall not be treated as qualified banking or financing income or as qualified insurance income, and shall not be taken into account in applying sections 954(h) and 954(i) for purposes of determining whether other income of the entity is excluded from section 954(c)(1) under section 954(h) or 954(i), but only if any such person (or a person that is related to such person within the meaning of paragraph (e)(5)(iv)(B)(4) of this section) is eligible for a foreign tax benefit described in paragraph (e)(5)(iv)(B)(4) of this section. In addition, in applying section 954(h) for purposes of this paragraph (e)(5)(iv)(C)(5)(i) and paragraph (e)(5)(iv)(C)(5)(ii) of this section, section 954(h)(3)(E) shall not apply, section 954(h)(2)(A)(ii) shall be satisfied only if the entity conducts substantial activity with respect to its business through its own employees,

and the term “any foreign country” shall be substituted for “home country” wherever it appears in section 954(h).

(ii) *Income attributable to lower-tier entities; holding company exception.* Income of an upper-tier entity that is attributable to an equity interest in a lower-tier entity, including dividends, an allocable share of partnership income, and income attributable to the ownership of an interest in an entity that is disregarded as an entity separate from its owner is passive investment income unless substantially all of the upper-tier entity’s assets consist of qualified equity interests in one or more lower-tier entities, each of which is engaged in the active conduct of a trade or business and derives more than 50 percent of its gross income from such trade or business, and substantially all of the upper-tier entity’s opportunity for gain and risk of loss with respect to each such interest in a lower-tier entity is shared by the U.S. party (or persons that are related to a U.S. party) and, assuming the entity is an SPV, a counterparty (or persons that are related to a counterparty) (“holding company exception”). If an arrangement involves more than one U.S. party or more than one counterparty or both, then substantially all of the upper-tier entity’s opportunity for gain and risk of loss with respect to its interest in any lower-tier entity must be shared (directly or indirectly) by one or more U.S. parties (or persons related to such U.S. parties) and, assuming the upper-tier entity is an SPV, one or more counterparties (or persons related to such counterparties). Substantially all of the upper-tier entity’s opportunity for gain and risk of loss with respect to its interest in any lower-tier entity is not shared if the opportunity for gain and risk of loss is borne (directly or indirectly) by one or more U.S. parties (or persons related to such U.S. party or parties) or, assuming the upper-tier entity is an SPV, by one or more counterparties (or persons related to such counterparty or counterparties). Whether and the extent to which a person is considered to share in an upper-tier entity’s opportunity for gain and risk of loss is determined based on all the facts and cir-

cumstances, provided, however, that a person does not share in an upper-tier entity’s opportunity for gain and risk of loss if its equity interest in the upper-tier entity was acquired in a sale-repurchase transaction or if its interest is treated as debt for U.S. tax purposes. If a U.S. party owns an interest in an entity indirectly through a chain of entities, the application of the holding company exception begins with the lowest-tier entity in the chain that may satisfy the holding company exception and proceeds upward; provided, however, that the opportunity for gain and risk of loss borne by any upper-tier entity in the chain that is a counterparty shall be disregarded to the extent borne indirectly by a U.S. party. An upper-tier entity that satisfies the holding company exception is itself considered to be engaged in the active conduct of a trade or business and to derive more than 50 percent of its gross income from such trade or business for purposes of applying the holding company exception to the owners of such entity. A lower-tier entity that is engaged in a banking, financing, or similar business shall not be considered to be engaged in the active conduct of a trade or business unless the income derived by such entity would be excluded from section 954(c)(1) under section 954(h) or 954(i) as modified by paragraph (e)(5)(iv)(C)(5)(i) of this section.

(6) *Qualified equity interest.* With respect to an interest in a corporation, the term *qualified equity interest* means stock representing 10 percent or more of the total combined voting power of all classes of stock entitled to vote and 10 percent or more of the total value of the stock of the corporation or disregarded entity, but does not include any preferred stock (as defined in section 351(g)(3)). Similar rules shall apply to determine whether an interest in an entity other than a corporation is a qualified equity interest.

(7) *Related person.* Two persons are related if—

(i) One person directly or indirectly owns stock (or an equity interest) possessing more than 50 percent of the total value of the other person; or

(ii) The same person directly or indirectly owns stock (or an equity interest) possessing more than 50 percent of the total value of both persons.

(8) *Special purpose vehicle (SPV)*. The term *SPV* means the entity described in paragraph (e)(5)(iv)(B)(1) of this section.

(9) *U.S. party*. The term *U.S. party* means a person described in paragraph (e)(5)(iv)(B)(2) of this section.

(D) *Examples*. The following examples illustrate the rules of paragraph (e)(5)(iv) of this section. No inference is intended as to whether a taxpayer would be eligible to claim a credit under section 901(a) if a foreign payment were an amount of tax paid. The examples set forth below do not limit the application of other principles of existing law to determine the proper tax consequences of the structures or transactions addressed in the regulations.

Example 1. U.S. borrower transaction. (i) *Facts*. A domestic corporation (USP) forms a country M corporation (Newco), contributing \$1.5 billion in exchange for 100% of the stock of Newco. Newco, in turn, loans the \$1.5 billion to a second country M corporation (FSub) wholly owned by USP. USP then sells its entire interest in Newco to a country M corporation (FP) for the original purchase price of \$1.5 billion, subject to an obligation to repurchase the interest in five years for \$1.5 billion. The sale has the effect of transferring ownership of the Newco stock to FP for country M tax purposes. Assume the sale-repurchase transaction is structured in a way that qualifies as a collateralized loan for U.S. tax purposes. Therefore, USP remains the owner of the Newco stock for U.S. tax purposes. In year 1, FSub pays Newco \$120 million of interest. Newco pays \$36 million to country M with respect to such interest income and distributes the remaining \$84 million to FP. Under country M law, the \$84 million distribution is excluded from FP's income. None of FP's stock is owned, directly or indirectly, by USP or any shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Under an income tax treaty between country M and the United States, country M does not impose country M tax on interest received by U.S. residents from sources in country M.

(ii) *Result*. The \$36 million payment by Newco to country M is not a compulsory payment, and thus is not an amount of tax paid because the foreign payment is attributable to a structured passive investment arrangement. First, Newco is an SPV because all of Newco's income is passive investment

income described in paragraph (e)(5)(iv)(C)(5) of this section; Newco's only asset, a note, is held to produce such income; the payment to country M is attributable to such income; and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(iv)(B)(1)(i) of this section. Second, if the foreign payment were treated as an amount of tax paid, USP would be deemed to pay the foreign payment under section 902(a) and, therefore, would be eligible to claim a credit for such payment under section 901(a). Third, USP would not pay any country M tax if it directly owned Newco's loan receivable. Fourth, the distribution from Newco to FP is exempt from tax under country M law, and the exempt amount corresponds to more than 10% of the foreign base with respect to which USP's share (which is 100% under U.S. tax law) of the foreign payment was imposed. Fifth, FP is a counterparty because FP owns stock of Newco under country M law and none of FP's stock is owned by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, FP is the owner of 100% of Newco's stock for country M tax purposes, while USP is the owner of 100% of Newco's stock for U.S. tax purposes, and the amount of credits claimed by USP if the payment to country M were an amount of tax paid is materially greater than it would be if country M tax treatment controlled for U.S. tax purposes such that FP, rather than USP, owned 100% of Newco's stock. Because the payment to country M is not an amount of tax paid, USP is not deemed to pay any country M tax under section 902(a). USP has dividend income of \$84 million and also has interest expense of \$84 million. FSub's post-1986 undistributed earnings are reduced by \$120 million of interest expense.

Example 2. U.S. borrower transaction. (i) *Facts*. The facts are the same as in *Example 1*, except that FSub is a wholly-owned subsidiary of Newco. In addition, assume FSub is engaged in the active conduct of manufacturing and selling widgets and derives more than 50% of its gross income from such business.

(ii) *Result*. The results are the same as in *Example 1*. Although Newco wholly owns FSub, which is engaged in the active conduct of manufacturing and selling widgets and derives more than 50% of its income from such business, Newco's income that is attributable to Newco's equity interest in FSub is passive investment income because the sale-repurchase transaction limits FP's interest in Newco and its assets to that of a creditor, so that substantially all of Newco's opportunity for gain and risk of loss with respect to its stock in FSub is borne by USP. See paragraph (e)(5)(iv)(C)(5)(ii) of this section. Accordingly, Newco's stock in FSub is held

to produce passive investment income. Thus, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section. Newco's assets are held to produce such income, the payment to country M is attributable to such income, and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(iv)(B)(1)(i) of this section.

Example 3. U.S. borrower transaction. (i) *Facts.* (A) A domestic corporation (USP) loans \$750 million to its wholly-owned domestic subsidiary (Sub). USP and Sub form a country M partnership (Partnership) to which each contributes \$750 million. Partnership loans all of its \$1.5 billion of capital to Issuer, a wholly-owned country M affiliate of USP, in exchange for a note and coupons providing for the payment of interest at a fixed rate over a five-year term. Partnership sells all of the coupons to Coupon Purchaser, a country N partnership owned by a country M corporation (Foreign Bank) and a wholly-owned country M subsidiary of Foreign Bank, for \$300 million. At the time of the coupon sale, the fair market value of the coupons sold is \$290 million and, pursuant to section 1286(b)(3), Partnership's basis allocated to the coupons sold is \$290 million. Several months later and prior to any interest payments on the note, Foreign Bank and its subsidiary sell all of their interests in Coupon Purchaser to an unrelated country O corporation for \$280 million. None of Foreign Bank's stock or its subsidiary's stock is owned, directly or indirectly, by USP or Sub or by any shareholders of USP or Sub that are domestic corporations, U.S. citizens, or resident alien individuals.

(B) Assume that both the United States and country M respect the sale of the coupons for tax law purposes. In the year of the coupon sale, for country M tax purposes USP's and Sub's shares of Partnership's profits total \$300 million, a payment of \$60 million to country M is made with respect to those profits, and Foreign Bank and its subsidiary, as partners of Coupon Purchaser, are entitled to deduct the \$300 million purchase price of the coupons from their taxable income. For U.S. tax purposes, USP and Sub recognize their distributive shares of the \$10 million premium income and claim a direct foreign tax credit for their shares of the \$60 million payment to country M. Country M imposes no additional tax when Foreign Bank and its subsidiary sell their interests in Coupon Purchaser. Country M also does not impose country M tax on interest received by U.S. residents from sources in country M.

(ii) *Result.* The payment to country M is not a compulsory payment, and thus is not an amount of tax paid, because the foreign payment is attributable to a structured pas-

sive investment arrangement. First, Partnership is an SPV because all of Partnership's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section; Partnership's only asset, Issuer's note, is held to produce such income; the payment to country M is attributable to such income; and if the payment were an amount of tax paid, it would be paid or accrued in a U.S. taxable year in which Partnership meets the requirements of paragraph (e)(5)(iv)(B)(1)(i) of this section. Second, if the foreign payment were an amount of tax paid, USP and Sub would be eligible to claim a credit for such payment under section 901(a). Third, USP and Sub would not pay any country M tax if they directly owned Issuer's note. Fourth, for country M tax purposes, Foreign Bank and its subsidiary deduct the \$300 million purchase price of the coupons and are exempt from country M tax on the \$280 million received upon the sale of Coupon Purchaser, and the deduction and exemption correspond to more than 10% of the \$300 million base with respect to which USP's and Sub's 100% share of the foreign payments was imposed. Fifth, Foreign Bank and its subsidiary are counterparties because they indirectly acquired assets of Partnership, the interest coupons on Issuer's note, and are not directly or indirectly owned by USP or Sub or shareholders of USP or Sub that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the amount of taxable income of Partnership for one or more years is different for U.S. and country M tax purposes, and the amount of income attributable to USP and Sub for U.S. tax purposes is materially less than the amount of income they would recognize if the country M tax treatment of the coupon sale controlled for U.S. tax purposes. Because the payment to country M is not an amount of tax paid, USP and Sub are not considered to pay tax under section 901. USP and Sub have income of \$10 million in the year of the coupon sale.

Example 4. Active business; no SPV. (i) *Facts.* A, a domestic corporation, wholly owns B, a country X corporation engaged in the manufacture and sale of widgets. On January 1, year 1, C, also a country X corporation, loans \$400 million to B in exchange for an instrument that is debt for U.S. tax purposes and equity in B for country X tax purposes. As a result, C is considered to own stock of B for country X tax purposes. B loans \$55 million to D, a country Y corporation wholly owned by A. In year 1, B has \$166 million of net income attributable to its sales of widgets and \$3.3 million of interest income attributable to the loan to D. Substantially all of B's assets are used in its widget business. Country Y does not impose tax on interest paid to nonresidents. B makes a payment of \$50.8 million to country X with respect to B's net income. Country X does not impose tax on

dividend payments between country X corporations. None of C's stock is owned, directly or indirectly, by A or by any shareholders of A that are domestic corporations, U.S. citizens, or resident alien individuals.

(ii) *Result.* B is not an SPV within the meaning of paragraph (e)(5)(iv)(B)(I) of this section because the amount of interest income received from D does not constitute substantially all of B's income and the \$55 million note from D does not constitute substantially all of B's assets. Accordingly, the \$50.8 million payment to country X is not attributable to a structured passive investment arrangement.

Example 5. U.S. lender transaction. (i) *Facts.* (A) A country X corporation (Foreign Bank) contributes \$2 billion to a newly-formed country X company (Newco) in exchange for 90% of the common stock of Newco and securities that are treated as debt of Newco for U.S. tax purposes and preferred stock of Newco for country X tax purposes. A domestic corporation (USP) contributes \$1 billion to Newco in exchange for 10% of Newco's common stock and securities that are treated as preferred stock of Newco for U.S. tax purposes and debt of Newco for country X tax purposes. Newco loans the \$3 billion to a wholly-owned, country X subsidiary of Foreign Bank (FSub) in return for a \$3 billion, seven-year note paying interest currently. The Newco securities held by USP entitle the holder to fixed distributions of \$4 million per year, and the Newco securities held by Foreign Bank entitle the holder to receive \$82 million per year, payable only on maturity of the \$3 billion FSub note in year 7. At the end of year 5, pursuant to a prearranged plan, Foreign Bank acquires USP's Newco stock and securities for a prearranged price of \$1 billion. Country X does not impose tax on dividends received by one country X corporation from a second country X corporation. Under an income tax treaty between country X and the United States, country X does not impose country X tax on interest received by U.S. residents from sources in country X. None of Foreign Bank's stock is owned, directly or indirectly, by USP or any shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals.

(B) In each of years 1 through 7, FSub pays Newco \$124 million of interest on the \$3 billion note. Newco distributes \$4 million to USP in each of years 1 through 5. The distributions are deductible for country X tax purposes, and Newco pays country X \$36 million with respect to \$120 million of taxable income from the FSub note in each year. For U.S. tax purposes, in each year Newco's post-1986 undistributed earnings are increased by \$124 million of interest income and reduced by accrued interest expense with respect to the Newco securities held by Foreign Bank.

(ii) *Result.* The \$36 million payment to country X is not a compulsory payment, and thus is not an amount of tax paid, because the foreign payment is attributable to a structured passive investment arrangement. First, Newco is an SPV because all of Newco's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section; Newco's only asset, a note of FSub, is held to produce such income; the payment to country X is attributable to such income; and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which Newco meets the requirements of paragraph (e)(5)(iv)(B)(I)(i) of this section. Second, if the foreign payment were an amount of tax paid, USP would be deemed to pay its pro rata share of the foreign payment under section 902(a) in each of years 1 through 5 and, therefore, would be eligible to claim a credit under section 901(a). Third, USP would not pay any country X tax if it directly owned its proportionate share of Newco's assets, a note of FSub. Fourth, for country X tax purposes, Foreign Bank is eligible to receive a tax-free distribution of \$82 million attributable to each of years 1 through 5, and that amount corresponds to more than 10% of the foreign base with respect to which USP's share of the foreign payment was imposed. Fifth, Foreign Bank is a counterparty because it owns stock of Newco for country X tax purposes and none of Foreign Bank's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the United States and country X treat various aspects of the arrangement differently, including whether the Newco securities held by Foreign Bank and USP are debt or equity. The amount of credits claimed by USP if the payment to country X were an amount of tax paid is materially greater than it would be if the country X tax treatment controlled for U.S. tax purposes such that the securities held by USP were treated as debt or the securities held by Foreign Bank were treated as equity, and the amount of income recognized by Newco for U.S. tax purposes is materially less than the amount of income recognized for country X tax purposes. Because the payment to country X is not an amount of tax paid, USP is not deemed to pay any country X tax under section 902(a). USP has dividend income of \$4 million in each of years 1 through 5.

Example 6. Holding company; no SPV. (i) *Facts.* A, a country X corporation, and B, a domestic corporation, each contribute \$1 billion to a newly-formed country X entity (C) in exchange for 50% of the common stock of C. C is treated as a corporation for country X purposes and a partnership for U.S. tax purposes. C contributes \$1.95 billion to a newly-formed country X corporation (D) in

exchange for 100% of D's common stock. C loans its remaining \$50 million to D. Accordingly, C's sole assets are stock and debt of D. D uses the entire \$2 billion to engage in the business of manufacturing and selling widgets. In year 1, D derives \$300 million of income from its widget business and derives \$2 million of interest income. Also in year 1, C has dividend income of \$200 million and interest income of \$3.2 million with respect to its investment in D. Country X does not impose tax on dividends received by one country X corporation from a second country X corporation. C makes a payment of \$960,000 to country X with respect to C's net income.

(ii) *Result.* C qualifies for the holding company exception described in paragraph (e)(5)(iv)(C)(5)(ii) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, C's interest in D constitutes substantially all of C's assets, and A and B share in substantially all of C's opportunity for gain and risk of loss with respect to D. As a result, C's dividend income from D is not passive investment income and C's stock in D is not held to produce such income. Accordingly, C is not an SPV within the meaning of paragraph (e)(5)(iv)(B)(1) of this section, and the \$960,000 payment to country X is not attributable to a structured passive investment arrangement.

Example 7. Holding company; no SPV. (i) *Facts.* The facts are the same as in *Example 6*, except that instead of loaning \$50 million to D, C contributes the \$50 million to E in exchange for 10% of the stock of E. E is a country Y corporation that is not engaged in the active conduct of a trade or business. Also in year 1, D pays no dividends to C, E pays \$3.2 million in dividends to C, and C makes a payment of \$960,000 to country X with respect to C's net income.

(ii) *Result.* C qualifies for the holding company exception described in paragraph (e)(5)(iv)(C)(5)(ii) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, C's interest in D constitutes substantially all of C's assets, and A and B share in substantially all of C's opportunity for gain and risk of loss with respect to D. As a result, less than substantially all of C's assets are held to produce passive investment income. Accordingly, C is not an SPV because it does not meet the requirements of paragraph (e)(5)(iv)(B)(1) of this section, and the \$960,000 payment to country X is not attributable to a structured passive investment arrangement.

Example 8. Holding company; no SPV. (i) *Facts.* The facts are the same as in *Example 6*, except that B's \$1 billion investment in C consists of 30% of C's common stock and 100% of C's preferred stock. A's \$1 billion in-

vestment in C consists of 70% of C's common stock. B sells its preferred stock to F, a country X corporation, subject to a repurchase obligation. Assume that under country X tax law, but not U.S. tax law, F is treated as the owner of the preferred shares and receives a distribution in year 1 of \$50 million. The remaining earnings are distributed 70% to A and 30% to B.

(ii) *Result.* C qualifies for the holding company exception described in paragraph (e)(5)(iv)(C)(5)(ii) of this section because C holds a qualified equity interest in D, D is engaged in an active trade or business and derives more than 50% of its gross income from such trade or business, and C's interest in D constitutes substantially all of C's assets. Additionally, although F does not share in C's opportunity for gain and risk of loss with respect to C's interest in D because F acquired its interest in C in a sale-repurchase transaction, B (the U.S. party) and in the aggregate A and F (who would be counterparties assuming C were an SPV) share in substantially all of C's opportunity for gain and risk of loss with respect to D and such opportunity for gain and risk of loss is not borne exclusively either by B or by A and F in the aggregate. Accordingly, C's shares in D are not held to produce passive investment income and the \$200 million dividend from D is not passive investment income. C is not an SPV within the meaning of paragraph (e)(5)(iv)(B)(1) of this section, and the \$960,000 payment to country X is not attributable to a structured passive investment arrangement.

Example 9. Asset holding transaction. (i) *Facts.* (A) A domestic corporation (USP) contributes \$6 billion of country Z debt obligations to a country Z entity (DE) in exchange for all of the class A and class B stock of DE. DE is a disregarded entity for U.S. tax purposes and a corporation for country Z tax purposes. A corporation unrelated to USP and organized in country Z (FC) contributes \$1.5 billion to DE in exchange for all of the class C stock of DE. DE uses the \$1.5 billion contributed by FC to redeem USP's class B stock. The terms of the class C stock entitle its holder to all income from DE, but FC is obligated immediately to contribute back to DE all distributions on the class C stock. USP and FC enter into—

(1) A contract under which USP agrees to buy after five years the class C stock for \$1.5 billion; and

(2) An agreement under which USP agrees to pay FC periodic payments on \$1.5 billion.

(B) The transaction is structured in such a way that, for U.S. tax purposes, there is a loan of \$1.5 billion from FC to USP, and USP is the owner of the class C stock and the class A stock. In year 1, DE earns \$400 million of interest income on the country Z debt obligations. DE makes a payment to country Z of \$100 million with respect to such income

and distributes the remaining \$300 million to FC. FC contributes the \$300 million back to DE. None of FC's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Assume that country Z imposes a withholding tax on interest income derived by U.S. residents.

(C) Country Z treats FC as the owner of the class C stock. Pursuant to country Z tax law, FC is required to report the \$400 million of income with respect to the \$300 million distribution from DE, but is allowed to claim credits for DE's \$100 million payment to country Z. For country Z tax purposes, FC is entitled to current deductions equal to the \$300 million contributed back to DE.

(ii) *Result.* The payment to country Z is not a compulsory payment, and thus is not an amount of tax paid because the payment is attributable to a structured passive investment arrangement. First, DE is an SPV because all of DE's income is passive investment income described in paragraph (e)(5)(iv)(C)(5) of this section; all of DE's assets are held to produce such income; the payment to country Z is attributable to such income; and if the payment were an amount of tax paid it would be paid or accrued in a U.S. taxable year in which DE meets the requirements of paragraph (e)(5)(iv)(B)(1)(i) of this section. Second, if the payment were an amount of tax paid, USP would be eligible to claim a credit for such amount under section 901(a). Third, USP's proportionate share of DE's foreign payment of \$100 million is substantially greater than the amount of credits USP would be eligible to claim if it directly held its proportionate share of DE's assets, excluding any assets that would produce income subject to gross basis withholding tax if directly held by USP. Fourth, FC is entitled to claim a credit under country Z tax law for the payment and recognizes a deduction for the \$300 million contributed to DE under country Z law. The credit claimed by FC corresponds to more than 10% of USP's share (for U.S. tax purposes) of the foreign payment and the deductions claimed by FC correspond to more than 10% of the base with respect to which USP's share of the foreign payment was imposed. Fifth, FC is a counterparty because FC is considered to own equity of DE under country Z law and none of FC's stock is owned, directly or indirectly, by USP or shareholders of USP that are domestic corporations, U.S. citizens, or resident alien individuals. Sixth, the United States and country X treat certain aspects of the transaction differently, including the proportion of equity owned in DE by USP and FC, and the amount of credits claimed by USP if the country Z payment were an amount of tax paid is materially greater than it would be if the country X tax treatment controlled for U.S. tax purposes such that FC, rather than USP, owned the class C

stock. Because the payment to country Z is not an amount of tax paid, USP is not considered to pay tax under section 901. USP has \$400 million of interest income.

Example 10. Loss surrender. (i) *Facts.* The facts are the same as in *Example 9*, except that the deductions attributable to the arrangement contribute to a loss recognized by FC for country Z tax purposes, and pursuant to a group relief regime in country Z FC elects to surrender the loss to its country Z subsidiary.

(ii) *Result.* The results are the same as in *Example 9*. The surrender of the loss to a related party is a foreign tax benefit that corresponds to the base with respect to which USP's share of the foreign payment was imposed.

Example 11. Joint venture; no foreign tax benefit. (i) *Facts.* FC, a country X corporation, and USC, a domestic corporation, each contribute \$1 billion to a newly-formed country X entity (C) in exchange for stock of C. FC and U.S.C. are entitled to equal 50% shares of all of C's income, gain, expense and loss. C is treated as a corporation for country X purposes and a partnership for U.S. tax purposes. In year 1, C earns \$200 million of net passive investment income, makes a payment to country X of \$60 million with respect to that income, and distributes \$70 million to each of FC and USC. Country X does not impose tax on dividends received by one country X corporation from a second country X corporation.

(ii) *Result.* FC's tax-exempt receipt of \$70 million, or its 50% share of C's profits, is not a foreign tax benefit within the meaning of paragraph (e)(5)(iv)(B)(4) of this section because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Accordingly, the \$60 million payment to country X is not attributable to a structured passive investment arrangement.

Example 12. Joint venture; no foreign tax benefit. (i) *Facts.* The facts are the same as in *Example 11*, except that C in turn contributes \$2 billion to a wholly-owned and newly-formed country X entity (D) in exchange for stock of D. D is treated as a corporation for country X purposes and disregarded as an entity separate from its owner for U.S. tax purposes. C has no other assets and earns no other income. In year 1, D earns \$200 million of passive investment income, makes a payment to country X of \$60 million with respect to that income, and distributes \$140 million to C.

(ii) *Result.* C's tax-exempt receipt of \$140 million is not a foreign tax benefit within the meaning of paragraph (e)(5)(iv)(B)(4) of this section because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Fifty percent of C's foreign tax exemption is not a foreign tax benefit within

the meaning of paragraph (e)(5)(iv)(B)(4) because it relates to earnings of D that are distributed with respect to an equity interest in D that is owned indirectly by U.S.C. under both U.S. and foreign tax law. The remaining 50% of C's foreign tax exemption, as well as FC's tax-exempt receipt of \$70 million from C, is also not a foreign tax benefit because it does not correspond to any part of the foreign base with respect to which USC's share of the foreign payment was imposed. Accordingly, the \$60 million payment to country X is not attributable to a structured passive investment arrangement.

(f) *Taxpayer*—(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.

(2) *Party undertaking tax obligation as part of transaction*—(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.

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

Example 1. Under a loan agreement between A, a resident of country 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.

(3) *Taxes imposed on combined income of two or more persons*—(i) *In general.* If foreign tax is imposed on the combined income of two or more persons (for example, a husband and wife or a corporation and one or more of its subsidiaries), foreign law is considered to impose legal liability on each such person for the amount of the tax that is attributable to such person's portion of the base of the tax. Therefore, if foreign tax is imposed on the combined income of two or more persons, such tax is allocated among, and considered paid by, such persons on a pro rata basis in proportion to each person's portion of the combined income, as determined under foreign law and paragraph (f)(3)(iii) of this section. Combined income with respect to each foreign tax that is imposed on a combined basis is computed separately, and the tax on that combined income is allocated separately under this paragraph (f)(3)(i). If foreign law exempts from tax, or provides for specific rates of tax with respect to, certain types of income, or if certain expenses, deductions or credits are taken into account only with respect to a particular type of income, combined income with respect to such portions of the combined income is also computed separately, and the tax on that combined income is allocated separately under this paragraph (f)(3)(i). The rules of this paragraph (f)(3) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. For purposes of this paragraph (f)(3), the term *person* means an individual or an entity (including a disregarded entity described in § 301.7701-2(c)(2)(i) of this chapter) that is subject to tax in a foreign country as a corporation (or otherwise at the entity level). In determining the amount of tax paid by an owner of a partnership or a disregarded entity, this paragraph (f)(3) first applies to determine the amount of tax paid by the partnership or disregarded entity, and then paragraph (f)(4) of this section applies to al-

locate the amount of such tax to the owner.

(ii) *Combined income.* For purposes of this paragraph (f)(3), foreign tax is imposed on the combined income of two or more persons if such persons compute their taxable income on a combined basis under foreign law and foreign tax would otherwise be imposed on each such person on its separate taxable income. For example, income is computed on a combined basis if two or more persons add their items of income, gain, deduction, and loss to compute a single consolidated taxable income amount for foreign tax purposes. Foreign tax is considered to be imposed on the combined income of two or more persons even if the combined income is computed under foreign law by attributing to one such person (for example, the foreign parent of a foreign consolidated group) the income of other such persons or by treating persons that would otherwise be subject to tax as separate entities as unincorporated branches of a single corporation for purposes of computing the foreign tax on the combined income of the group. However, foreign tax is not considered to be imposed on the combined income of two or more persons if, because one or more persons is a fiscally transparent entity (under the principles of § 1.894-1(d)(3)) under foreign law, only one of such persons is subject to tax under foreign law (even if two or more of such persons are corporations for U.S. Federal income tax purposes). Therefore, foreign tax is not considered to be imposed on the combined income of two or more persons solely because foreign law:

(A) Permits one person to surrender a loss to another person pursuant to a group relief or other loss-sharing regime described in § 1.909-2T(b)(2)(vi);

(B) Requires a shareholder of a corporation to include in income amounts attributable to taxes imposed on the corporation with respect to distributed earnings, pursuant to an integrated tax system that allows the shareholder a credit for such taxes;

(C) Requires a shareholder to include, pursuant to an anti-deferral regime (similar to subpart F of the Internal Revenue Code (sections 951 through

965)), income attributable to the shareholder's interest in the corporation;

(D) Reallocates income from one person to a related person under foreign transfer pricing rules;

(E) Requires a person to take into account a distributive share of income of an entity that is a partnership or other fiscally transparent entity for foreign tax law purposes; or

(F) Requires a person to take all or part of the income of an entity that is a corporation for U.S. Federal income tax purposes into account because foreign law treats the entity as a branch or fiscally transparent entity (a reverse hybrid). A reverse hybrid does not include an entity that is treated under foreign law as a branch or fiscally transparent entity solely for purposes of calculating combined income of a foreign consolidated group.

(iii) *Portion of combined income*—(A) *In general.* Each person's portion of the combined income is determined by reference to any return, schedule or other document that must be filed or maintained with respect to a person showing such person's income for foreign tax purposes, as properly amended or adjusted for foreign tax purposes. If no such return, schedule or other document must be filed or maintained with respect to a person for foreign tax purposes, then, for purposes of this paragraph (f)(3), such person's income is determined from the books of account regularly maintained by or on behalf of the person for purposes of computing its income for foreign tax purposes. Each person's portion of the combined income is determined by adjusting such person's income determined under this paragraph (f)(3)(iii)(A) as provided in paragraph (f)(3)(iii)(B) and (f)(3)(iii)(C) of this section.

(B) *Effect of certain payments*—(1) Each person's portion of the combined income is determined by giving effect to payments and accrued amounts of interest, rents, royalties, and other amounts between persons whose income is included in the combined base to the extent such amounts would be taken into account in computing the separate taxable incomes of such persons under foreign law if they did not compute their income on a combined basis. Each person's portion of the

combined income is determined without taking into account any payments from other persons whose income is included in the combined base that are treated as dividends or other non-deductible distributions with respect to equity under foreign law, and without taking into account deemed dividends or any similar attribution of income made for purposes of computing the combined income under foreign law, regardless of whether any such deemed dividend or attribution of income results in a deduction or inclusion under foreign law.

(2) For purposes of determining each person's portion of the combined income, the treatment of a payment is determined under foreign law. Thus, for example, interest accrued by one group member with respect to an instrument held by another member that is treated as debt for foreign tax purposes but as equity for U.S. Federal income tax purposes would be considered income of the holder and would reduce the income of the issuer. See also § 1.909-2T(b)(3)(i) for rules requiring suspension of foreign income taxes paid or accrued by the owner of a U.S. equity hybrid instrument.

(C) *Net losses.* If tax is considered to be imposed on the combined income of three or more persons and one or more of such persons has a net loss for the taxable year for foreign tax purposes, the following rules apply. If foreign law provides mandatory rules for allocating the net loss among the other persons, then the rules that apply for foreign tax purposes apply for purposes of this paragraph (f)(3). If foreign law does not provide mandatory rules for allocating the net loss, the net loss is allocated among all other such persons on a pro rata basis in proportion to the amount of each person's income, as determined under paragraphs (f)(3)(iii)(A) and (f)(3)(iii)(B) of this section. For purposes of this paragraph (f)(3)(iii)(C), foreign law is not considered to provide mandatory rules for allocating a net loss solely because such loss is attributed from one person to a second person for purposes of computing combined income, as described in paragraph (f)(3)(ii) of this section.

(iv) *Collateral consequences.* U.S. tax principles apply to determine the tax

consequences if one person remits a tax that is the legal liability of, and thus is considered paid by, another person.

(4) *Taxes imposed on partnerships and disregarded entities*—(i) *Partnerships*. If foreign law imposes tax at the entity level on the income of a partnership, the partnership is considered to be legally liable for such tax under foreign law and therefore is considered to pay the tax for U.S. Federal income tax purposes. The rules of this paragraph (f)(4)(i) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. See §§1.702-1(a)(6) and 1.704-1(b)(4)(viii) for rules relating to the determination of a partner's distributive share of such tax. If the U.S. taxable year of a partnership closes for all partners due to a termination of the partnership under section 708(b)(1)(A) and the regulations under that section and the foreign taxable year of the partnership does not close, then foreign tax paid or accrued with respect to the foreign taxable year in which the termination occurs is allocated between the terminating partnership and its successors or assigns. For example, if, as a result of a change in ownership during a partnership's foreign taxable year, the partnership becomes a disregarded entity and the entity's foreign taxable year does not close, foreign tax paid or accrued by the owner of the disregarded entity with respect to the foreign taxable year is allocated between the partnership and the owner of the disregarded entity. If the U.S. taxable year of a partnership closes for all partners due to a termination of the partnership under section 708(b)(1)(B) and the regulations under that section and the foreign taxable year of the partnership does not close, then foreign tax paid or accrued by the new partnership with respect to the foreign taxable year in which the termination occurs is allocated between the terminating partnership and the new partnership. If multiple terminations under section 708(b)(1)(B) occur within the foreign taxable year, foreign tax paid or accrued with respect to that foreign taxable year by a new partnership is allo-

cated among all terminating and new partnerships. In the case of any termination under section 708(b)(1), the allocation of foreign tax is made based on the respective portions of the taxable income (as determined under foreign law) for the foreign taxable year that are attributable under the principles of §1.1502-76(b) to the period of existence of each terminating and new partnership, or successor or assign of a terminating partnership, during the foreign taxable year. Foreign tax allocated to a terminating partnership under this paragraph (f)(4)(i) is treated as paid or accrued by such partnership as of the close of the last day of its final U.S. taxable year. In the case of a change in any partner's interest in the partnership (a variance), except as otherwise provided in section 706(d)(2) (relating to certain cash basis items) or 706(d)(3) (relating to tiered partnerships), foreign tax paid or accrued by the partnership during its U.S. taxable year in which the variance occurs is allocated between the portion of the U.S. taxable year ending on, and the portion of the U.S. taxable year beginning on the day after, the day of the variance. The allocation is made under the principles of this paragraph (f)(4)(i) as if the variance were a termination under section 708(b)(1).

(ii) *Disregarded entities*. If foreign law imposes tax at the entity level on the income of an entity described in §301.7701-2(c)(2)(i) of this chapter (a *disregarded entity*), the person (as defined in section 7701(a)(1)) who is treated as owning the assets of the disregarded entity for U.S. Federal income tax purposes is considered to be legally liable for such tax under foreign law. Such person is considered to pay the tax for U.S. Federal income tax purposes. The rules of this paragraph (f)(4)(ii) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid. If there is a change in the ownership of such disregarded entity during the entity's foreign taxable year and such change does not result in a closing of the disregarded entity's foreign taxable year,

foreign tax paid or accrued with respect to such foreign taxable year is allocated between the transferor and the transferee. If there is more than one change in the ownership of a disregarded entity during the entity's foreign taxable year, foreign tax paid or accrued with respect to that foreign taxable year is allocated among all transferors and transferees. The allocation is made based on the respective portions of the taxable income of the disregarded entity (as determined under foreign law) for the foreign taxable year that are attributable under the principles of § 1.1502-76(b) to the period of ownership of each transferor and transferee during the foreign taxable year. If, as a result of a change in ownership, the disregarded entity becomes a partnership and the entity's foreign taxable year does not close, foreign tax paid or accrued by the partnership with respect to the foreign taxable year is allocated between the owner of the disregarded entity and the partnership under the principles of this paragraph (f)(4)(ii). If the person who owns a disregarded entity is a partnership for U.S. Federal income tax purposes, see § 1.704-1(b)(4)(viii) for rules relating to the allocation of such tax among the partners of the partnership.

(5) *Allocation of foreign taxes in connection with elections under section 336(e) or 338.* For rules relating to the allocation of foreign taxes in connection with elections made pursuant to section 336(e), see § 1.336-2(g)(3)(ii). For rules relating to the allocation of foreign taxes in connection with elections made pursuant to section 338, see § 1.338-9(d).

(6) *Examples.* The following examples illustrate the rules of paragraphs (f)(3) and (f)(4) of this section:

Example 1. (i) *Facts.* A, a United States person, owns 100 percent of B, an entity organized in country X. B owns 100 percent of C, also an entity organized in country X. B and C are corporations for U.S. and foreign tax purposes that use the "u" as their functional currency. Pursuant to a consolidation regime, country X imposes an income tax described in (a)(1) of this section on the combined income of B and C within the meaning of paragraph (f)(3)(ii) of this section. In year 1, C pays 25u of interest to B. If B and C did not report their income on a combined basis for country X tax purposes, the interest paid from C to B would result in 25u of interest

income to B and 25u of deductible interest expense to C. For purposes of reporting the combined income of B and C, country X first requires B and C to determine their own income (or loss) on a separate schedule. For this purpose, however, neither B nor C takes into account the 25u of interest paid from C to B because the income of B and C is included in the same combined base. The separate income of B and C reported on their country X schedules for year 1, which do not reflect the 25u intercompany payment, is 100u and 200u, respectively. The combined income reported for country X purposes is 300u (the sum of the 100u separate income of B and 200u separate income of C).

(ii) *Result.* On the separate schedules described in paragraph (f)(3)(iii)(A) of this section, B's separate income is 100u and C's separate income is 200u. Under paragraph (f)(3)(iii)(B)(1) of this section, the 25u interest payment from C to B is taken into account for purposes of determining B's and C's portions of the combined income under paragraph (f)(3)(iii) of this section, because B and C would have taken the items into account if they did not compute their income on a combined basis. Thus, B's portion of the combined income is 125u (100u plus 25u) and C's portion of the combined income is 175u (200u less 25u). The result is the same regardless of whether the 25u interest payment from C to B is deductible for U.S. Federal income tax purposes. See paragraph (f)(3)(iii)(B)(2) of this section.

Example 2. (i) *Facts.* A, a United States person, owns 100 percent of B, an entity organized in country X. B is a corporation for country X tax purposes, and a disregarded entity for U.S. income tax purposes. B owns 100 percent of C and D, entities organized in country X that are corporations for both U.S. and country X tax purposes. B, C, and D use the "u" as their functional currency and file on a combined basis for country X income tax purposes. Country X imposes an income tax described in paragraph (a)(1) of this section at the rate of 30 percent on the taxable income of corporations organized in country X. Under the country X combined reporting regime, income (or loss) of C and D is attributed to, and treated as income (or loss) of, B. B has the sole obligation to pay country X income tax imposed with respect to income of B and income of C and D that is attributed to, and treated as income of, B. Under the law of country X, country X may proceed against B, but not C or D, if B fails to pay over to country X all or any portion of the country X income tax imposed with respect to such income. In year 1, B has income of 100u, C has income of 200u, and D has a net loss of (60u). Under the law of country X, B is considered to have 240u of taxable income with respect to which country X income tax is imposed. Country X does not

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provide mandatory rules for allocating D's loss.

(ii) *Result.* Under paragraph (f)(3)(ii) of this section, the 72u of country X tax is considered to be imposed on the combined income of B, C, and D. Because country X law does not provide mandatory rules for allocating D's loss between B and C, under paragraph (f)(3)(iii)(C) of this section D's (60u) loss is allocated pro rata: 20u to B $((100u/300u) \times 60u)$ and 40u to C $((200u/300u) \times 60u)$. Under paragraph (f)(3)(i) of this section, the 72u of country X tax must be allocated pro rata among B, C, and D. Because D has no income for country X tax purposes, no country X tax is allocated to D. Accordingly, 24u $(72u \times (80u/240u))$ of the country X tax is allocated to B, and 48u $(72u \times (160u/240u))$ of such tax is allocated to C. Under paragraph (f)(4)(ii) of this section, A is considered to have legal liability for the 24u of country X tax allocated to B under paragraph (f)(3) of this section.

Example 3. (i) *Facts.* A, B, and C are U.S. persons that each use the calendar year as their taxable year. A and B each own 50 percent of the capital and profits of D, an entity organized in country M. D is a partnership for U.S. tax purposes, but is a corporation for country M tax purposes. D uses the "u" as its functional currency and the calendar year as its taxable year for both U.S. tax purposes and country M tax purposes. Country M imposes an income tax described in paragraph (a)(1) of this section at a rate of 30 percent at the entity level on the taxable income of D. On September 30 of Year 1, A sells its 50 percent interest in D to C. A's sale of its partnership interest results in a termination of the partnership under section 708(b)(1)(B) for U.S. tax purposes. As a result of the termination, "old" D's taxable year closes on September 30 of Year 1 for U.S. tax purposes. New D also has a short U.S. taxable year, beginning on October 1 and ending on December 31 of Year 1. The sale of A's interest does not close D's taxable year for country M tax purposes. D has 400u of taxable income for its foreign taxable year ending December 31, Year 1 with respect to which country M imposes 120u of income tax, equal to \$120 as translated in accordance with section 986(a).

(ii) *Result.* Under paragraph (f)(4)(i) of this section, partnership D is legally liable for the \$120 of country M income tax imposed on its foreign taxable income. Because D's taxable year closes on September 30, Year 1, for U.S. tax purposes, but does not close for country M tax purposes, under paragraph (f)(4)(i) of this section the \$120 of country M tax must be allocated under the principles of § 1.1502-76(b) between terminating D and new D. See § 1.704-1(b)(4)(viii) for rules relating to the allocation of terminating D's country M taxes between A and B and the allocation of new D's country M taxes between B and C.

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

(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."

(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.

(3) The term *foreign levy* means a levy imposed by a foreign country.

(h) *Effective/applicability date*—(1) *In general.* This section and §§ 1.901-2A and 1.903-1 apply to taxable years beginning after November 14, 1983.

(2) Except as provided in paragraph (h)(3) of this section, paragraph (e)(5)(iv) of this section applies to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued under § 1.901-2(f) on or after July 13, 2011. See 26 CFR 1.901-2T(e)(5)(iv) (revised as of April 1, 2011), for rules applicable to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued before July 13, 2011.

(3) The last sentence of paragraph (e)(5)(iv)(B)(I)(ii) of this section applies to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued under § 1.901-2(f) on or after September 4, 2013. See 26 CFR 1.901-2T(e)(5)(iv)(B)(I)(iii) (revised as of April 1, 2013) for rules applicable to foreign payments that, if such payments were an amount of tax paid, would be considered paid or accrued under § 1.901-2(f) before September 4, 2013.

(4) Paragraphs (f)(3), (f)(4), and (f)(6) of this section apply to foreign taxes paid or accrued in taxable years beginning after February 14, 2012. However, if an amount of tax is paid or accrued in a taxable year of any person beginning on or before February 14, 2012, and the tax is treated as paid or accrued by

such person under 26 CFR 1.901-2(f) (revised as of April 1, 2011), then paragraph (f)(4) of this section will not apply, and 26 CFR 1.901-2(f) (revised as of April 1, 2011) will apply, to determine the person with legal liability for that tax. No other person will be treated as legally liable for such tax, even if the tax is paid or accrued on a date that falls within a taxable year of such other person beginning after February 14, 2012. Taxpayers may choose to apply paragraph (f)(3) of this section to foreign taxes paid or accrued in taxable years beginning after December 31, 2010, and on or before February 14, 2012.

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§ 1.901-2A Dual capacity taxpayers.

(a) *Application of separate levy rules as applied to dual capacity taxpayers—(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 § 1.901-2(d), the levy as applicable to such dual capacity taxpayers 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.

(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