DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

May 16, 2000

Number: **200032037**
Release Date: 8/11/2000
CC:INTL:Br3
WTA-N-105964-00
UILC: 901.01-04

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Anne O'Connell Devereaux
Assistant to the Branch Chief CC:INTL:BR3

SUBJECT:

This Field Service Advice responds to your memorandum dated March 7, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND

Taxpayer =

USSub1 =
USSub2 =
year 1 =
year 2 =
year 3 =
Business b =
Agreement C =
Indonesia entity =

ISSUES

1. Does the Treaty treat certain levies paid pursuant to Agreement C as an income tax, thereby satisfying the requirements of Treas. Reg. §1.901-2A(b)(2) and avoiding application of Treas. Reg. §1.901-2A(b)(1) and (c) that might treat a portion of the levies as paid in exchange for a specific economic benefit?

2. May Taxpayer switch from claiming a deduction to a credit for foreign income taxes paid or accrued within the 10-year period of section 6511(d)(3)(A) of the

Internal Revenue Code whether the Taxpayer claims the foreign tax credit under the Code or the Treaty?

CONCLUSIONS

1. Treasury Reg. §1.901-2A(b)(2) is not applicable since the Treaty does not treat, as required by that regulation, the taxes to which USSub2 is subject as income taxes. Accordingly, the rules of Treas. Reg. §1.901-2A(b)(1) and (c) apply.

2. Taxpayer may switch from claiming a deduction to a credit for foreign income taxes paid or accrued within the 10-year period of section 6511(d) (3)(A) of the Code whether the Taxpayer claims the foreign tax credit under the Code or the Treaty.

FACTS

Taxpayer is a domestic corporation that files a consolidated federal income tax return with its affiliates, including USSub1 and USSub2. USSub1 owns 100% of the stock of USSub2, a domestic corporation engaged in Business b through a permanent establishment in Indonesia.

USSub2's operations are conducted under Agreement C with Indonesia entity, a controlled entity of the government of Indonesia. Agreement C obligates USSub2 to pay Indonesian taxes as indicated in the agreement. USSub2's obligation under Agreement C to pay Indonesian taxes is not affected by subsequent changes to Indonesian law or to tax rates established under the income tax treaty between the U.S. and Indonesia (TIAS 11593) ("Treaty").

The Treaty, which entered into force on December 30, 1990, and was in effect for years 1 through 3, allows Indonesia to impose a tax on the business profits of U.S. corporations that operate in Indonesia through a permanent establishment, such as USSub2. *See* Article 8 of the Treaty. In addition, under Article 11(4) of the Treaty, Indonesia is allowed to impose a tax on the after-tax business profits of U.S. corporations that operate in Indonesia through a permanent establishment. The taxes that may be imposed by Indonesia under the Treaty are specified in Article 2 of the Treaty (the income tax (pajak penghasilian 1984), and to the extent provided in such income tax, the company tax (pajak perseroan 1925), and the tax on interest, dividends, and royalties (pajak atas bunga, dividen dan royalty 1970) (and identical or substantially similar taxes)) ("Treaty specified taxes").

Agreement C was executed before, and continued to apply after, the Treaty went into effect. Under Agreement C, USSub2 paid tax to Indonesia on its permanent establishment's business profits and after-tax profits at the rates contractually fixed

under the agreement. These rates differed from both the rates set under the laws and decrees of Indonesia and the Treaty.

For years 1 through 3, Taxpayer elected on its originally filed U.S. federal income tax returns for those years to deduct, rather than credit, foreign income taxes, including qualifying taxes paid to Indonesia. More than three years, but before ten years, after the filing deadline for those years, Taxpayer filed an informal claim for refund to credit, rather than deduct, those foreign income taxes.

During years 1 through 3, USSub2 was a dual capacity taxpayer with regard to Indonesia as defined in Treas. Reg. §1.901-2(a)(2)(ii).

LAW AND ANALYSIS

1. Treasury Reg. §1.901-2A(b)(1) provides that in order to claim a credit under section 901 or 903 of the Code for a foreign levy "the person claiming the credit must establish that the foreign levy with respect to which credit is claimed is an income tax or a tax in lieu of an income tax." Where a foreign levy is paid by a dual capacity taxpayer that taxpayer, in order for any part of the levy to be creditable, is required "to establish the amount, if any, that is paid pursuant to the distinct element of the levy that is a tax" (as distinguished from a payment for a specific economic benefit) pursuant to either the facts and circumstances method or the safe harbor method as set forth in Treas. Reg. §1.901-2A(c). Accordingly, under these regulations, since it is a dual capacity taxpayer with respect to Indonesia, USSub2 would be required in its affirmative claim for refund to apply one of those methods to establish the part of the taxes paid to Indonesia that is a tax. However, Taxpayer has asserted that the special rule of Treas. Reg. §1.901-2A(b)(2) applies so that the entire amount paid by USSub2 to Indonesia is a tax. That regulation provides a special rule, as follows, for situations in which a dual capacity taxpayer claims a foreign tax credit under a treaty:

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

Here, Treas. Reg. §1.901-2A(b)(2) is inapplicable since the Treaty does not treat the Treaty specified taxes "as an income tax." Paragraph 1 of Article 23 of the Treaty provides that double taxation of income will be avoided in the United States as follows:

> (1) In accordance with the provisions and subject to the limitations of the law of the United States, as in force from time to time, the United States shall allow to a citizen or resident of the United States as a credit against the United States tax the appropriate amount of Indonesian tax. Such appropriate amount shall be based upon the amount of tax paid to Indonesia, but the credit shall not exceed the limitations provided by United States law for the taxable year. For the purpose of applying the United States credit in relation to taxes paid to Indonesia, the rules set forth in Article 7 (Source of Income) shall be applied to determine the source of income, subject to such source rules in domestic law as apply solely for the purposes of limiting the foreign tax credit.

Article 23 of the Treaty follows the structure and substance of the corresponding article in the 1977 U.S. Model income tax treaty ("Model Treaty"). In addition to language nearly identical to the language of Article 23 quoted above, the Model Treaty provides that "[f]or purposes of applying the United States credit in relation to tax paid to _____ the taxes referred to in paragraphs 2 b) and 3 of Article 2 (Taxes Covered) shall be considered to be income taxes." Here, the Treaty specifies in Article 2 what taxes are covered by the Treaty (*i.e.,* Treaty specified taxes). However, the Treaty does not include the Model Treaty provision which specifically states that the covered taxes will be considered income taxes. The drafters of the Treaty intended, as explained in the Treasury Department's Technical Explanation of the Treaty, to leave it to each Contracting State to "apply its domestic law to determine what is a creditable tax."

Accordingly, Treas. Reg. §1.901-2A(b)(2) is inapplicable since the Treaty does not treat the Treaty specified taxes as "as an income tax." Since Taxpayer cannot rely on that special regulatory rule, it must instead apply either the facts and circumstances method or the safe harbor method of Treas. Reg. §1.901-2A(c) to determine the amount of the payment made by USSub2 to Indonesia that is a tax.

2. On its original federal income tax returns for the years 1 through 3, Taxpayer elected to deduct rather than credit foreign income taxes, including qualifying taxes paid to Indonesia. Taxpayer filed claims for refund to credit, rather than deduct, those foreign income taxes after the expiration of the three-year period of limitation provided by section 6511(a) of the Code, but within the ten-year period provided by section 6511(d)(3)(A).

During years 1 through 3, section 6511(d)(3)(A) of the Code provided:

> (A) SPECIAL PERIOD OF LIMITATION WITH RESPECT TO FOREIGN TAXES PAID OR ACCRUED. - If the claim for credit or refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country or to any possession of the United States for which credit is allowed against the tax imposed by subtitle A in accordance with the provisions of section 901 or the provisions of any treaty to which the United States is a party, in lieu of the 3-year period of limitation prescribed in subsection (a), the period shall be 10 years from the date prescribed by law for filing the return for the year with respect to which the claim is made.

Under section 901(a) of the Code and Treas. Reg. §1.901-1(d) a taxpayer may switch from deduction to a credit within the 10-year special statute of limitations period provided in section 6511(d)(3)(A). Section 901(a) provides:

> If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall ... be credited with the amounts provided in the applicable paragraph of subsection (b) .... Such choice for any taxable year may be made or changed at any time before the expiration of the period for making a claim for credit or refund of the tax imposed by this chapter for such taxable year.... (emphasis added).

Treas. Reg. § 1.901-1(d) clarifies that a taxpayer may switch from a deduction to a credit within the 10-year period of section 6511(d)(3)(A) of the Code. Further, that 10-year period would have applied had the Treaty treated the Indonesian taxes to which USSub2 is subject as income taxes. Article 23 of the Treaty provides that the U.S. shall allow a credit for Indonesian tax in accordance with the provisions and subject to the limitations of the law of the U.S. One such provision of U.S. law is the 10-year period of section 6511(d)(3)(A).

Please call (202) 622-3850 if you have any further questions.

ANNE O'CONNELL DEVEREAUX
Assistant to the Branch Chief
Branch 3, Office of Associate
Chief Counsel (International)