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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

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

SUBJECT:

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LEGEND

TL-N-471-00

Taxpayer =

Fsub =
year W =
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A =
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ISSUES

1. Whether the Canadian Petroleum Gas and Revenue Taxes ("PGRT") paid by Fsub and the tax paid or accrued under the Income Tax Act of Canada (“ITA” and “ITA tax”) by Fsub in 1981 and 1982 are taxes in lieu of an income tax as defined in section 903 of the Internal Revenue Code and Temp. Treas. Reg. §4.903-1(a)?

2. Whether the modified ITA tax in 1984, 1985, and 1986 is a creditable tax under section 901 of the Code?

3. Whether the PGRT as paid or accrued by Fsub in 1984, 1985, and 1986 is a tax in lieu of an income tax as defined in section 903 of the Code and Treas. Reg. §1.903-1(a)?

4. Whether the PGRT and modified ITA tax in 1985 and 1986 are creditable taxes under the U.S.-Canada Income Tax Treaty as applicable for those years?

5. Whether the PGRT and modified ITA tax in 1981, 1982, and 1984 are creditable taxes under the U.S.-Canada Income Tax Treaty as applicable for those years?

CONCLUSIONS

1. The PGRT paid or accrued by Fsub in 1981 and 1982 is not a tax paid in lieu of an income tax under section 903 of the Code since it failed to meet the substitution requirement of Temp. Treas. Reg. §4.901-1(b). The separate charge ITA tax paid or accrued by Fsub in those years is not an in lieu of tax since it failed to meet the comparability requirement of Temp. Treas. Reg. §4.901-1(c).

2. The modified ITA tax in 1984, 1985, and 1986 is not a separate levy from the ITA tax that applies to all corporate taxpayers resident in Canada. The generally imposed ITA tax is a creditable income tax for purposes of section 901 of the Code.

3. For 1984, 1985, and 1986, the PGRT was in addition to the ITA tax since the base of the PGRT included income of the oil producers that was also included in the base of the ITA tax. Accordingly, the PGRT paid or accrued by Fsub in those years is not creditable under section 903 of the Code.

4. The modified ITA tax in 1985 and 1986, since it was a covered tax, is a creditable tax under the 1984 Treaty. The PGRT is not a covered tax under the 1984 Treaty and therefore is not a creditable tax under that treaty.

5. The modified ITA tax in 1981, 1982, and 1984 is not a creditable tax under the 1942 Treaty since the Treaty allows a credit "subject to the limitations provided in section 131, Internal Revenue Code," and thus permits a credit for covered taxes only if they would have been creditable under the Code. Also, the 1942 Treaty does not specifically require the U.S. to allow a deemed paid credit for income taxes paid to Canada. The PGRT is not a covered tax under the 1942 Treaty and therefore is not a creditable tax under that treaty.

FACTS

In 1981-1986, Fsub was involved in the production of petroleum in Canada. During those years, Fsub was a controlled foreign corporation as defined in section 957 of the Code and Taxpayer was a U.S. shareholder of Fsub as defined in section 951(b).

In 1983, with respect to Fsub, Taxpayer included in its gross income under sections 951 and 956 of the Code its pro rata share of the increase in Fsub's earnings invested in U.S. property for that year. With respect to that inclusion in gross income for 1983, Taxpayer claimed under section 960 foreign tax credits for PGRT and ITA taxes in the aggregate amount of $A.

In year X, Taxpayer recognized gain on the sale of its stock in Fsub. Taxpayer reported the gain as a dividend on its year X federal income tax return to the extent required by section 1248(a) of the Code. With regard to that dividend, Taxpayer claimed on that return foreign tax credits in the amount of $B for PGRT paid or accrued by Fsub during 1981, 1982, 1984, 1985, and 1986. Of this amount, $C was paid or accrued in 1981, $D was paid or accrued in 1982, and $E was paid or accrued in 1984-1986. Since Taxpayer has supplied empirical data that it asserts show that the PGRT is not creditable under section 901 because it fails to meet the

regulatory net income requirement, we assume Taxpayer claimed the PGRT is creditable under section 903. For purposes of our analysis of whether the PGRT is creditable under section 903, we assume that Taxpayer is correct that the PGRT paid by Fsub in 1981, 1982, 1984, 1985, and 1986 is not creditable under section 901.

Also, with regard to the section 1248 deemed dividend, Taxpayer claimed on its year X federal income tax return foreign tax credits in the amount of $F for amounts paid or accrued under the ITA tax as applicable to petroleum and other natural resource producers in Canada ("modified ITA tax"), such as Fsub, for the years W-X. With regard to some of those years, 1981-1986, Taxpayer asserts that the modified ITA tax was a separate charge or levy and also asserts that empirical data which it has supplied show that the modified ITA tax is not creditable under section 901 of the Code because it fails to meet the regulatory net income requirement. Therefore, presumably, Taxpayer has claimed foreign tax credits for the modified ITA tax during those years under either section 903 or the U.S.-Canada Income Tax Treaty.[1] With regard to our analysis of whether the modified ITA tax is creditable under section 903 for 1981 and 1982, Taxpayer's assertion that it is a separate charge is correct.[2] Also, for purposes of that analysis we assume that Taxpayer is correct that the modified ITA tax is not creditable under section 901 because the regulatory net income requirement was not met. However, with regard to 1984, 1985, and 1986, Taxpayer's assertion that the modified ITA tax was a separate levy is incorrect; therefore, it is subject to a different analysis under section 901.

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[1]Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, TIAS 11087, 1986-2 C.B. 258 ("1984 Treaty").

[2]Temp. Treas. Reg. §4.901-2(a)(1) provides that "[w]hether a charge imposed by a foreign country ('foreign charge') is an income tax is determined independently for each separate foreign charge." A foreign charge is a separate charge if (1) it has a separate base, Temp. Treas. Reg. §4.901-2(d)(2), (2) foreign law imposes a separate rate on the same base, Temp. Treas. Reg. §4.901-2(d)(3), (3) the foreign charge is modified by contractual modifications, Temp. Treas. Reg. §4.901-2(d)(5), or (4) foreign law provisions "significantly increase the liability only of persons engaged in a particular industry or industries, and if those provisions would prevent the charge from being an income tax if persons engaged in the industry or industries were the only persons subject to the charge", Temp. Treas. Reg. §4.901-2(d)(4). Here, the modified ITA tax was a separate charge because of the restrictions on deductibility of many expenses for the companies in the petroleum extraction industry and the requirement that those companies include certain royalties paid in income "significantly increase the liability only of persons engaged in" that industry. Temp. Treas. Reg. §4.901-2(d)(4).

Taxpayer did not elect by October 12, 1984, the deadline set in Treas. Reg. §1.901-2(h)(2)(iv), to apply Treas. Reg. §§1.901-2, 1.901-2A and 1.903-1, which are effective for taxable years beginning after November 14, 1983, to earlier years with respect to Canada. Year X began after November 14, 1983.

LAW AND ANALYSIS

Under section 1248(a) of the Code, Taxpayer was required to treat as a dividend its recognized gain on the sale in year X of its Fsub stock to the extent of Fsub's earnings and profits, other than earnings and profits described in section 1248(d), attributable to the stock sold by Taxpayer and accumulated in Fsub's taxable years 1981, 1982, 1984, 1985, and 1986. Since the recognized gain was treated as a dividend as required by section 1248(a), Taxpayer was entitled to claim in year X a deemed paid foreign tax credit for foreign income taxes paid or accrued by Fsub attributable to those earnings and profits.

Taxpayer is entitled to a deemed-paid foreign tax credit for "any income, war profits, or excess profits taxes paid by the foreign corporation to any foreign country." Section 902(c)(4) of the Code. "Foreign income taxes" means "foreign income, war profits, and excess profits taxes as defined in §1.901-2(a), and taxes included within the term income, war profits, and excess profits taxes by reason of section 903." Treas. Reg. §1.902-1(a)(7). This definition "applies to any distribution made in and after a foreign corporation's first taxable year beginning on or after January 1, 1987." Treas. Reg. §1.902-2(g). Here, year X, the year when Taxpayer sold its Fsub stock, was after 1987 so the regulatory definition is applicable. However, the regulation's reference to Treas. Reg. §1.901-2(a) is incomplete to the extent that a deemed-paid foreign tax credit is allowed for taxes paid or accrued by Fsub in its taxable years beginning before November 15, 1983, the effective date of Treas. Reg. §1.901-2(a). Treas. Reg. §1.901-2(h). For taxable years beginning before November 15, 1983, the definitions of foreign income tax for purposes of section 901 and taxes in lieu of income taxes for purposes of section 903 were found in Temp. Treas. Reg. §§4.901-2 and 4.903-1.

As stated above, Taxpayer did not elect under Treas. Reg. §1.901-2(h)(2) to apply Treas. Reg. §§1.901-2, 1.901-2A and 1.903-1, which are effective for taxable years beginning after November 14, 1983, to earlier years with respect to Canada. Accordingly, Temp. Treas. Reg. §§4.901-2 and 4.903-1 apply to Fsub's 1981 and 1982 tax years. Treas. Reg. §§1.901-2(a), 1.901-2A, and 1.903-1 apply to Fsub's 1984, 1985, and 1986 tax years.

The Canadian Petroleum and Gas Revenue Tax

The PGRT was generally effective beginning January 1, 1981, and was repealed for production revenues received after September 1986. Amendments made to the Petroleum and Gas Revenue Act ("PGRTA") by Bill C-17. The PGRT applied to any person who had income (other than royalties) from the production of petroleum or gas in Canada or from the processing of Canadian petroleum to a stage not beyond the stage of crude oil or its equivalent. Where petroleum was processed beyond the stage of crude oil or its equivalent, there was a deemed disposition of the petroleum when it reached the crude oil stage at its market value at that time. Section 82(1) of the PGRTA. The PGRT was payable whether oil rights were under federal or provincial jurisdiction or were privately owned.

Production revenue was generally computed in accordance with the ITA except that many items that were deductible under the ITA were disallowed for purposes of the PGRT under section 82(1) of the PGRTA. These items included the capital cost allowance, interest expense, addition to bad debt and other reserves, exploration expense, research and development expenses, the cost depletion allowance, and crown royalties. Beginning in January 1982, section 82(2)(e) of the PGRTA and section 5.1 of the PGRTA regulations allowed a resource allowance of 25% of production revenue for the year in computing the PGRT. Fsub was entitled to the resource allowance for its taxable years 1982, 1984, 1985, and 1986 but not for taxable year 1981. If the taxpayer was required to include in income the fair market value of the petroleum since it was subject to additional processing beyond the crude oil stage the taxpayer was entitled to a deduction for the amount in inventory at the end of the year. The PGRT was not deductible in computing income subject to the ITA.

For years 1981 through 1985, sections 81 and 84(1)(a) of the PGRTA imposed the PGRT at rates varying from 8% to 16% on production revenue. The PGRT rate decreased to 10% in 1986. Amendments made to the PGRTA by Bill C-82.

The Canadian Income Tax Act

All resident Canadian corporations were subject to the ITA on their taxable income for 1981, 1982, 1984, 1985, and 1986. ITA, Section 2(1). Taxable income for purposes of the ITA tax was the corporation's income from all businesses for the year, as determined under section 3 of the ITA, less deductions for the expenses incurred to produce that income. ITA, Section 18(1)(a). Each taxpayer determined its income or loss for the year from each business and then aggregated the income and losses to determine the taxpayer's taxable income for the year. A taxpayer that incurred non-capital losses in its business activities not involving the extraction of natural resources could deduct those losses against its income from the extraction

of natural resources. Likewise, losses from the extraction activities could be deducted against income from non-extraction activities. ITA, Section 3(d).

Determination of income from the extraction of natural resources, including petroleum, was governed by the general rules of the ITA. However, certain provisions of the ITA tax were unique to corporations involved in the extraction of natural resources, including petroleum producers. For 1981, 1982, 1984, 1985, and 1986, where the federal government of Canada or a province was entitled to a portion of the production or a portion of the proceeds from production sales, the amounts receivable by the federal government of Canada or a province in respect thereof were specifically included in the taxpayer's income. ITA, Section 12(1)(o). Also, royalty payments that were not required to be taken into income, lease payments, and mineral taxes paid to a federal or provincial government in Canada in respect of the production of petroleum were not allowed as deductible expenses for purposes of the ITA tax. ITA, Section 18(1)(m). The PGRT was not deductible for purposes of calculating ITA taxable income. ITA, 18(1)(1.1). However, a resource allowance in the amount of 25% of the petroleum producer's resource profits was permitted. ITA, Section 20(1)(v.1) and IT Regulation, Section 1206(1). In addition, a taxpayer such as Fsub could deduct virtually all exploration and development expenses incurred with regard to oil wells in Canada and a more limited amount of foreign exploration and development expenses. ITA, Sections 66(1), 66(3), and 66(4).

In 1981, 1982, 1984, 1985, and 1986, the income of petroleum producers was subject to the 46% tax rate that applied to all other corporations subject to the ITA tax. ITA, Section 123.

Issue 1. Creditability of the PGRT and Modified ITA Tax Under the Temporary Section 903 Regulations: 1981 and 1982 Tax Years

As stated above, for purposes of determining whether the PGRT and the modified ITA tax in 1981 and 1982 may be creditable under section 903 of the Code as taxes paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by a foreign country, it is assumed that Taxpayer is correct that the PGRT and the modified ITA tax in those years are not creditable under section 901. Temp. Treas. Reg. §4.903-1(a), as in effect for 1981 and 1982, provides that a foreign charge will be a tax in lieu of an income tax for purposes of section 903 only if the charge is not compensation for a specific economic benefit, meets substitution and comparability requirements, and follows reasonable rules of the taxing jurisdiction. Each separate charge, such as the modified ITA tax and the PGRT, must generally meet these tests independently. Temp. Treas. Reg. §4.901-1(e)(4). However, otherwise-qualifying separate charges must be combined to determine

whether the comparability test has been met. Temp. Treas. Reg. §4.901-1(f), *Example* (15). Both the PGRT and the modified ITA tax were not paid by Fsub in order to receive a specific economic benefit since they were imposed on Fsub without regard to whether the oil rights (*i.e.*, the only potential "benefit") were under federal or provincial jurisdiction or were privately owned. Also, both the modified ITA tax and the PGRT follow "reasonable rules of taxing jurisdiction." However, neither the PGRT nor the modified ITA tax is an income tax under section 903 of the Code since the PGRT fails the substitution requirement and the modified ITA tax fails the comparability requirement.

Temp. Treas. Reg. §4.901-1(b) provides that the substitution requirement will be met "if the charge is clearly intended, and in fact operates, as a charge imposed in substitution for, and not in addition to, an income tax otherwise generally imposed." Here, this test is met with regard to the modified ITA tax since it was intended, and in fact operated, in substitution for the ITA tax that is generally imposed on non-natural resource companies in Canada. However, the PGRT was not intended as a substitute for the general ITA tax imposed on non-natural resource extraction companies or for any other income tax generally imposed. Accordingly, the PGRT paid or accrued in 1981 and 1982 by Fsub is not a tax in lieu of an income tax under section 903 of the Code.

The comparability requirement of Temp. Treas. Reg. §4.901-1(c) will not be met if "the charge is structured, or in fact operates, so that the amount of liability of persons subject to the charge will generally be significantly greater, over a reasonable period of time, than the amount for which such persons would be liable if they were subject to the income tax otherwise generally imposed." Here, the modified ITA tax was "significantly greater" than the ITA tax imposed on non-natural resource companies because of the requirement that royalties paid to the federal government be included in income and the denial of deductions, even after taking into account the resource allowance. Accordingly, the modified ITA tax for 1981 and 1982 is not a tax in lieu of an income tax under section 903 of the Code because it fails the comparability requirement.

Issue 2. Creditability of Modified ITA Tax Under the Final Section 901 Regulations: 1984, 1985, and 1986 Tax Years

Fsub paid or accrued modified ITA tax in 1984, 1985, and 1986. Treas. Reg. §1.901-2 sets forth the requirements that the modified ITA tax in those years must meet in order for it to be considered an income tax. Under Treas. Reg. §1.901-2(a) and (d), determination of whether a foreign levy is an income tax is made independently for each separate levy and U.S. principles are applied for the purpose of determining the extent to which a tax or taxes should be considered

separate levies. Treas. Reg. §1.901-2(d)(1) provides that "levies are not separate merely because some provisions determining the base of the levy apply, by their terms or in practice, to some, but not all, persons subject to the levy." Also, that regulation provides that amounts separately computed merely for purposes of a preliminary computation and then combined as a single base are not separate levies. However, the levy will be considered a separate levy if the base of the levy "is different in kind, and not merely in degree, for different classes of persons subject to the levy." Treas. Reg. §1.901-2(d)(1). A foreign levy that is otherwise not a separate levy under these general rules may be classified as a separate levy as applied to dual capacity taxpayers. Treas. Reg. §1.901-2A(a)(1) provides that

> [i]f the application of a foreign levy *** is different, either by the terms of the levy or in practice, for dual capacity taxpayers *** from its application to other persons, then *** such difference is considered to be related to the fact that dual capacity taxpayers receive, directly or indirectly, a specific economic benefit *** from the foreign country and thus to be a difference in kind, and not merely in degree. In such case, notwithstanding any contrary provision of §1.901-2(d), the levy as applicable to such dual capacity taxpayers is a separate levy from the levy as applicable to such other person***.

Here the special provisions in the modified ITA tax that apply to Fsub and other extractors of natural resources, primarily the inclusion in income of royalties paid to the federal government of Canada, the denial of certain deductions, and the deductibility of the resource allowance, are significant. Nonetheless, under the general rules of Treas. Reg. §1.901-2(d)(1), those special provisions make the modified ITA tax as applied to the extractors of natural resources different in degree and not in kind from the general ITA tax as applied to non-extractors of natural resources.

Furthermore, as discussed above, natural resource extractors compute their profits from the extraction activity separately in determining the 25% resource allowance and in determining their income from the extraction business. These separate calculations do not render the modified ITA tax as applied to natural resource extractors a separate levy since for purposes of determining taxable income the extractor's non-capital losses in their non-extraction business activities can be deducted against their extraction income, and extraction losses can be deducted against their non-extraction income. Thus, under the general rules of Treas. Reg. §1.901-2(d)(1), the modified ITA tax is not a separate levy since determining the profits from natural resource extraction is only a preliminary computation that is then combined with profits and losses from other activities of the extractors into an aggregate taxable base. *See* Treas. Reg. §1.901-2(d)(1) and (3), *Example* (4).

Accordingly, the modified ITA tax as applied to extractors is not a “separate levy” under the general rules of Treas. Reg. §1.901-2(d).

The special rules of Treas. Reg. §1.901-2A(a) that apply to dual capacity taxpayers are also applicable here to determine whether the modified ITA tax as applied to dual capacity taxpayers is a separate levy. Treas. Reg. §1.901-2A(a)(1) provides that if the application of a foreign levy to dual capacity taxpayers differs from its application to other persons, then such difference is considered to be related to the fact that dual capacity taxpayers receive a specific economic benefit from the foreign country and thus to be different in kind and not merely in degree. Such a levy as applicable to dual capacity taxpayers is then a separate levy within the meaning of Treas. Reg. §1.901-2(d). Treas. Reg. §1.901-2A(a)(1). In 1984, 1985, and 1986 Fsub was a dual capacity taxpayer as defined in Treas. Reg. §1.901-2(a)(2)(ii)(A), because it received a specific economic benefit from the federal government of Canada, the concession to extract oil, and because it paid a levy to the federal government of Canada. Under the special dual capacity rules of Treas. Reg. §1.901-2A(a)(1), the modified ITA tax as applied to dual capacity taxpayers is not a separate levy. The special provisions of the ITA tax applicable to natural resource extractors applied to both extractors who were dual capacity taxpayers and those extractors who were not dual capacity taxpayers. Accordingly, the ITA tax imposed on the dual capacity extractors, including Fsub, is not a separate levy since it “is neither different by its terms nor in practice for dual capacity taxpayers from its application to other persons.” Treas. Reg. §1.901-2A(a)(1) and (2), *Example* (2). The facts in *Example* (2) are very similar to the facts in this case. In that example, as here, because corporations that engaged in exploitation of the minerals and paid the levy included both dual capacity taxpayers and other persons, the levy was not a separate levy.

Since the modified ITA tax is not a separate levy, determination of whether the ITA tax is an income tax is made with regard to the ITA tax as applied to all corporate taxpayers subject to it. Treas. Reg. §§1.901-2(a) and 1.901-2A(a)(1).

A foreign levy is an income tax only if it is a tax and its predominant character is that of an income tax in the U.S. sense. Treas. Reg. §1.901-2(a)(1). Under Treas. Reg. §1.901-2(a)(2), a foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. Also, 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 from the foreign country in exchange for payment pursuant to the levy. Here, the ITA tax was a tax since it was a compulsory payment levied pursuant to the federal laws of Canada and taxpayers, including

Fsub, did not receive in exchange for the payment of the ITA tax a specific economic benefit. Treas. Reg. §1.901-2(a)(2)(i).

The predominant character of a foreign levy is that of an income tax in the U.S. sense if the foreign tax is likely to reach net gain in the normal circumstances in which it applies, but only to the extent that liability for the tax does not depend on the availability of a credit for the tax against income tax liability to another country ("soak-up tax"). Treas. Reg. §1.901-2(b)(1) and (c)(1). The ITA tax as imposed on all taxpayers was not a soak-up tax. In order to pass the net gain test, the predominant character of the tax must satisfy the "realization," "gross receipts," and "net income" requirements of Treas. Reg. §1.901-2(b)(2), (b)(3), and (b)(4), respectively. The ITA tax as applied to all corporate taxpayers resident in Canada meet these requirements. Therefore, the ITA tax is an income tax for purposes of section 901 of the Code.

Although certain specific provisions of the ITA tax (such as the requirement that natural resource extractors include in income royalties paid to the federal government of Canada) do not individually satisfy the realization requirement, the predominant character of the ITA tax does so. Likewise, it is clear that the predominant character of the ITA tax meets the gross receipts requirement. With regard to the net income requirement, no evidence has been supplied to indicate that the deductions disallowed to various corporate taxpayers under the ITA tax, including the natural resource extractors, were significant when compared to deductions for the whole class of taxpayers who pay the ITA for purposes of Treas. Reg. §1.901-2(b)(4)(i)(A). It appears likely that the extent of disallowed deductions for all taxpayers would be insignificant. Accordingly, under that assumption the net income requirement is met.

Issue 3. Creditability of the PGRT Under the Final Section 903 Regulations: 1984, 1985, and 1986 Tax Years

Since it is assumed that the PGRT paid or accrued by Fsub in 1984, 1985, and 1986 is not creditable under section 901 of the Code because of failure to meet the net income requirement of Treas. Reg. §1.901-2(b)(4), the alternative issue is whether it is creditable under section 903 as a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by a foreign country. Under Treas. Reg. §1.903-1(a), the levy in order to be a qualifying "in lieu of" tax must (1) be a tax within the meaning of Treas. Reg. §1.901-2(a)(2), and (2) meet the substitution requirement set forth in Treas. Reg. §1.903-1(b). For these purposes, it is immaterial whether the base of the foreign levy bears any relation to realized net income. The rules for determining whether a tax has been paid in lieu

of a tax on income is applied independently to each separate levy. Treas. Reg. §1.903-1(a).

Under Treas. Reg. §1.901-2(a)(2), a foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. Also, 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 from the foreign country in exchange for payment pursuant to the levy. Here, it is clear that the PGRT paid or accrued by Fsub in 1984, 1985, and 1986 were compulsory payments as required by the regulation. In addition, it is clear that Fsub did not pay the PGRT in order to receive a specific economic benefit since the PGRT was payable whether the oil rights were under federal or provincial jurisdiction or were privately owned. Accordingly, the first test of Treas. Reg. §1.903-1(a) is met since the PGRT is a tax within the meaning of Treas. Reg. §1.901-2(a)(2).

A foreign tax satisfies the substitution requirement, the second test of Treas. Reg. §1.903-1(a), if the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed. Treas. Reg. §1.903-1(b)(1). Here the PGRT was a separate levy paid by oil producers, such as Fsub, that was in addition to, and not in substitution for, the generally imposed ITA tax that was an income tax imposed on Canadian resident corporations. The PGRT was in addition to the ITA tax since the base of the PGRT included income of the oil producers that was also included in the base of the ITA tax. Accordingly, the PGRT tax paid or accrued by Fsub in 1984, 1985, and 1986 is not creditable under section 903 of the Code.

U.S.-Canada Income Tax Treaties

The 1984 Treaty entered into force on August 16, 1984, and replaced the income tax treaty between the two countries that was signed March 4, 1942 ("1942 Treaty").[3] The 1984 Treaty is effective with regard to Canadian taxes (other than withholding taxes) paid in taxable years beginning on or after January 1, 1985. Article XXX, paragraph 2(b). Accordingly, the issue of whether the modified ITA tax and PGRT paid or accrued by Fsub in 1981, 1982, and 1984 are creditable taxes is covered by the 1942 Treaty and that issue for 1985 and 1986 is covered by the 1984 Treaty.

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[3]The Tax Convention and Protocol between the United States and Canada, TS 983; 56 Stat. 1399, 1943 C.B. 526.

Issue 4. Creditability of the PGRT and the Modified ITA Tax Under the 1984 Treaty: 1985 and 1986 Tax Years

With regard to 1985 and 1986, the 1984 Treaty applies to "Canadian taxes" which are "taxes imposed by the Government of Canada under Parts I, XIII and XIV of the Income Tax Act." Article III, paragraph 1(c) and Article II, paragraph 2(a), respectively. The 1984 Treaty also applies to "substantially similar taxes on income." Article II, paragraph 3(a). Part I of the Income Tax Act is the general income tax portion of the ITA. The modified ITA tax and the ITA tax that applies to non-natural resource producers tax fall within Part I.[4] The PGRT does not. Article XXIV, Elimination of Double Taxation, of the 1984 Treaty provides that the United States will allow a foreign tax credit, including a deemed paid credit, for "the appropriate amount of income tax paid or accrued to Canada." Article XXIV, paragraph 1. Article XXIV, paragraph 7, defines "income tax paid or accrued to Canada" as including "Canadian tax."

With regard to whether the modified ITA tax is a creditable tax under the 1984 Treaty, the Treasury Department's Technical Explanation to paragraph 7 of Article XXIV states that "[p]aragraph 1 provides a credit for these specified taxes [taxes specified in Article II, paragraph 2(a)] whether or not they qualify as creditable under Code section 901 or 903." 1986-2 C.B. 275, 289. Likewise, the Report of the Senate Foreign Relations Committee ("Committee Report") states that "the treaty applies to the income taxes imposed by the Federal Government of Canada under Parts I, XIII, and XIV of the Income Tax Act. Exec. Rept. 98-22, 98th Cong., 2nd Sess. These taxes will be creditable income taxes for purposes of the U.S. foreign tax credit granted by Article XXIV(1)(Relief from Double Taxation)." The Committee Report also states that the general Canadian corporate income tax is creditable under the 1984 Treaty even though it disallows a deduction for the PGRT, which it states was imposed at a rate of 12% at the time. However, the Committee Report states that it is "not clear how much Canada could increase this non-deductible flat-rate tax before Treasury viewed the Canadian corporate income tax as not a substantially similar tax and thus not creditable under the proposed treaty."

As stated above, the PGRT was eventually imposed at a rate of 16%. Nonetheless, Treasury has not indicated that that increase in the tax rate has changed its view regarding the creditability of the modified ITA tax under the 1984 Treaty. Accordingly, the modified ITA tax in 1985 and 1986 is a creditable tax under the 1984 Treaty.

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[4]Parts XIII and XIV of the ITA cover "Tax on income from Canada of non-resident persons" and "Additional tax on corporations (other than Canadian corporations) carrying on business in Canada", respectively.

The 1984 Treaty does not make the PGRT a creditable tax because the PGRT was not a part of Part I, XIII, or XIV of the ITA and therefore was not a covered tax. This view is consistent with the Treasury Department's Technical Explanation which states that "[t]he Convention also does not generally cover *** the Petroleum and Gas Revenue Tax (PGRT)", 1986-2 C.B. 275, and with a statement in the Committee Report. Accordingly, the PGRT paid by Fsub in 1985 and 1986 is not a creditable tax under the 1984 Treaty.

Issue 5. Creditability of the PGRT and the Modified ITA Tax Under the 1942 Treaty: 1981, 1982, and 1984 Tax Years

The 1942 Treaty applies to taxes paid by Fsub in 1981, 1982, and 1984. Article XV, paragraph 2, of the 1942 Treaty provided, as follows:

> 2. As far as may be in accordance with the provisions of the United States Internal Revenue Code, the United States of America agrees to allow as a deduction from the income and excess profits taxes imposed by the United States of America the appropriate amount of such taxes paid to Canada.

Taxes covered by the 1942 Treaty were, for Canada, "the Dominion income taxes, including surtaxes, and excess-profits taxes." Protocol, paragraph 1(b). The regulations for Article XV of the 1942 Treaty provided that "there shall be allowed against the United States income and excess profits tax liability a credit for any such taxes paid to Canada by United States citizens or domestic corporations. *** Such credit, however, is subject to the limitations provided in section 131, Internal Revenue Code." 26 CFR §519.116.

Neither the modified ITA tax nor the PGRT is a creditable tax under the 1942 Treaty. Unlike the 1984 Treaty, the 1942 Treaty by its terms did not explicitly state that the United States must give a deemed paid credit for taxes covered. Although the modified ITA tax is a covered tax, the credit provided by the Treaty "is subject to the limitations provided in section 131, Internal Revenue Code," which means that in order to be creditable a covered tax must satisfy the requirements of section 901 or 903 of the Code. The PGRT is not a covered tax.

In summary, the PGRT paid by Fsub in 1981, 1982, 1984, 1985, and 1986 was not a creditable tax under either section 903 of the Code or the applicable U.S.-Canada income tax treaty. The modified ITA tax paid by Fsub in 1981 and 1982 was a separate charge that is not creditable under either section 903 (because it failed the comparability requirement of Temp. Reg. §4.901-1(c)) or the 1942 Treaty. The modified ITA Tax paid by Fsub in 1984, 1985, and 1986 is a creditable tax under section 901 and, for 1985 and 1986, under the 1984 Treaty. Accordingly, in

computing its deemed paid credit with respect to the sale of Fsub stock in year X, Taxpayer may include as creditable taxes of Fsub only the ITA it paid in 1984, 1985, and 1986.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

1. [redacted] PGRT

A. The Service issued two 1994 private letter rulings (PLR 9429019 and PLR 9429020), revoking two earlier rulings (PLR 8731044 and PLR 8525122, with respect to the PGRT only, respectively), that concluded that the PGRT was not an income tax under section 901 of the Code. The revocations were prospective only. Within months of the issuance of the revocation rulings the Service issued CCA #3571 in which it agreed that the PGRT was not an income tax. The CCA also stated that section 7805(b) relief was not appropriate for the taxpayer in issue since it was not entitled to rely on rulings issued to other taxpayers. [redacted]

B. The Service ruled in PLR 8429079 that "[u]nder Treas. Reg. §1.901-2(d)(1) of the final regs., the ITA imposed on Corp 2 is a separate levy" and that the taxes paid under the ITA tax were creditable income taxes for purposes of section 901 of the Code. It is unclear whether the Service ruled that the ITA tax as applied to a petroleum extractor is a separate levy or whether the Service ruled, consistent with our opinion as expressed above, that the ITA tax as applied to natural resource extractors is not a separate levy from the ITA tax as generally imposed. Contrary to our view, the Taxpayer has asserted that the ruling holds that the ITA tax as applied to petroleum extractors is a separate levy. If it is a separate levy it would probably not be a creditable tax under section 901 but it probably would be a creditable tax under section 903. The hazard is that Taxpayer could then assert that the PGRT is also creditable under section 903 based on Treas. Reg. §1.903-1(b)(3), *Example* (4), which appears to provide that two different taxes such as the modified ITA tax and the PGRT can meet the regulatory substitution requirement as a unit. In our

view, however, a court would be unlikely to assign much weight to an ambiguous statement in a PLR issued to another taxpayer.

2. Modified ITA Tax

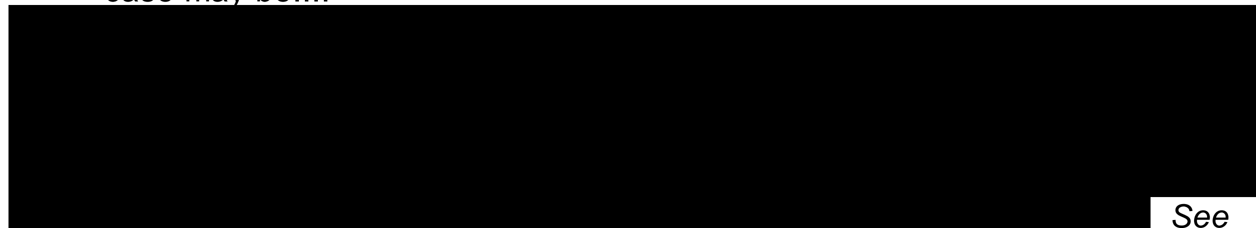
As we stated in Issue 1, the modified ITA Tax failed the comparability requirement of Temp. Treas. Reg. §4.901-1(c) and therefore, the modified ITA tax for 1981 and 1982 was not a tax in lieu of an income tax under section 903 of the Code.

3. Case Development: Correct Amount of Tax

As stated above in the discussion with regard to Issue 2, it is our opinion that the modified ITA tax in , , and is a creditable tax under section 901 of the Code and that Taxpayer is entitled to a deemed paid credit for those taxes in . There were different sets of rules prior to 1987 for computing and translating E&P and foreign taxes for actual dividends and deemed inclusions. In the case of actual dividends, annual E&P and foreign tax accounts for purposes of section 902 were computed in foreign currency and translated into U.S. dollars at the rate in effect on the dividend date. In the case of deemed inclusions, annual E&P accounts for purposes of section 960 were maintained in U.S. dollars (using the full section 964 method) and foreign taxes were translated into U.S. dollars at the exchange rates in effect when the taxes were paid or accrued. It is the position of the Service that, for purposes of determining the amount of the deemed-paid foreign tax credit associated with a section 1248 deemed dividend under pre-1987 law, the accumulated earnings and foreign income tax accounts (the denominator and the multiplicand of the fraction set out above) are properly computed in accordance with the method that was used for a section 960 credit. See G.C.M. 37133 (May 24, 1977) (E&P denominator of section 1248 credit fraction determined under section 960 method); G.C.M. 37839 (January 31, 1979) (foreign tax

multiplicand determined under section 960 method for purposes of former section 963 where both terms of fraction also determined under section 960 method); *cf.* Treas. Reg. §1.905-5T (b)(1) (foreign taxes deemed paid under section 902 with respect to section 1248 deemed dividend translated into U.S. dollars at rate of exchange for date of payment of foreign taxes). This position is based on the principles of proportionality and consistency: because the amount of the section 1248 deemed dividend is computed by reference to section 964 E&P (which applies to the section 960 credit), the denominator and the multiplicand should likewise be determined under the method that applies to the section 960 credit, so that the percentage of foreign taxes deemed paid matches the percentage of accumulated earnings deemed distributed. *See* PLR 199906035. However, Treas. Reg. §1.1248-1(d)(1)(i) states that

> [t]he foreign tax credit provisions of section 901 through 908 shall apply in the same manner and subject to the same conditions and limitations as if the first tier corporation on such date distributed to the domestic corporation as a dividend that portion of the amount included in gross income under section 1248(a) which does not exceed the earnings and profits of the first tier corporation attributable to the stock under §1.1248-2 or §1.1248-3, as the case may be....



See PLR 199906035.

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

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CC:INTL:BR3