DEPARTMENT OF THE TREASURY

INTERNAL REVENUE SERVICE

WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

July 06, 2010

Number: **2010-0205**
Release Date: 9/24/2010

CC:INTL:BR3
GENIN-125445-10

UIL: 901.01-03

Dear :

This letter responds to your authorized representative's request for information dated June 18, 2010, regarding whether the Salvadoran withholding tax that is imposed only where the recipient's country of residency grants a foreign tax credit is a creditable tax under section 901 and the regulations under that section.

In response to your inquiry, we are providing the following general information. This information letter is advisory only and has no binding effect on the Internal Revenue Service.

Article 14 of the Salvadoran law provides:

> Financial institutions domiciled outside of El Salvador that have had qualifications granted by the Central Reserve Bank during 2009 and that on the effective date of this law, the countries, states or territories in which they are domiciled do not provide in their internal laws with legal means to eliminate the respective double taxation or that have not enacted and ratified conventions with El Salvador to avoid the double taxation of the income tax, that allows them to effectively eliminate the double taxation for the tax paid on the interest for debt instruments given in the country, either by way of fiscal credit or exemption, will continue to enjoy the exemption of the income tax and obtaining annual qualifications from the Central Reserve Bank until the countries, states or territories in which the referenced financial institutions are domiciled have in their laws legal means to eliminate the double taxation or enacted and ratified conventions to avoid the double taxation of the income tax with the Republic of El Salvador.

I.R.C. § 901 allows a credit against U.S. income tax for the amount of any income, war profits, or excess profits taxes paid or accrued during the taxable year to any foreign country. I.R.C. § 901(b)(1). Whether a levy is an "income tax" within the meaning of I.R.C. § 901 and the regulations under that section is determined by two tests: (1) whether it is a tax and (2) whether its predominant character is that of an income tax in the U.S. sense. Treas. Reg. §§ 1.901-2(a)(1) and 1.901-2A.

The predominant character of a foreign levy will be that of an income tax if the levy reaches net gain in the normal circumstances to which it applies, but only to the extent that liability for the tax is not dependent on the availability of a credit for the tax against tax liability to another country. Treas. Reg. § 1.901-2(a)(3). Liability for foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only if and to the extent that the foreign tax would not be imposed on the taxpayer but for the availability of such a credit. Treas. Reg. § 1.901-2(c)(1). If the foreign tax is only imposed in this situation, the foreign levy is called a “soak-up tax.” Example (1) of Treas. Reg. § 1.901-2(c)(2) illustrates a situation where the withholding tax imposed by a foreign country is increased from 15% to 20% on royalties paid to residents of a foreign country which allows its residents a foreign tax credit for taxes paid to another country. The additional 5% is considered a soak-up tax and, therefore, is not an income tax.

I.R.C. § 903 allows a credit against U.S. income tax for an amount of tax paid or accrued to a foreign country “in lieu of” an income tax otherwise generally imposed by the foreign country. Under Treas. Reg. § 1.903-1(a), a foreign levy is in lieu of an income tax only if it is a tax and meets the substitution requirement of Treas. Reg. § 1.903-1(b). Treas. Reg. § 1.903-1(b)(2) provides that a foreign tax meets the substitution requirement only to the extent that the liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the foreign tax against the income tax liability to another country.

Accordingly, a foreign income tax or a tax in lieu of an income tax that is dependent (by its terms or otherwise) on the availability of a U.S. foreign tax credit, as appears to be the case with the Salvadoran withholding tax, is a “soak-up tax” for which no U.S. foreign tax credit is allowed.

This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2010-1, §2.04, 2010-1 IRB 7 (January 4, 2010). In accordance with the provisions of a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative. If you have any additional questions, please contact our office at .

Sincerely,

Barbara A. Felker
Chief, Branch 3
Office of the Associate Chief Counsel
(International)

cc: