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Int'l Tax Treaties

Wayne State University Law School
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Class #10 (March 19). Relief from Double Taxation

Please read and consider:

1. Article 23 of the OECD Model Treaty, the UN Model Treaty, and the U.S. Model Treaty.

2. McIntyre, *The U.S. Foreign Tax Credit* (attached).

3. The following Notes and Questions.

Notes and Questions

1. The OECD and UN Model Treaties provides for two alternative methods of granting relief from international double taxation. Under the exemption method, a contracting state exempts its residents on certain income derived in the other contracting state. Under the credit method, a contracting state provides its residents with a tax credit for certain foreign taxes imposed on income derived in the other contracting state. A country that uses the credit method to relieve double taxation under its domestic tax laws will use the credit method in its tax treaties, whereas a country that generally uses the exemption method domestically will use the same method in its bilateral tax treaties.

All U.S. tax treaties seek to eliminate double taxation. The primary mechanism that the United States employs to eliminate double taxation, reflected in Article 23 of the U.S. Model Treaty (2006), is the foreign tax credit. All U.S. tax treaties provide that the United States will give a credit to its taxpayers for the income taxes imposed by its treaty partner. Those treaties also provide that the treaty partner will give comparable tax relief to their residents with respect to income taxes paid to the United States. Some countries give that relief through the credit mechanism, whereas other countries give relief by exempting their taxpayers on certain income earned in the United States. In some cases, the United States uses an exemption method for granting relief from the risk of double taxation. For example, it exempts foreigners on certain interest and royalty income sourced in the United States.

Some countries, most notably the United States, grant a foreign tax credit unilaterally. The statutory rules governing the foreign tax credit are contained in Internal Revenue Code sections 901-908. Other countries unilaterally exempt their companies on income earned in foreign countries. Even when relief from double taxation is granted unilaterally, however, a tax treaty can serve a useful role in clarifying what taxes qualify for relief and in solving double-taxation problems unrelated to an overlap of source and residence taxation. For example, tax treaties contain tie-breaker rules designed to treat a dual-resident taxpayer who is otherwise a resident of both Contracting States as a resident in only one of the Contracting States.

The problems of double taxation that plagued multinational businesses in the early post-World War II period have largely been solved through the development of an extensive network of bilateral tax treaties. The one area where significant problems of double taxation continue to arise is in the operation of the so-called arm's length standard for policing transfer price abuses.

A country that uses the credit method authorized by Article 23B is required in some circumstances to use the exemption method for relieving international double taxation. For example, a contracting state is required under Article 19 of the OECD Model Treaty to exempt its resident individuals on certain salaries and pensions paid by the government of the other contracting state.

Similarly, a country that generally uses the exemption method is entitled to use the credit method in some circumstances. Article 23A(2) provides that if a country chooses to tax its residents on dividends and interest income arising in the other contracting state, as contemplated by Articles 10 and 11, then it must give its residents a credit for the taxes imposed in the source state. Articles 10 and 11 contemplate a sharing of the jurisdiction to tax between the residence state and the source state. The source state is permitted to tax dividends and interest arising within its borders, but at a rate not to exceed the rates specified in Articles 10 and 11.

Tax treaties based on the OECD and UN Model Treaties contain many provisions that require a contracting state to exempt income derived within its borders if that income is earned by a resident of the other contracting state. For example, business income derived in one contracting state by a resident of the other contracting state generally is not taxable in the source state if the income is not earned through a permanent establishment located in the source state. Thus, double taxation of the income does not occur.

2. If a contracting state is required to exempt certain income of its residents from tax under Article 23A, is it entitled to take that exempt income into account in determining the rate of tax to apply to its residents on income that is not exempt from tax?

3. Country X and Country Y have entered into a tax treaty based on the OECD Model Treaty. The treaty includes Article 23A, which provides, *inter alia*, that income derived from a permanent establishment located in the source state is exempt from tax in the residence state. X, a resident of Country X, earns manufacturing income in Country Y through a permanent establishment located in Country Y. As an incentive to investment, the domestic tax laws of Country Y provide that manufacturing income derived by nonresident taxpayers through a permanent establishment located in Country Y is exempt from tax for a five-year period. In this circumstance, is Country X obliged by treaty to exempt X on the income derived from Country Y?

4. DCo, a resident of Country X, conducts a money-lending business in Country X and also through a permanent establishment located in Country Y. DCo derives gross income in Country X of 200,000 and gross income of 100,000 in Country Y. DCo has a total interest expense of 240,000. DCo deducts 70,000 of interest expense (the amount attributable to the PE by Country Y) in computing its taxes under the tax laws of Country Y and pays tax in that country on net income of 30,000. Country X and Country Y have entered into a tax treaty based on the OECD Model Treaty under which both countries agree to use the exemption method for relieving double taxation. Under the treaty, DCo is exempt from tax in Country X on the income derived through its PE in Country Y. Under the tax laws of Country X, DCo is required to allocate interest expense to income derived in Country Y in proportion to its gross income in that state. Thus, it is required to allocate interest expense of 80,000 (240,000 × 100,000/300,000) to Country Y and the remaining 160,000 to Country X, with the result that DCo must report net

income from Country X of 40,000 (200,000 – 160,000). Is this result consistent with the treaty? What if Country Y allows DCo to deduct interest expense of 90,000 instead of 70,000?

5. A is a resident of Country A and earns income in Country B through a permanent establishment located therein. A's gross income derived through the permanent establishment is 500, and he has expenses directly related to the earning of that income of 200. A also has gross salary income of 300 from Country A and has no deductions directly relating to the salary. Under the domestic tax laws of Country A, A is entitled to a deduction for family circumstances of 240. A must apportion that deduction between Country A and Country B, however, by reference to the gross income derived from each country. Thus, A is allowed a family-circumstances deduction of only 90 against his income derived in Country A in computing his taxes due to Country A. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty that provides for relief of double taxation using the exemption method. Is the apportionment method used by Country A consistent with its obligations under the treaty?

6. ACo, a resident of Country A, conducts a manufacturing business in Country B through a permanent establishment, earning net income in Country B of 300. ACo is subject to tax on the income in Country B at a rate of 40 percent, resulting in a tax of 120. ACo also conducts business in Country A, earning net income of 500. The tax rate in Country A is 20 percent. Under the domestic tax laws of Country A, ACo is required to pay tax on its worldwide net income of 800 (300 + 500). ACo is also allowed a credit for foreign taxes paid to Country B on income derived in that country, but only up to the amount of tax that Country A would have imposed on that income. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty that provides for relief of double taxation using the credit method. ACo claims the right under that treaty to a credit of 120, representing the full amount of its taxes paid to Country B. Country A limits the credit to 60 (20% of 300). Has Country A violated its treaty obligations?

7. On its tax return filed with Country A for year 1, ACo reports net income of 100 from Country A and net income of 100 from the operation of a business through a permanent establishment in Country B. ACo reports no income on its tax return filed with Country B for the year, due to a difference in the tax accounting rules in the two countries. ACo pays tax of 80 to Country A for year 1 (40% of 200). In year 2, ACo reports income of 100 from Country A and no income from Country B on its tax return filed with Country A. It reports income of 100 to Country B and pays tax of 40 to Country B for year 2 (40% of 100). The 100 of income reported to Country B for year 2 reflects the income that was earned in year 1 under the tax accounting rules applicable under the domestic tax laws of Country A. Under the domestic tax laws of Country A, ACo pays tax of 40 (40% of 100) and is not allowed a credit for the taxes paid to Country B. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty that provides for relief of double taxation using the credit method. Is ACo entitled to a credit for the 40 in taxes paid to Country B?

8. X is a resident of Country X. He earns net income of 1,000 in Country X. He also earns 200 of interest income in Country Y and net business income of 400 through a permanent establishment located in Country Y. Country Y imposes a tax of 200 (50% of 400) on the business income and no tax on the interest income. Under the domestic tax laws of Country X, X is entitled to a credit for taxes paid to Country Y, but the credit is limited to the tax imposed by

Country X on each category of income taxed separately by Country Y. The tax rate in Country X is 20 percent. Thus it allows X a credit of 80 for the taxes imposed by Country Y on the business income earned through the permanent establishment located in Country Y. No additional credit is allowed because Country Y did not impose any tax on the interest income derived from that country. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty that provides for relief of double taxation using the credit method. X claims that the treaty authorizes him to take a credit of 120 (20% of 200 + 400). Has Country X violated the treaty by allowing X a credit for only 80?

9. Country A and Country B have entered into a tax treaty based on the UN Model Treaty that provides for relief of double taxation using the credit method. PCo is resident in Country A. It owns all of the stock of SCo, which is resident and carries on business in Country B. SCo earns 400 in Country B, pays tax of 100 (25% of 400) to that country, and distributes its after-tax profits of 300 to PCo as a dividend. Under Article 10(2)(a) the treaty, the dividend is subjected to a reduced withholding tax of 5 by Country B. Country A allows resident taxpayers a credit for foreign income taxes only to the extent required by treaty. PCo claims a credit for taxes of 115 (100 + 15) paid to Country B. Country A denies the credit, claiming that the taxes of 115 were paid by SCo, and SCo is not entitled to any credit as it is not a resident of Country A. Has Country A violated its tax treaty with Country B by not allowing the claimed credit of 115?

The Foreign Tax Credit

Michael J. McIntyre (2006)

Most countries tax on the basis of both the residence status of the taxpayer and the source of income. Consequently, foreign-source income earned by a resident of a country may be taxed by both the country of source and the country of residence, absent relief provisions designed to prevent double taxation. If income tax rates are low, as they were in the early years of this century, the inefficiencies and unfairness caused by double taxation are modest enough to be bearable. But when tax rates reach the levels that now prevail, double-tax burdens can become onerous and interfere substantially with international commerce. The necessity for relief is clear on grounds of equity and economic policy. The kind of relief that is appropriate, however, is a controversial question.

International double taxation can arise from a variety of causes. The following three types of double taxation arise from conflicts over tax jurisdiction.

- *Source-source conflicts*. Two or more countries assert the right to tax the same income of a taxpayer because they all claim the income is sourced in their country.
- *Residence-residence conflicts*. Two or more countries assert the right to tax the same income of a taxpayer because they claim the taxpayer is a resident of their country. A taxpayer that is a resident of two countries is commonly referred to as a "dual-resident taxpayer."
- *Residence-source conflicts*. One country asserts the right to tax foreign-source income of a taxpayer because the taxpayer is a resident of that country, and another country asserts the right to tax the same income because the source of the income is in that country.

Of these three types of international double taxation, residence-source conflicts are the most likely to occur absent measures to relieve double taxation. Residence-source conflicts are very difficult for a taxpayer to avoid through tax planning. To some degree, taxpayers can minimize their exposure to the other types of double taxation through careful tax planning. Most of the attempts of the international tax community to deal with international double taxation have focused on the elimination of residence-source conflicts.

International double taxation can also occur due to differences in the way countries define income and in the timing and tax accounting rules they adopt. For example, it may occur due to disputes among countries over how to set a proper arm's length price on cross-border transfers between related parties. Other rules adopted to curtail tax avoidance can also produce double taxation. For example, if one country denies the deduction of interest paid by a resident corporation to a shareholder in another country pursuant to thin capitalization rules, the amount may be taxable in both countries.

1. Tax Treaty Relief

Tax treaties typically provide relief from the three major types of international double taxation, and from some of the other types as well. Double taxation resulting from source-source conflicts is addressed by seeking some uniformity in source rules. For example, Article 11(5) of the OECD Model Treaty provides rules concerning the source of interest income. Most tax treaties do not contain extensive source rules. Instances of the source-source type of double taxation that are not resolved by the specific provisions of a treaty may be resolved through consultation between the tax officials of the two treaty countries (the "competent authorities") under the treaty's mutual agreement procedures. Resolution of such issues is not easy, however, because the competent authorities of most countries are reluctant to bargain away their country's source jurisdiction.

Individual taxpayers almost always obtain relief from international double taxation resulting from residence-residence conflicts through tax treaties. Many residence-residence conflicts involving legal entities are also resolved by treaty. Article 4(2) of the OECD Model Treaty provides a series of "tie-breaker" rules to resolve cases in which an individual is resident in both countries. The question of dual residence of a legal entity is resolved under the OECD and UN Model Treaties by deeming the entity to be resident in the country where the place of effective management is located. This tie-breaker rule is usually modified by countries (such as the United States) using the place-of-incorporation test for determining the residence of a corporation. The mutual agreement procedure is sometimes used to deal with dual-residence cases that are not resolved explicitly in the treaty.

Relief from double taxation resulting from the imposition of tax by a residence country and a source country on the same income is ordinarily granted by the residence country. In other words, the source country's right to tax has priority over the residence country's right.

Three methods — the deduction method, the exemption method, and the credit method — are commonly used for providing relief from double taxation.

2. U.S. Rules Governing the Foreign Tax Credit

The Internal Revenue Code (Code) grants U.S. persons a tax credit for income taxes paid to foreign governments.[1] The foreign tax credit is the chief mechanism used by the United States for relinquishing to the country of source the primary right to tax revenue from the foreign source taxable income of U.S. persons.[2] By employing the credit mechanism rather than an exemption for foreign source income, the United States reduces the risks of international tax avoidance and preserves some possibility of obtaining tax revenue from the foreign source taxable income derived by U.S. persons.

The credit rules provided under the Code are occasionally modified by tax treaties. For example, some foreign taxes that might not qualify for the credit under the Code and regulations are specifically characterized as creditable taxes under U.S. tax treaties.[3] The limitations on the credit contained in Code section 904 generally apply notwithstanding possible conflicts with U.S. treaty obligations.[4]

[1] IRC §§ 901 (defining the allowable credit) and 27(a) (granting the credit).

[2] Foreign persons may claim a credit for foreign income taxes imposed by a foreign government on their foreign source effectively connected income. IRC § 906. Foreign persons subject to tax on foreign source income are treated as quasi-residents under the Code. That is, their U.S. office generally is treated as if it were a juridical person resident in the United States. An analogous rule applies to former U.S. citizens and former long-term residents who are taxable on certain foreign source income having a U.S. nexus. IRC § 877(b).

[3] See, e.g., U.S./Norway treaty, Art. 23(1).

[4] Most modern U.S. treaties explicitly provide that U.S. limitation rules, as amended, may be applied. See, e.g., U.S./Norway treaty, Art. 23(1)(b); U.S. /Portugal treaty, Art. 25(1).

2.1. Overview

The United States asserts jurisdiction to tax U.S. persons, including its citizens, residents, and domestic corporations, on their worldwide income. U.S. persons deriving income from transnational transactions may also be subject to tax by foreign countries exercising their source jurisdiction. Without some relief provisions, double taxation is a likely result of this potential overlap of U.S. and foreign taxing powers. Double taxation is generally undesirable because it can stifle international commerce and investment and can cause U.S. persons to bear tax burdens that are unfair under traditional concepts of tax equity.

The credit is not designed to prevent all forms of double taxation. Only double taxation resulting from a conflict of U.S. residence jurisdiction with the source jurisdiction of a foreign government is remedied by the credit mechanism. The credit mechanism provides no relief from double taxation caused by overlapping residence claims or overlapping source claims.[5]

2.2. General Operative Provisions

The Code has included provisions for granting a foreign tax credit since 1918.[6] Those provisions have been amended many times to curtail abuses of the credit and to respond to changes in the form of transnational transactions. A foreign tax credit is also guaranteed by the network of tax treaties that the United States has entered into with its major trading partners.[7] Subject to some important limitations, taxpayers eligible for the credit can reduce the U.S. income tax otherwise due on their worldwide income by one dollar for each dollar of tax paid to a foreign government. The U.S. tax that would be imposed but for the foreign tax credit is referred to as the "tentative U.S. tax."

Code section 901(a) provides that the foreign tax credit cannot be used to reduce a taxpayer's liability for taxes listed in Code section 26(b). The taxes listed there include the tax on recoveries of foreign expropriation losses and the tax on periodical, etc., income imposed by Code section 871(a) or 881.

The foreign tax credit is elective.[8] Each year the taxpayer has the option of crediting[9] or deducting[10] its foreign income taxes and its foreign taxes imposed in lieu of an income tax. In most cases, a credit is more advantageous to the taxpayer than a deduction.[11] Taxpayers electing to claim a foreign tax credit are not foreclosed from taking a deduction for sales taxes, property

[5] The United States does attempt through its tax treaties to reduce or eliminate such double taxation. For example, most U.S. tax treaties contain tie-breaker rules that generally prevent individuals from being taxed as a resident of the United States and the other Contracting State. See U.S. Model Treaty (2006), Art. 4(2).

[6] For a history of the credit, see Elisabeth A. Owens, *The Foreign Tax Credit* (1961) at 20-21.

[7] See, e.g., Art. 23 (Relief from Double Taxation) of the U.S. Model Treaty. The typical treaty provision guarantees that each Contracting State will grant a tax credit to its residents for the income taxes of the other Contracting State.

[8] IRC § 901(a) and Reg. § 1.901-1(a) and (d) (1987). The election can be made annually, and an election made can be modified within the period permitted for filing an amended return.

[9] IRC § 27(a).

[10] IRC § 164(a)(3) authorizes the deduction of foreign income taxes. IRC § 275(a)(4) prohibits that deduction for any year in which the taxpayer elects to claim a foreign tax credit.

[11] A U.S. person with no foreign source taxable income according to U.S. concepts that was subject to a foreign income tax could not claim a credit for the foreign tax because of the limitation on the credit. In that situation, a taxpayer would reduce its U.S. tax liability by claiming a deduction for the foreign tax.

taxes, or other taxes that do not qualify for the foreign tax credit. The basic operation of the foreign tax credit and its advantage over a deduction are illustrated in the example below.

Example: Deduction Versus Credit

P, a U.S. corporation, derives taxable income (computed according to U.S. tax concepts) of $200 from Country A and has no other income. P pays $60 in income taxes to Country A. The U.S. tax rate is 35%. If P takes a credit of $60 for foreign taxes paid, the U.S. tax consequences are as follows:

(1)	Taxable income	$200
(2)	Country A tax	60
(3)	Tentative U.S. tax (U.S. tax rate × line (1))	70
(4)	Credit for foreign taxes paid (line (2))	60
(5)	Net U.S. tax (line (3) – line (4))	10
(6)	Total taxes paid by P (line (4) + line (5))	70
(7)	Net after-tax income (line (1) – line (6))	130

If P elects to deduct the foreign taxes paid to Country A from its gross income, the U.S. tax consequences are as follows:

(8)	Taxable income before deduction for Country A tax (line (1))	$200
(9)	Deduction for Country A tax (line (2))	60
(10)	Taxable income (line (8) – line (9))	140
(11)	U.S. tax (U.S. tax rate × line (10))	49
(12)	Total taxes paid by P (line (2) + line (11))	109
(13)	Net after-tax income (line (8) – line (12))	91

Because of the credit, taxpayers subject to the worldwide tax jurisdiction of the United States generally are relieved of U.S. tax on their foreign source income to the extent that the income has already borne foreign income taxes. Thus if the foreign income taxes on an item of foreign source income are equal to or greater than the applicable U.S. tax on that income, no U.S. taxes are collected on that income. When foreign income taxes on an item of income are lower than the U.S. tax on that income, the United States generally collects the amount that would have been due but for the credit, reduced by the allowable credit. Subject to some limitations,[12] the United States also allows foreign income taxes imposed on one item of income to offset the tentative U.S. tax on another item of income.

The basic rules governing the foreign tax credit are outlined below.

(1) With two exceptions, only U.S. persons are entitled to the benefit of the foreign tax credit.[13] One exception is applicable to foreign persons subject to U.S. tax on their foreign source effectively connected income. The other exception applies to former U.S. citizens and former long-term residents who gave up citizenship or U.S. residence status to avoid taxation.[14]

[12] The separate basket limitations on the credit may prevent taxes paid with respect to one item of foreign source income from offsetting U.S. taxes on another item of foreign source income.

[13] IRC § 901(b). The President of the United States may deny the credit to resident aliens from a particular country if that country does not provide reciprocal relief for U.S. citizens. IRC § 901(c). No President has exercised his power under this provision.

[14] IRC § 877(b) (last sentence of flush language).

(2) Foreign income taxes and foreign taxes imposed in lieu of an income tax are creditable.[15] The regulations contain detailed rules for determining whether a foreign levy qualifies either as a creditable income tax or as a creditable in-lieu tax.

(3) Subject to an important exception described in subparagraph (4) below, the foreign tax for which credit is sought must be a tax imposed on the taxpayer claiming the credit.[16] A U.S. citizen, for example, cannot claim a credit for an income tax imposed on a foreign corporation, even if the citizen has borne the economic burden of that tax.[17]

(4) A U.S. corporation may claim an indirect, or deemed-paid, credit for its share of the eligible foreign taxes that are imposed on foreign corporations in which they have a substantial voting stock interest.[18] U.S. corporations may claim the indirect credit in the year in which they received dividends from such foreign affiliates.[19] An indirect credit is also allowable under Code section 960 with respect to amounts taxable as deemed dividends under the subpart F provisions of the Code. The indirect credit is discussed in section 3, below.

(5) The amount of the direct and indirect credit is subject to some limitations. Since 1976, the United States has employed what was once called the overall limitation and is now called the general limitation. The general limitation restricts the amount a taxpayer can claim as a credit to the tentative U.S. tax assessed on the taxpayer's general limitation income. A taxpayer's general limitation income is its total foreign source taxable income, minus that portion of its foreign source taxable income subject to a special limitation.[20] The primary goal of the general limitation is to prevent taxes assessed by foreign governments from offsetting U.S. taxes on income sourced in the United States. The separate basket limitations were greatly simplified for taxable years beginning after 2006.

(6) A foreign tax generally becomes creditable either in the year in which it is paid or in the year in which it accrues, depending upon the method of accounting employed by the taxpayer. A cash basis taxpayer may elect to claim the credit when it is paid or when it accrues.[21]

[15] See IRC § 27(a) (granting a foreign tax credit for foreign taxes that meet the definitional requirements of IRC § 901). The taxes defined in IRC §§ 902 (indirect credit on actual dividends from a foreign corporation), 960 (indirect credit on deemed dividends from a foreign corporation under subpart F), 903 (in-lieu taxes), and 906 (nonresident credit) are treated as taxes defined in IRC § 901. The credit granted under IRC § 877(b) is not treated as a tax defined in IRC § 901 and is not listed in § 27.

[16] Reg. § 1.901-2(f) (1991). The person legally liable for a tax imposed by a foreign government is popularly referred to as the "technical taxpayer."

[17] A U.S. citizen or resident may elect to be taxed as a corporation with respect to amounts included in his income under subpart F as a deemed dividend from a controlled foreign corporation (CFC). Electing persons may claim a credit for foreign taxes paid by the CFC. A similar rule applies to individuals taxable under IRC § 1248(b).

[18] IRC § 902. In general, a U.S. corporation must own 10% or more of the voting stock of a foreign corporation to qualify for the indirect credit. Some entities are treated as conduits for purposes of the credit. Beneficiaries and partners may claim a direct credit for their share of the eligible foreign taxes that are imposed, respectively, on trusts or estates and on partnerships. IRC § 901(b)(1). A direct credit is also allowed to shareholders of a qualified electing regulated investment company for foreign taxes assessed on the company. IRC § 853.

[19] IRC § 902(a).

[20] IRC § 904(a).

[21] IRC § 905(a).

(7) The Code permits a carryback and carryforward of otherwise allowable credits that were disallowed because of the limitations on the credit.[22] Credits must be carried back to the first year preceding the taxable year, and then forward to the next ten succeeding years.[23] The purpose of the carryover rules is to prevent loss of credit because of timing problems. Those rules allow averaging of effective tax rates from year to year, however, without reference to possible timing problems.

(8) A taxpayer must submit proof that a foreign tax has been paid or properly accrued in order to claim the credit.[24] The requirements for proving that a foreign tax has actually been paid have been tightened in recent years to reduce the risk of tax fraud.

(9) If the taxpayer has claimed a foreign tax credit for foreign taxes directly paid or accrued and then receives a refund of some portion of the foreign taxes in a subsequent year, the taxpayer generally must report the refund to the tax authorities and recompute its foreign tax credit for the year that the refunded foreign taxes were claimed as a credit.[25] A similar adjustment generally must be made if the dollar value of a foreign currency has changed from the time an accrued foreign tax was claimed as a credit to the time the foreign tax was actually paid in that foreign currency.[26] Taxpayers claiming an indirect credit for taxes paid by their foreign affiliates generally are not required to recompute their prior U.S. tax liability. Instead, a redetermination of foreign taxes results in a change in the amount of credit allowable in the year of that redetermination or in subsequent taxable years.[27] If an accrued tax has not been paid within two years of the accrual, the credit for the accrued tax must be redetermined.[28]

(10) The results reached under the Code may be modified by a U.S. tax treaty. Many income tax treaties specify the taxes that are eligible for the foreign tax credit.[29]

3. Indirect Credit

Many credit countries provide what is often referred to as an "indirect" foreign tax credit. The indirect credit is a credit granted to a domestic corporation for the foreign income taxes paid by a foreign affiliated company. It is granted at the time the domestic corporation receives a dividend distribution from its foreign affiliate. The amount allowable as a credit is the amount of the underlying foreign tax paid by the foreign affiliate on the income out of which the dividend was

[22] IRC § 904(c).

[23] Id.

[24] IRC § 905(b) and Reg. § 1.905-2 (1998).

[25] IRC § 905(c) and Reg. §§ 1.905-3T (1988) (foreign tax redetermination) and 1.905-4T (1988) (notice requirements).

[26] Reg. § 1.905-3T(c)(2) and (3) (1988). An increase in the dollar value of a foreign currency can result in an increase in the credit and a refund of U.S. taxes previously paid . Minor fluctuations in foreign currency values are governed by a *de minimis* rule. Reg. § 1.905-3T(d)(1) (1988).

[27] Reg. § 1.905-3T(d)(2) (1988). Some portions of this regulation have been suspended by Notice 9026, 1990-1 C.B. 336 until the issuance of final regulations under IRC § 905(c). Reg. § 1.905-3T(d)(4) (1988) requires a redetermination of U.S. tax liability with respect to indirect credits claimed in some circumstances. For example, a redetermination must be made if the foreign tax liability is in a hyperinflationary currency.

[28] IRC § 905(c)(1)(B). In general, no credit is allowed for taxes not paid within two years, although an adjustment is made if the tax is paid in some subsequent year. IRC § 905(c)(2).

[29] See, e.g., U.S. Model Treaty (2006), Art. 23.

paid. Ordinarily, a foreign tax credit is allowable only for foreign income taxes that a resident taxpayer directly pays. In effect, the indirect credit rules ignore the separate corporate existence of the domestic and foreign corporations for the limited purpose of allowing the credit. To claim a credit for taxes paid by a foreign affiliate, the domestic corporation must own at least a minimum percentage, usually 10 percent, of the capital of the foreign corporation.

The basic operation of an indirect foreign tax credit is illustrated in the following example. Assume that ACo, resident in Country A, has a wholly-owned subsidiary BCo, resident in Country B. BCo's income for the year is 800, and Country B levies tax at a rate of 40 percent, for a tax of 320 on that income. BCo distributes all of its after-tax profits of 480 (800 – 320) to ACo as a dividend. ACo will be taxable in Country A on 800 — the dividend of 480 and the underlying tax of 320 (often referred to as the "gross-up amount"). Assuming that Country A levies tax at a rate of 50 percent and no limitation rule is applicable, the tax payable would be 400, minus a foreign tax credit of 320 for the foreign taxes paid by BCo on the income out of which the dividend was paid.

BCo's income	800
Country B tax	320
After-tax profit	480
Dividend paid	480
ACo's income:	
Dividend received from BCo	480
Gross-up amount	320
Total income of ACo	800
Country A tax before credit	400
Credit for Country B tax paid by BCo	320
Net Country A tax	80

If the dividend received by ACo in the above example is subject to withholding tax by Country B, the withholding tax also is creditable against ACo's tax payable to Country A, subject to any applicable limitation rule. The credit for withholding tax is a direct foreign tax credit, not an indirect credit, because ACo itself is treated as the payer of the withholding tax.

The credit method may have the effect of discouraging domestic corporations that have earned profits abroad through foreign affiliates from repatriating these profits as dividend distributions. Assume that ACo, resident in Country A, has a wholly-owned affiliate, FCo, resident in Country F. The tax rate in Country A is 50 percent and the rate in Country F is 20 percent. FCo earns profits in Country F of 100 and pays tax of 20. If ACo repatriates FCo's profits by causing FCo to pay a dividend of 80, it will get a foreign tax credit of 20, but it will be required to pay a net tax to Country A of 30, calculated as follows. By retaining the profits in FCo, ACo can defer indefinitely the potential Country A tax of 30.

Dividend	80
Gross-Up Amount	20
Income of ACo	100
Tax Before Credit (50% rate)	50
Indirect Foreign Tax Credit for Taxes Paid by FCo	20
Country A Tax	30

To avoid creating a bias against the repatriation of profits, a credit country could tax the income of foreign affiliates on an accrual basis. Accrual taxation eliminates the deferral of the residence country tax on the foreign-source income earned by residents through foreign affiliates. Although proposals for a comprehensive accrual system have surfaced from time to time, they have not as yet been adopted in any country. Accrual taxation is used, however, in some circumstances. The controlled foreign corporation rules and the offshore investment fund rules impose domestic taxes currently on certain income earned through foreign affiliates and foreign funds in what are perceived to be abusive situations.

The rules designed to govern the indirect foreign tax credit are typically the most complex part of a foreign tax credit system. The indirect credit is allowed only when a domestic corporation has received a dividend from a foreign affiliate. The amount allowable as a credit is the amount of foreign income tax properly attributable to that dividend. Difficult timing and income measurement issues must be resolved to allow a corporation to compute that amount. For example, the domestic corporation typically must determine the profits of the foreign affiliate out of which the dividend was paid. Those profits may have been earned many years in the past and may have been computed in a foreign currency under tax accounting rules that differ significantly from the tax accounting rules applicable to the domestic corporation.

The complexities of the indirect credit have caused some credit countries, for example Argentina, Finland, Peru, South Korea, and Sweden, to allow only a direct credit or to grant the indirect credit only by treaty. A country considering the adoption of an indirect credit might avoid some of the worst complexities by allowing the indirect credit only if the foreign affiliate distributes its profits as a dividend in the year they are earned. Much of the operational complexity of the indirect credit arises when taxpayers are claiming credits for foreign taxes paid by their foreign affiliates out of earnings accumulated over several years.