Part 5
Foreign Tax Credit

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Chapter 18
Qualification for the Foreign Tax Credit

The 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. The limitations on the credit contained in Code section 904 generally apply notwithstanding possible co nflicts with U. S. treaty obligations.

This chapter sets forth the general rules governing the allowance of a foreign tax credit. It also describes the foreign taxes that qualify for a credit. Chapter 19 describes the rules governing the indirect or deemed paid credit for taxes paid by the foreign affiliates of domestic corporations. The many limitations on the credit are discussed in chapter 20. Additional special rules restricting the allowance of a foreign tax credit are described in chapter 21.

§ 18.01. General Rules Governing the Foreign Tax Credit

The United States asserts jurisdiction to taxi 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.[3]

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.[4]

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[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] 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).

[4] 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 an individual taxpayer from being taxed as a resident of the United States and the other Contracting State. See U.S. Model Treaty (2006), Art. 4(2)-(4).

Section 18.01.1, below, describes the generally applicable rules governing the allowance of the credit under Code section 901 and provides an introduction to the remaining sections of this chapter. Section 18.01.2 describes the rules that allow a credit to U.S. persons against their minimum tax (section 59 credit) and to foreign persons with respect to their foreign source effectively connected income (section 906 credit).

§ 18.01.1. General Operative Provisions

The Code has included provisions for granting a foreign tax credit since 1918.[5] Those provisions have been amended many times to curtail abuses of the credit and to respond to changes in the forms 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.[6] 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 in this book 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 accumulated earnings tax, the personal holding company tax, the tax on recoveries of foreign expropriation losses, and the tax on periodical, etc., income imposed by Code section 871(a) or 881. Also on the list is the minimum tax, imposed by Code section 55. Taxpayers are granted, however, an "alternative minimum tax foreign tax credit" that can be used to offset the minimum tax otherwise due.

The foreign tax credit is elective. Each year the taxpayer has the option of crediting[7] or deducting[8] 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.[9] Taxpayers electing to claim a foreign tax credit are not foreclosed from taking a deduction for sales taxes, property 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 18.1: Deduction Versus Credit

PCo, a U.S. corporation, derives taxable income (computed according to U.S. tax concepts) of $200 from Country A and has no other income. PCo pays $60 in income taxes to Country A. The U.S. tax rate is 35%. If PCo 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

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

[6] 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.

[7] IRC 27(a).

[8] 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.

[9] 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.

(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 PCo (line (4) + line (5)) 70

(7) Net after-tax income (line (1) – line (6)) 130

If PCo 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 PCo (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,[10] 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. Some of these rules are discussed in detail in the subsequent sections of this chapter.

(1) With two exceptions, only U.S. persons are entitled to the benefit of the foreign tax credit.[11] One exception, applicable to foreign persons subject to U.S. tax on their foreign source effectively connected income, is described in section 18.01.2., below. 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.[12]

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[10] 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.

[11] 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.

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

(2) Foreign income taxes and foreign taxes imposed in lieu of an income tax are creditable.[13] Section 18.03 describes the 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.[14] 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. [15]

(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.[16] U.S. corporations may claim the indirect credit in the year in which they received dividends from such foreign affiliates.[17] The indirect credit rules are addressed in chapter 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.

(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.[18] 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 operation of the general limitation is explained in chapter 20.01. The special limitation rules, generally referred to as the separate basket limitations, are discussed in chapter 20.02. The separate basket limitations were greatly simplified for taxable years beginning after 2006. Other restrictions on the credit are discussed in chapter 21.

(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. [19]

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[13] 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.

[14] Reg. § 1.901-2(f) (1) (2012). The person legally liable for a tax imposed by a foreign government is popularly referred to as the "technical taxpayer."

[15] A U.S. citizen or resident may elect to be taxed as a corporation with respect to amounts included in their 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 somewhat similar rule applies to individuals taxable under IRC § 1248(b).

[16] 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.

[17] IRC § 902(a).

[18] IRC § 904(a).

[19] 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.[20] Credits must be carried back to the first year preceding the taxable year, and then forward to the next ten succeeding years.[21] 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.[22] 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. The proof requirements are discussed in section 18.05.2.

(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.[23] A similar adjustment generally must be made if the taxpayer paid the tax two years or more after the close of the tax year to which they relate and the dollar value of a foreign currency has changed from the time accrued to the time of payment.[24] 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. [25]

(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. [26] A special "per country" limitation on the credit may apply if a taxpayer take advantage of a treaty to treat income otherwise treated as U.S. source income as having a foreign source.[27]

§18.01.2. Credit to Foreign Persons

Foreign persons may claim a foreign tax credit under Code section 906 for foreign income taxes imposed, or deemed imposed under Code section 902, on income that is effectively connected with a U.S. trade or business.[28] The purpose of the credit is to prevent double taxation of foreign source effectively connected income that is taxable by a foreign country on the basis of its source. Although the section 906 credit may be applied against U.S. taxes imposed on any effectively connected income, the limitations on that credit contained in Code section 904 generally prevent taxpayers from offsetting U.S. tax on U.S. source effectively connected income. For purposes of the section 906 credit, those limitations are computed as if

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[20] IRC § 904(c).

[21] Id.

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

[23] IRC § 905(c) and Reg. §§ 1.905-3T (2007) (foreign tax redetermination) and 1.905-4T (2007) (notice requirements).

[24] Reg. § 1.905-3T(b)(1)(ii)(A) (2007). 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) (2007).

[25] Reg. § 1.905-3T(d)(2)(i) (2007). Some portions of this regulation have been suspended by Notice 90-26, 1990-1 C.B. 336 until the issuance of final regulations under section 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.

[26] See, e.g., U.S. Model Treaty (1996), Art. 23.

[27] IRC 904(d)(6).

[28] For details on the § 906 credit, see Elisabeth A. Owens, "Foreign Tax Credit Granted to Foreigners," 45 *Taxes* 463 (1967).

the only taxable income of the taxpayer is effectively connected income. The credit cannot reduce the 30-percent withholding tax imposed on periodical, etc., income[29] or the 30-percent branch profits tax. [30]

The importance of the 906 credit has been reduced substantially by changes in the source of gross income rules enacted in 1986. Under pre-1987 law, income earned by a foreign person from the sale of inventory property through a U.S. office generally was foreign source income as long as title to the property passed outside the United States. Such income is now classified as U.S. source income if the property is either sold for use within the United States or is sold for use outside the United States and no foreign office materially participated in the sale.[31] Because of this narrowing of the definition of foreign source effectively connected income, the limitations on the section 906 credit imposed by Code section 904 generally will prevent foreign taxpayers from claiming a credit for foreign income taxes previously allowable under section 906.

The Code also grants a foreign tax credit under Code section 877 to expatriating taxpayers. An expatriating taxpayer is a former U.S. citizen or long-term residence who surrenders citizenship or residence status to avoid U.S. taxes. In general, expatriating taxpayers are taxable under Code section 877 on certain foreign source income that has a U.S. nexus and has been recharacterized as U.S. source income under the resourcing rules of section 877.[32] This "section 877" credit is analogous to the credit granted under Code section 906 to foreign persons who are taxable with respect to certain foreign source effectively connected income. In large part, Code section 877 has been supplanted by Code section 877A.

§ 18.01.3. Credit Against Minimum Tax

A foreign tax credit, computed under special limitation rules, can be claimed under Code section 59 against the alternative minimum tax (AMT) imposed by Code section 55. The AMT is a tax imposed on U.S. taxpayers, including foreign persons having effectively connected income, with respect to their alternative minimum taxable income over an exempt amount. In general, alternative minimum taxable income is taxable income, adjusted upward to include various tax preference items. The rate of the minimum tax generally is 20 percent for corporations.[33] For individuals, the rate generally is 26 percent for the first $175,000 over the exempt amount and 28 percent thereafter.[34] Congress has adjusted the exempt amount for individual taxpayers from time to time to prevent large numbers of individuals of moderate means from paying the AMT. The exempt amount for corporations initially was set at $40,000 and has not been adjusted. The exempt amount is phased out for higher-income taxpayers.[35]

Prior to 2005, the section 59 credit generally could not be used to offset more than 90 percent of the minimum tax otherwise imposed, computed without reference to the deduction for net operating losses.[36] The 90-percent rule was repealed in 2004. The rule initially had been adopted in order to require taxpayers

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[29] IRC § 906(b)(3).

[30] IRC § 906(b)(6).

[31] IRC § 865(c)(2).

[32] IRC § 877(b) (last sentence).

[33] IRC § 55(b)(1)(B).

[34] IRC § 55(b)(1)(A).

[35] IRC § 55(d)(3).

[36] IRC § 59(a)(2) (prior to amendment in 2004).

having substantial economic income to pay at least some U.S. taxes, notwithstanding the benefits otherwise obtained from the foreign tax credit and the net operating loss provisions.[37]

The section 59 credit is subject to all of the limitations applicable to a credit claimed under Code section 901 against the normal U.S. income tax.[38] For example, the credit generally can only be claimed by U.S. persons, although the minimum tax may be imposed on foreign persons. The limitations on the credit contained in Code section 904 also apply, in modified form, to the section 59 credit. In general, the taxpayer is required to use alternative minimum taxable income, rather than regular taxable income, in computing the various limitation fractions under section 904.[39]

Consider, for example, a U.S. corporation, PCo, having general limitation alternative minimum taxable income of $5 million, of which $3 million is from foreign sources. It has no taxable income. Its general limitation fraction would be $3 million/$5 million. Its tentative alternative minimum tax, computed without reference to the foreign tax credit, would be $1 million (20% of $5 million). Under the limitation rules, PCo's allowable section 59 credit cannot exceed $600,000 ($1 million × ($3 million/$5 million)).

§ 18.02. Policy of the Foreign Tax Credit

Section 18.02.1, below, discusses the policy reasons for granting a foreign tax credit. Once the basic decision has been made to grant a credit for foreign taxes, two subsidiary inquiries should be pursued. The first inquiry, undertaken in § 18.02.2, relates to the proper definition of a creditable foreign tax. The second inquiry, undertaken in section § 18.02.3, concerns the justification for the limitations on the credit.

§ 18.02.1. Why Grant a Credit for Foreign Taxes?

The foreign tax credit is designed to eliminate the double taxation of U.S. persons that results from the overlap of the residence jurisdiction of the United States with the source jurisdiction of one or more foreign countries. Under the credit provisions, income taxes paid by a U.S. person to a foreign government generally are treated as if they had been paid to the U.S. government in satisfaction of that person's U.S. tax liability.

Two arguments can be advanced in favor of the credit and, by implication, against double taxation of transnational income. First, a properly designed credit improves the fairness of the income tax by equalizing the tax burdens imposed on U.S. persons engaged in transnational transactions with the tax burdens imposed on otherwise similarly situated U.S. persons engaged only in domestic transactions. This equal treatment of equal-income taxpayers is required to achieve the traditional fairness goal of horizontal equity.[40]

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[37] General Explanation of the Tax Reform Act of 1986 (1987) at 465.

[38] IRC § 59(a)(1) (incorporating by reference the limitations of § 27(a), which incorporates by reference the limitations of § 901).

[39] IRC § 59(a)(1)(B). This limitation applies notwithstanding any tax treaty provisions to the contrary. Technical and Miscellaneous Revenue Act of 1988 at § 1012aa(2)(B) (not codified).

[40] Equal treatment of equal-income individuals is an intuitively appealing fairness goal. What would constitute fair treatment of corporations, trusts, race horses, and other impersonal earners of income is less clear. Indeed, the concept of fairness, as applied to entities, has little or no content. Many commentators would introduce traditional fairness standards into the corporate tax by treating it as a mechanism for imposing an indirect tax on corporate shareholders. Unlike the tax systems of many countries, however, the U.S. tax system makes no formal provision for the integration of the individual and corporate income taxes. It does offer many opportunities for self-help integration, however, and it allows corporations with a limited number of shareholders to elect pass-through treatment under IRC §§ 1361 et seq. (subchapter S). A discussion of the grounding for the corporation tax is outside the scope of this book. It is enough to note that horizontal equity, understood as a principle of fairness, can be applied to corporations

The second argument for the credit is that it tends to promote the efficient use of capital by U.S. persons by removing a tax penalty on income-producing activities otherwise subject to a double tax. Without the credit, worldwide productivity would be curtailed because U.S. persons would be induced to forgo certain foreign income-producing activities in favor of U.S. activities that would give them a lower return before taxes but a higher after-tax return.

Consider, for example, XCo, a U.S. corporation contemplating an investment of $1,000 in a Country A. That investment is expected to produce a yield, before taxes, of $100. Like the United States, Country A has a corporate tax rate of 35 percent. Under a credit system, the after-tax yield on XCo's Country A investment would be $65 ($100 – 35% of $100). XCo would favor that investment over any investment in the United States that produced a before-tax yield below $100. The result would be that XCo would be likely to maximize the pre-tax yield of its $1,000 of capital.[41]

XCo would not be likely to maximize the productivity of its capital in a tax system that gave a deduction rather than a credit for foreign income taxes paid to Country A. Instead, XCo sometimes would be induced to favor U.S. investments over investments in Country A having a higher before-tax yield. Investment income of $100 earned in Country A would bear a Country A tax of $35 and a U.S. tax of $22.75 (35% of $65). XCo's after-tax income would be $42.25. Under these conditions, U.S. investment of $1,000 having a pretax yield in excess of $65 ($42.2(1 –.35)) would be more attractive to XCo than investment of $1,000 in Country A having a pre-tax yield of $100.

Elimination of the credit would create a bias against foreign investment. Some commentators have defended that bias on the ground that domestic investment typically provides greater benefits to the United States than foreign investment. For example, domestic investment generates employment for U.S. workers and tax revenues for the U.S. government. Broad arguments for and against foreign investment are difficult to evaluate. Part of the difficulty is due to the fact that not all investments are fungible. Some types of foreign investments, such as, for example, investments that preserve market share for U.S.-based businesses, probably serve U.S. national interests. It is a reasonable, although unproven, hypothesis, however, that U.S. national interests generally would be served by a policy that moderately promoted domestic investment at the expense of foreign investment.

Critics of the credit are probably wrong, nevertheless, in their assumption that a general repeal of the credit by the United States would tend to increase U.S. investment. Total U.S. investment depends not only on the U.S. investments by U.S. persons but also on the U.S. investments of foreigners. A repeal of the credit by the United States almost certainly would result in a retaliatory repeal by many other countries of the relief from double taxation that they now provide to their nationals on income earned within the United States. Such retaliatory action would create a bias against U.S. investment by foreigners.

During the 1950s and 1960s, when foreign investment by U.S. persons greatly exceeded U.S. investment by foreigners, the United States might have obtained some net benefit from a mutual repeal of the credit by the United States and its trading partners. Under current conditions, however, the United States should not expect to obtain a significant net benefit from a general abandonment of international cooperation to reduce double taxation of transnational income. Instead, it should expect a net loss. An end

only by analogy.

[41] The credit generally would not eliminate the disincentive to foreign investment caused by a foreign effective tax rate in excess of the U.S. rate unless the credit is made refundable. No country grants a refundable foreign tax credit, at least on purpose.

to such international cooperation would tend to reduce the efficiency of worldwide capital allocations with no special gain for the United States.

A telling argument can be made on grounds of U.S. national interests for limiting the credit to taxes paid to those foreign countries that defer to the source jurisdiction of the United States in the taxation of their nationals. Countries that do not give relief to their nationals from double taxation, through a credit or some other mechanism, generally are in no position to retaliate against the United States for its failure to give a credit for their taxes. Indeed, by conditioning its credit for foreign taxes on foreign governments granting reciprocal treatment for the U.S. taxes paid by their nationals, the United States might induce some countries to join in a cooperative effort to reduce international double taxation.

The credit is not the only mechanism that could be used to provide relief from double taxation. It is simply the best of those mechanisms. Some foreign governments seek to eliminate double taxation by exempting their nationals from taxation on their foreign source income. Use of an exemption system generally is less fair and less efficient than a credit system. Exemption systems tend to be unfair because they allow persons earning income in a tax haven jurisdiction to pay less in taxes than otherwise similarly situated taxpayers earning only domestic income. An exemption system also tends to be inefficient because it provides a tax bias for foreign investment in tax haven jurisdictions.

Some commentators would defend an exemption system on administrative grounds. An exemption system obviously avoids the complex rules needed to implement a credit system. Unless protected by complex anti-avoidance rules, however, an exemption system would undermine the basic integrity of an income tax. Well-informed taxpayers would arrange their affairs so as to generate foreign source gross income and domestic source deductions. Easily shifted income, such as investment income, would tend to disappear from the tax base. Rules can be devised to protect against such abuses, but it is unlikely that those rules would be less complex then the rules needed to operate a credit system.

The general international practice is for countries to cede primary jurisdiction over transnational income to the country of source. Relief from double taxation could be provided, however, through an international tax regime in which the country of source and the country of residence shared jurisdiction over transnational income. Many tax treaties provide for shared jurisdiction over certain categories of investment income. The goal of a system of shared jurisdiction is to have both the source country and the residence country have a monetary stake in accurate reporting by taxpayers earning transnational income.

In theory, a system of shared jurisdiction has great appeal. Such a system would tend to produce a fairer sharing of revenue for countries that are experiencing a temporary imbalance in their international trade or capital flows. In addition, the limited experience of the United States with a sharing approach in its tax treaties indicates that such sharing of tax jurisdiction over transnational income tends to induce countries to cooperate more extensively on compliance matters.

For business income, sharing through a withholding mechanism applied to gross income is not appropriate because businesses vary widely in the ratio of their taxable income to their gross income. The current system is to assign the right to tax to the residence country unless the business has a PE in the other country. This system has not worked well in practice, to say the least. Combined reporting with formulary apportionment would result automatically in all countries in which an enterprise operates having a stake in accurate reporting of income. The basic premise of combined reporting is that all countries in which an enterprise operates a unitary business are source countries to some degree. If that basic premise is adopted, some sharing methods by formula could be designed that fall far short of full combined reporting.

§ 18.02.2. What Taxes Should Qualify for the Credit?

The foreign tax credit provisions allow U.S. persons to treat certain taxes paid to foreign governments as if those taxes had been paid to the U.S. government in satisfaction of their U.S. income tax liability. Not all foreign taxes, however, should qualify for the credit. In general, a foreign tax should be creditable only if allowance of the credit would advance the policy goals of the U.S. income tax.

An important goal of the U.S. income tax is to raise revenue for government expenditures. This goal generally gives little guidance for the design of the details of an income tax system, as it is a common goal of almost all taxes. It can inform the definition of a creditable foreign tax, nevertheless, because foreign governments may demand a particular definition of a creditable tax, through the tax treaty process or otherwise, as a condition for granting a credit to their own nationals for U.S. income taxes. The United States may gain certain benefits, including an increase in tax revenues, when foreign governments give a credit to their nationals for income taxes paid to the United States on U.S. source income. The reason for the potential revenue increase is that without the credit, the U.S. tax on foreign income might operate as an unfair and inefficient excise tax on U.S. persons, leading to the elimination of the U.S. tax. For example, the United States is reluctant to tax foreign persons on their U.S. source interest income because of a concern that the burden of the tax would fall on U.S. borrowers. If the lenders are receiving a credit in their home country for the U.S. tax, however, that problem would not arise.

Besides raising revenue, the U.S. income tax is designed to promote fairness and efficiency. Whether a tax is collected by the United States or by a foreign government generally has little relevance in determining its fairness or efficiency. What is important for fairness and efficiency is the impact of the tax on the economic condition of U.S. persons paying it. It follows, therefore, that a foreign tax should be creditable, in theory, whenever its impact on U.S. persons is comparable to the impact of the U.S. income tax on otherwise similarly situated U.S. persons deriving their income entirely from U.S. sources.

Fairness and efficiency would not be advanced by allowing U.S. persons a credit for foreign sales taxes and other indirect taxes that they do not in fact pay. For example, it would be unfair and inefficient to allow U.S. persons a credit for foreign value-added taxes that are assessed on them and then passed on to their customers through higher prices. Similarly, a credit should not be allowed for a foreign tax if the nominal taxpayer gets a rebate of the tax or obtains a specific economic benefit in exchange for paying the tax. Thus royalty payments made by a U.S. person that have been structured by a foreign government to look like income tax payments should not be creditable against that person's U.S. tax liability.

In general, foreign taxes that are designed in a way that facilitates the shifting of tax burdens from the nominal taxpayer to some other person should not qualify for the credit. Otherwise U.S. persons nominally subject to a shifted tax would bear a lower overall tax burden than similarly situated U.S. persons paying the U.S. income tax. A general prohibition against a credit for shiftable taxes would be improper, however, for two reasons.

First, tax analysts can offer no practical method for systematically determining whether particular taxpayers have borne the burden of a foreign tax nominally imposed on them. Economic theory suggests that under some idealized conditions, the nominal taxpayer would bear the burden of an income tax. There is no consensus on the incidence of the personal and corporate income taxes in the real world. Even those most optimistic about their ability to determine the incidence of a tax should admit that they cannot determine the impact of many foreign taxes on the economic condition of particular U.S. persons.

Second, the burden of the U.S. individual and corporate income taxes may be shifted away from the nominal taxpayer in some circumstances. Some economists assert, for example, that the corporate income tax tends to be shifted to all holders of capital. Some others claim it is shifted backward to labor. The result of denying a credit for all shifted foreign taxes, therefore, would be to favor U.S. persons paying a shifted U.S. income tax over otherwise similarly situated U.S. persons paying a shifted foreign tax.

The efficient and fair rule would be to allow U.S. persons a credit for unshifted foreign taxes and also for shifted foreign taxes, to the extent that the shifted taxes are comparable to a shifted U.S. income tax. Of course implementation of this rule would present hopeless problems of administration, given the lack of information that can be obtained on the incidence of U.S. and foreign taxes. These problems can be sidestepped, however, by indulging the assumption that a foreign tax generally has the same incidence as the U.S. income tax whenever its rules, in form and application, are essentially the same as the rules of the U.S. income tax.

To implement a requirement of formal equivalency between foreign creditable taxes and the U.S. income tax, analysts must develop a list of the features of the U.S. income tax that a foreign tax must include for it to qualify for the credit. An example of such a list is contained in the current Treasury regulations under Code section 901. Any list that purports to identify such required features is likely to be controversial. In general, the list should include those features of the U.S. income tax that tend to inhibit shifting. Features that would inhibit shifting under some economic conditions would be included on the list, even if those economic conditions are likely to exist in only a few countries. In appropriate cases, the United States could tailor the list to the economic conditions of particular countries through its treaty negotiations.

Objection can be made to a formal equivalency requirement on the ground that the economic conditions in a foreign country may be sufficiently different from U.S. conditions that a foreign tax could be shifted despite its formal equivalence to the U.S. income tax. This objection has theoretical merit. Whether it has important practical consequences, however, is questionable. Efficiency is unlikely to suffer under a formal equivalency requirement because U.S. persons generally do not know whether the U.S. income tax is more or less susceptible to shifting than a formally equivalent foreign tax.

The current U.S. rules defining a creditable income tax generally satisfy the formal equivalency requirement. Indeed, the general rule of the Treasury regulations can be interpreted as a formulation of that requirement. The regulations under Code section 901 state that a foreign tax cannot qualify for the credit unless it is a tax, rather than a disguised payment for goods or services, and "the predominant character of that tax is that of an income tax in the U.S. sense."[42]Subsequent language in the Treasury regulations give more content to this general statement by specifying what the Treasury Department understands to be the essential features of the U.S. income tax.

The allowance under current law of a credit for in-lieu taxes is contrary to the formal equivalence requirement. In-lieu taxes should be creditable only if they are structured in a way that minimizes the risks of shifting. Writing general rules that identify unshifted in-lieu taxes is difficult, perhaps impossible. It would be a better policy, therefore, to leave the problem of identifying creditable in-lieu taxes to tax treaty negotiations.

Foreign income taxes imposed by a subnational foreign government currently qualify for the credit. This treatment of foreign subnational taxes is open to question under the formal equivalency requirement

[42] Reg. § 1.901-2(a)(1) (2012).

because U.S. persons earning U.S. source income cannot claim a credit for the income taxes that they pay to subnational governments of the United States. Analogy to the treatment under the Code of income taxes paid to U.S. subnational governments would not support a denial of all credit for foreign subnational income taxes because many foreign governments have low national taxes and high subnational taxes. In such countries, some portion of the subnational taxes should be creditable under a formal equivalency requirement, to the extent that the taxes otherwise qualify as creditable income taxes.

The current policy of allowing a credit for foreign subnational income taxes is proper, notwithstanding the disallowance under the Code of a credit for taxes paid to U.S. subnational governments. Unless the United States allows such a credit, the burden of granting relief from the double taxation produced by foreign subnational taxes would fall on U.S. subnational governments.[43]

The state and local governments in the United States are not in a position to give double taxation relief with respect to foreign taxes or even to determine the proper amount of such relief. Nor are they in a position to insist that foreign subnational governments give reciprocal relief to their nationals. Thus there are substantial advantages to be obtained by delegating the responsibility for relief of double taxation to the federal government. The federal government also should be responsible for ensuring that foreign governments provide their nationals with a proper credit for U.S. subnational income taxes.

§ 18.02.3. Why Should the Credit Be Limited?

Some foreign countries impose creditable income taxes on income arising within their borders at effective tax rates in excess of the U.S. effective tax rates. When U.S. persons pay such high foreign taxes, the limitations on the foreign tax credit contained in Code section 904 come into play. Those limitations prevent U.S. persons from reducing the tentative U.S. tax imposed on their U.S. source income by their surplus foreign tax credits. U.S. persons are also prevented from using credits generated by high foreign taxes on certain categories of foreign source income to reduce the tentative U.S. tax on certain other categories of foreign source income. The question to be decided is whether those limitations, or some alternative limitations, are proper.

Limitations on the credit are not needed to achieve horizontal equity. An unlimited credit would tend to promote horizontal equity by equalizing the tax burdens imposed on U.S. persons subject to high foreign tax rates with the tax burdens imposed on otherwise similarly situated U.S. persons that are not subject to such taxes. Indeed, to fully achieve horizontal equity, the credit would have to be refundable. Without a refund provision, U.S. persons having surplus credits would pay higher income taxes than otherwise similarly situated U.S. persons having no surplus credits.

There is also no need to impose limitations on the credit in order to promote the efficient use of capital. In general, an unlimited credit, coupled with a refund feature, would tend to equalize the marginal tax rates that U.S. persons would face on foreign source income with the marginal rate that they would face on U.S. source income. The tax penalty that U.S. persons now pay for investing in countries that impose high income taxes would be eliminated.

The fact that an unlimited credit might improve the worldwide allocation of capital does not mean that the United States should provide such a credit. *First*, some measures that advance worldwide welfare may not advance U.S. national interests. For example, the United States generally benefits more from domestic

[43] In theory, the tentative U.S. tax against which credits for foreign taxes could be taken should include state and local taxes actually paid . Serious technical difficulties would arise in implementing such a rule.

investment than from foreign investment. If the limitation on the credit tends to induce investors to invest in the United States instead of in some foreign high-tax country, the United States may come out ahead. *Second*, an unlimited credit has a major revenue cost. If the goal of neutrality is to be achieved, the source country imposing a high tax may be the appropriate country to bear the revenue burden of achieving that goal.

Although limitations on the credit are unnecessary to promote fairness or efficiency, they are needed to preserve U.S. claims to tax revenue against the competing claims of other governments. The fundamental difference between a foreign income tax and a U.S. income tax is that the U.S. government obtains the revenue from its taxes and obtains no revenue from the taxes imposed by other countries. A limitation on the credit was added to the Code in 1921 in order to preserve U.S. claims to tax revenue from the U.S. source income of U.S. persons. Fairness and efficiency properly were subordinated to this goal. Since 1921, a robust debate has ensued over the proper choice of limitation rules. A variety of limitation rules have been adopted. There has been no debate at all, however, over the propriety of having some limitation on the credit.

The design of limitation rules depends on their goal. If the goal is to prevent taxpayers from getting a credit for foreign taxes assessed at a rate above the United States rate, that goal coold be achieved by creating two limitation baskets. In the first basket would be items of income that were taxed at an effective rate below the U.S. rate. The second basket would be for items of income taxed at an effective rate above the U.S. rate. Taxes paid with respect to income in the first basket could only be used to offset the U.S. tax otherwise due on items of income in that basket. A similar rule would apply to taxes paid with respect to items of income in the second basket.

The system described above would not be easy to implement, for two reasons. *First*, taxpayers would have great difficulty determining the effective tax rate on some items of income. *Second*, the system would be difficult to implement, due in large measure to the difficulties that would arise in attributing particular deductions to particular items of income.

The United States, in the 1986 tax act, adopted a set of separate basket rules that approximated, intentionally or otherwise, the two-basket system described above. In general, the 1986 system provides for several different baskets. Some were high-tax baskets — that is, baskets that would contain items of income likely to be taxed at a rate equal to or above the U.S. rate. Others were low-tax brackets. Foreign taxes relating to one of the baskets could only be used to offset the U.S. tax otherwise due on income placed in that basket. The separate basket system resulted in some administrative burdens on multinational companies, although those burdens tended to go down considerably over time, once the companies had incorporated the basic rules into their accounting systems.

Whatever its merits, the 1986 system was scrapped by Congress in 2004 and replaced with a system having only two basket. The first basket, the passive basket, includes interest, dividends, rents and various other items of investment income unless that income has been subject to tax at a rate above the top U.S. rate (high-tax income). The other basket, called the general basket, includes all other items of income, including high-tax passive income. This system does have two baskets but it is fundamentally different from the two-basket system described above because it allow high-tax and low-tax income in the general basket.

A general limitation, with nothing more, allows U.S. persons to cross credit high foreign income taxes imposed on one item of foreign source income against the tentative U.S. tax imposed on other items of foreign source income. It prevents U.S. persons, however, from cross crediting high foreign taxes against the tentative tax on U.S. source income. As a result, the general limitation creates a powerful incentive for U.S.

persons having excess foreign tax credits to earn foreign source income rather than U.S. source income. The likely effect of that incentive, if left unchecked, would be to decrease the efficiency of worldwide capital allocations and to harm U.S. national interests.

The separate basket limitations promote efficiency by greatly reducing the incentive for foreign investment created by the general limitation. Without the separate basket limitations, or some functional equivalent, U.S. persons having surplus credits generally would serve their own economic interests by engaging in foreign activities rather than in economically more productive activities in the United States. Some foreign countries have effective tax rates that are higher than the U.S. effective rates, causing many U.S. persons engaged in transnational activities to have surplus credits. The revised separate basket system adopted in 2004 is significantly better than having only a general limitation, but it is less effectie in promoting U.S. national interests than the multiple-basket system it replaced.

As with any limitation rule, the separate basket limitations tend to decrease horizontal equity between U.S. persons paying high foreign income taxes and otherwise similarly situated U.S. persons paying only domestic taxes. At the same time, the separate basket limitations tend to promote horizontal equity between two groups of U.S. persons paying high foreign taxes. In the first group are those U.S. persons that could utilize their surplus credits but for the separate basket limitations. The second group is comprised of U.S. persons having insufficient foreign source income to utilize their surplus credits. These horizontal equity effects cannot be given much weight in designing the credit, however, because the inequity results primarily from the decision of foreign governments to impose high taxes on U.S. taxpayers.

The general and separate-basket limitations on the credit have two desirable side effects from the perspective of the United States. *First*, they put some pressure, albeit mild, on foreign governments to avoid the imposition of high income taxes on U.S. persons. It is high foreign taxes that create the necessity for limitations on the credit. *Second*, the limitations take some of the pressure off the definition of a creditable tax. Tough limitation rules allow the United States to use a somewhat less restrictive definition of a creditable tax without incurring large revenue losses. The substantial weakening of the separate basket limitations in 2004 has put added pressure on the definition of a creditable income tax.

§ 18.03. Qualification as an Income Tax

Only two kinds of foreign taxes are creditable: income taxes, including war profits and excess profits taxes, and taxes paid in lieu of such taxes. The Code does not attempt to specify what constitutes an income tax. The statutory void has been filled by a relatively small number of court decisions, by revenue rulings, and by detailed Treasury regulations.[44] Each bilateral tax treaty entered into by the United States specifies the taxes that qualify for the foreign tax credit under its terms.[45]

A foreign levy is creditable as an income tax if it meets two tests. First, the foreign levy must be a "tax," not some other kind of assessment or payment that provides the taxpayer with a "specific economic benefit" not generally available to the public without charge.[46] The operation of this test is addressed below. Second,

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[44] Reg. § 1.901-2(a)(3) (2012) (defining an income tax) and Reg. § 1.901-2A (1983) (defining "dual capacity taxpayers").

[45] See U.S. Model Treaty (2006), Art. 2.

[46] Reg. § 1.901-2(a)(2) (2012).

the levy generally must be based on "income" as that term is understood under U.S. tax law.[47] That test is also discussed below.

§ 18.03.1 . Determining Whether a Levy Is a Tax

Not every payment exacted by a foreign government will qualify as a "tax." To qualify as a tax, the levy must be a compulsory payment made to a government under its taxing powers.[48] A levy will not constitute a tax if it results in the taxpayer receiving, directly or indirectly, an economic benefit that is not made available to all persons subject to the levy.[49] Thus a payment for services or for government-owned mineral deposits would not constitute a tax. Whether a levy constitutes a tax depends upon U.S. tax concepts, not on the concepts of the foreign country imposing the levy.[50]

Much of the controversy over the classification of a foreign levy as a tax or a payment for a specific economic benefit has centered on the levies imposed by oil-owning states on U.S. oil companies and their foreign affiliates.[51] Typically a U.S. company would be required to pay a very substantially levy, labeled an income tax, under conditions that appeared to make the levy functionally equivalent to a royalty payable to the owner of an oil resource. Since 1975, Congress has imposed a number of important restrictions on the credit for oil and gas levies. Some of those restrictions have a serious bite. Others simply required taxpayers, operating in conjunction with foreign governments, to change the form of their foreign payments.

Some portion of a foreign levy that provides a taxpayer with a specific economic benefit may qualify as a tax under regulations adopted by the Treasury Department in 1983.[52] The effect of the regulations is to treat a foreign levy serving both as a tax and as a charge for an economic benefit as two separate levies. The portion of the levy operating as a tax is eligible for consideration as an income tax.[53] The other portion is treated as a payment for a specific benefit and not a tax.[54] That latter portion would be deductible if it met the requirements for a business expense.[55]

Taxpayers that pay a levy that serves both as payment for an economic benefit and as a tax are classified as "dual capacity taxpayers" under the regulations.[56] Contrary to the general rule described above,

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[47] Reg. § 1.901-2(a)(1) (2012).

[48] Reg. § 1-901-2(a)(2)(i) (2012) ("[a] foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes"). The regulations bar certain tax schemes designed to abuse the credit on the ground that the alleged payment to a foreign government was not "compulsory". See Reg. § 1.901-2(e)(iv)(A) (2012) ("an amount paid to a foreign country . . . is not a compulsory payment, and thus is not an amount of tax paid, if the foreign payment is attributable . . . to a structured passive investment arrangement").

[49] Reg. § 1.901-2(a)(1) (2012).

[50] Id.

[51] For a discussion of the creditability of various oil-related taxes decided under the 1980 temporary regulations, see *Phillips Petroleum v. Comm'r, 104 T.C.* 256 (1995) (allowing foreign tax credit for various Norwegian taxes after concluding that the taxes did not constitute payment for a specific economic benefit); see also *Exxon v. Comm'r*, 113 T.C. 338 (1999) (holding that the U.K. the petroleum revenue tax was a creditable excess profits tax or income tax and not a payment for a specific economic benefit).

[52] Reg. § 1.901-2A (1983). Prior to the 1983 regulations, a levy probably would not constitute a tax if the tax authorities could establish that the levy was being paid in part to obtain a specific economic benefit. For a nice analysis of the issues addressed by the 1983 regulations, including a *full* discussion of the pre-1983 and post-1983 rules defining a creditable tax, see Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes," 39 *Tax Law Review* 227 (1984).

[53] Reg. § 1.901-2(a)(2)(i) (2012). That levy may also qualify as an in-lieu tax.

[54] Id.

[55] Reg. § 1.901-2A(b)(1) (1983).

[56] Reg. § 1.901-2(a)(2)(ii) (2012). The Internal Revenue Service will not rule on the question of whether a dual capacity taxpayer has paid a tax in exchange for a specific economic benefit. Rev. Proc. 2012-7, 2012-1 I.R.B. 232, § 4.01(17).

a dual capacity taxpayer can obtain credit for the entire amount of a foreign levy if the following conditions are met. First, the foreign levy must apply to both dual capacity taxpayers and other taxpayers.[57] Second, the dual capacity taxpayer must establish that the levy applies to both groups of taxpayers in the same way, not only in form but in actual practice.[58] Third, the levy must qualify as an income tax (or as an in-lieu tax) under the usual tests.[59] In effect, the regulations give the credit to dual capacity taxpayers if it appears that the foreign taxing authority did not require those taxpayers to pay more than the normal income tax in order to obtain their specific economic benefit.

If a dual capacity taxpayer pays a foreign levy and some portion of that levy is considered under the regulations to be paid in order to obtain a specific economic benefit, then the taxpayer has the burden of showing the portion of the levy that constitutes a true tax.[60] To assist the taxpayer in meeting that burden, the Treasury regulations provide a safe- harbor allocation formula. Under the formula, the creditable portion of the levy equals (A – B – C) × D/(1 – D), where:

A = gross receipts subject to the foreign tax, computed according to the generally applicable income tax;

B = allocable deductions and other costs, computed according to the generally applicable income tax;

C = the amount actually paid under the dual-function levy;

D = the tax rate under the generally applicable income tax.[61]

The operation of the rules for dual-function foreign levies and the operation of the safe-harbor formula are illustrated in the following example.

Example 18.2: Dual-Function Foreign Levies

Country X has a generally applicable income tax with two brackets, a 40-percent bracket applicable to most taxpayers and a top bracket of 85 percent applicable, in practice, only to oil companies. The oil companies are not permitted to deduct their operating costs; other taxpayers are not subject to this limitation. The oil companies are permitted to extract oil from government-controlled land and thus obtain a specific economic benefit from paying their tax. Under these conditions, oil companies subject to the 85-percent tax will be treated as subject to two separate levies-the regular income tax of 40 percent, which may qualify as a tax, and a separate levy on their oil profits, which will not qualify as a tax.

XYZCo, a U.S. corporation, has gross receipts of $200 from its oil operations in Country X. It has costs of $15 allocable to those gross receipts that would be deductible under the 40-percent tax but are not deductible under the 85-percent tax. XYZCo has paid a levy to Country X of $170. It would have a creditable income tax of $10, computed under the safe harbor formula as follows:

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[57] Reg. § 1.901-2A(a)(1) (1983).

[58] Id. This condition is not violated simply because the dual capacity taxpayer pays tax at a lower rate of tax. In the typical case, the dual capacity taxpayer would pay at a higher rate, to compensate for the specific economic benefit it is receiving. If a higher rate is applicable in practice to the dual capacity taxpayer, then it cannot claim credit for the entire amount of the foreign levy. Reg. § 1.901-2A(a)(2)(Ex.4) (1983).

[59] Reg. § 1.901-2A(a)(1) (1983).

[60] Reg. § 1.901-2A(b)(1) (1983).

[61] Reg. § 1.901-2A(e)(1) (1983).

(1) Gross receipts (A) $200

(2) Deductions (B) 15

(3) Levy paid (C) 170

(4) A minus B minus C 15

(5) General tax rate (D) 40.0%

(6) D/O minus D) (.4/.6) 66.7%

(7) Amount of levy qualifying as a tax (A – B – C) × D/O – D) $10

(8) Amount of levy treated as deductible payment for specific economic benefit (line (3) – line (7)) 160

In this example, XYZCo's taxable income, determined under the rules of the 40-percent tax, can be computed by subtracting from the gross receipts of $200: (1) the -allowable deductions of $15 and (2) the deductible portion of the levy paid to Country X. That deductible portion, shown in line (8), is $160. Thus taxable income equals $25 ($200 – $15 – $160). An income tax of 40 percent on taxable income of $25 would equal $10, which is the amount treated as a tax under the formula. The $10 treated as a tax must qualify as an income tax to be eligible for the credit.

The point of the dual-levy formula, as the example above illustrates, is to compute the amount of tax that would have been paid if the generally applicable income tax had been applied to the taxable income of the dual-levy taxpayer, computed according to U.S. tax concepts. The first term in the formula, (A – B – C), is the amount that would be taxable under the generally applicable income tax if a deduction were allowed not only for the payment for a specific economic benefit but also for the income tax itself. A definition of taxable income that allows a deduction for income taxes paid is referred to as a tax-exclusive base. The U.S. tax base, which does not allow a deduction for the income tax itself, is referred to as a tax-inclusive base.

The second term in the dual-levy formula, D/(1 – D), is the rate that would need to be applied to taxable income in a tax system using a tax-exclusive base to yield the same revenue as a rate of D applied to taxable income in an otherwise identical tax system using a tax-inclusive base. Thus the result reached by multiplying the two terms together in the dual-levy formula is the amount of tax that would be collected by applying a rate of D to taxable income computed according to the rules of the generally applicable income tax.

Exxon Corp. v. Comm'r

113 T.C. 338 (1999)

Opinion (Judge Swift).

The issue for decision is whether petroleum revenue tax (PRT) petitioners paid to the United Kingdom for 1983 through 1988 constitutes, for U.S. income tax purposes, a creditable income or excess profits tax under section 901 or a creditable tax in lieu thereof under section 903. * * *

Under regulations applicable to the years in issue, foreign levies are to be regarded as income or excess profits taxes if they satisfy two tests: (1) The foreign levies constitute taxes, and (2) the predominant character of the taxes is that of an income tax in the U.S. sense. See *sec. 1.901-2(a)(1), Income Tax Regs.*

Generally, governmental levies imposed by and paid to foreign countries are to be treated as taxes if they constitute compulsory payments pursuant to the authority of the foreign countries to levy taxes. The regulations, however, also provide that foreign levies will not be regarded as taxes to the extent that payors of the levies receive specific economic benefits, directly or indirectly, from the foreign countries in exchange for payment of the levies. See *sec. 1.901-2(a)(2), Income Tax Regs.* The regulations also provide that economic benefits that foreign Governments do not make available on substantially the same terms to substantially all persons subject to the generally imposed income tax (such as a concession to extract Government-owned petroleum) will be regarded as specific economic benefits. See *sec. 1.901-2(a)(2)(ii)(B), Income Tax Regs.*

Exxon acknowledges that the licenses it received from the United Kingdom to exploit North Sea petroleum resources constitute the receipt of specific economic benefits and therefore that Exxon is to be treated under the regulations as a "dual capacity" taxpayer and as subject to the regulations with regard thereto under sections 1.901-2(a)(2) and 1.901-2A, Income Tax Regs. Thereunder, dual capacity taxpayers (who pay levies and who also receive specific economic benefits from the Government) have the burden to establish the extent, if any, to which foreign levies they pay constitute taxes—as opposed to payments for the specific economic benefits received—either by relying on the regulations' safe harbor method or on the facts and circumstances method. See sec. 1.901-2A(c)(1) and (2), Income Tax Regs. Exxon herein relies on the facts and circumstances method, and Exxon is required to establish, under all of the relevant facts and circumstances associated with its payment of PRT, what portion, if any, of PRT paid by it to the United Kingdom constitutes taxes, as distinguished from payments in exchange for the license rights it received. See sec. 1.901- 2A(b), (c), Income Tax Regs. * * *

The parties have stipulated that PRT meets the realization and gross receipts requirements of section 1.901-2(b)(2), (3), Income Tax Regs., that PRT constitutes a compulsory payment imposed by the United Kingdom within the meaning of *section 1.901-2(a)(2)(i), Income Tax Regs.*, and that PRT does not constitute a soak-up tax within the meaning of *section 1.901-2(c), Income Tax Regs.* The only issues before us are whether PRT paid by Exxon is to be treated as a tax (as opposed to payment for specific economic benefits) and whether the predominant character of PRT may be regarded as an income tax in the U.S. sense and thereby as satisfying the net income test. [The court concluded that the levy satisfied the net income test. Discussion of that issue is omitted.]

PRT and Compensation for Specific Economic Benefits

The evidence in these cases establishes that PRT paid by Exxon does not constitute compensation in exchange for license rights or other specific economic benefits received by Exxon. Upon enactment of PRT and upon or in exchange for payment of PRT, Exxon was granted no additional rights, under its licenses or otherwise, with respect to North Sea petroleum resources. Exxon's rights to explore for, develop, and exploit petroleum resources in the North Sea during the years in issue arose from and were dependent upon licenses Exxon obtained from the United Kingdom in prior years (before PRT was enacted) and on Exxon's payment to the United Kingdom of license fees and royalties due under those licenses.

The United Kingdom's purpose in enacting PRT in 1975 was to take advantage of rising oil prices and to ensure that the United Kingdom realize an appropriate share of excess profits to be realized by Exxon and

by other oil and gas companies from exploitation of petroleum resources in the North Sea under the licences granted to them.

License fees owed and paid by Exxon under terms of the discretionary licenses (consisting of the up-front fees, annual fees, and 12-1/2-percent royalties) represented substantial and reasonable compensation to the United Kingdom for the licenses. As indicated, through 1992 the oil and gas companies have paid to the U.K. Government more than £16 billion in royalties alone in connection with the North Sea licenses.

The United Kingdom's purpose in enacting PRT in 1975 was to take advantage of rising oil prices and to ensure that the United Kingdom realize an appropriate share of excess profits to be realized by Exxon and by other oil and gas companies from exploitation of petroleum resources in the North Sea under the licences granted to them.

Under its sovereign taxing power, the United Kingdom intended to and did impose PRT as a tax, not as payment for specific economic benefits. Respondent stipulates that PRT was not negotiated but was imposed unilaterally, as a compulsory payment, and that PRT was enacted and is administered as a tax under U.K. law—all characteristics of taxes, not of payments for specific economic benefits.

The parties herein rely heavily on expert witnesses—from the petroleum industry, from the U.K. Government, and from legal, tax, accounting, and economic professions—as to the character of PRT as a tax or as payment for specific economic benefits.

The basis of the opinions rendered by respondent's economic experts seems to be that, in hindsight, oil companies "got a good deal" when they entered into North Sea license agreements, that the licenses turned out to be more valuable than anyone anticipated at the time the licenses were issued, and therefore that the oil companies "probably felt there was an implicit contract" to pay some type of additional charges, and that these additional charges (whatever they may be called, however they are administered, and regardless of their features) should be regarded as what respondent's expert witnesses refer to as "economic rent" (i.e., as deferred payments in exchange for the licenses granted in earlier years to the oil companies) and not as taxes.

Respondent's experts overemphasize the fact that North Sea licenses issued by the United Kingdom to the oil and gas companies in the late 1960's and in the 1970's were issued largely without an auction system. As we have found, throughout the world most countries traditionally have not relied on auction systems to issue licenses for the right to exploit petroleum resources.

In considering North Sea licenses Exxon received and under which it operated in the North Sea, respondent's experts fail to recognize and to give proper weight to the significant uncertainties, risks, and investment commitments associated with oil and gas exploration and production in the North Sea that, at the time the licenses were issued to Exxon, were associated with the licenses—risks that insufficient oil and gas deposits in the North Sea would be found, that petroleum resources that might be discovered would not be commercially recoverable, and that the large investments required to explore for oil and gas and to operate in the North Sea would be lost.

Respondent's experts speculate that in light of increased oil prices in the late 1970's and early 1980's, the United Kingdom could have set the license fees higher and obtained higher revenues under the North Sea licenses. That, however, is not the proper inquiry. We are not particularly concerned with speculation, about whether in retrospect the United Kingdom extracted all the revenues it could have from oil companies under the licenses. Rather, as Exxon's witnesses emphasize, the proper focus is whether PRT was imposed and paid "in exchange for" North Sea license rights. This is the focus of the regulations under section 901 and that focus is to be maintained here. See *sec. 1.901-2(a)(2), Income Tax Regs*; see also *Phillips Petroleum Co. v. Commissioner, 104 T.C. 256, 297 (1995).*

In Phillips Petroleum Co., we held that Norway's Special Tax on oil and gas activity in the Norwegian sector of the North Sea constituted, for U.S. Federal income tax purposes, a creditable tax under section 901. Norway's Special Tax is similar in a number of significant respects to PRT.

Under temporary Treasury regulations applicable to the years involved in Phillips Petroleum Co., Norway's Special Tax was to be treated as a tax as long as "no significant part of the charge [represents] compensation for the specific economic benefit received". See *sec. 4.901-2(b)(2)(iii), Temporary Income Tax Regs.*, *45 Fed. Reg. 75649* (Nov. 17, 1980), as applicable to 1979 to 1982. Applying that test, we held in *Phillips Petroleum Co. v. Commissioner, supra 104 T.C. at 289-297,* that Norway's Special Tax constituted a tax and not payment for specific economic benefits.

The Norwegian Special Tax was enacted in 1975 and was imposed on oil and gas companies operating under discretionary licenses granted by Norway requiring payment of initial fees, annual fees, and 10-percent royalties. We concluded that by payment of the Special Tax the oil and gas companies were not granted additional rights under their licenses, that the fees and royalties paid under the licenses represented substantial compensation for such licenses, that the Special Tax constituted a tax and not an additional royalty, and that the purpose of the Special Tax was to impose taxes on excess and unexpected profits, not to impose additional charges on oil companies for rights to extract oil, and therefore that the Special Tax constituted a tax, not a levy in exchange for specific economic benefits. In *Phillips Petroleum Co. v. Commissioner, supra at 295,* we explained:

> The word "tax" in [the U.S.] * * * is generally understood to mean an involuntary charge imposed by legislative authority for public purposes. It is exclusively of statutory origin. Tax burdens and contractual liabilities are very different things. A tax is compulsory, an exaction of sovereignty rather than something derived by agreement. A tax is a revenue-raising levy imposed by a governmental unit. It is a required contribution to the governmental revenue without option to pay. A royalty refers to a share of the product or profit reserved by an owner for permitting another to use a property. [Citations omitted.]

In Phillips Petroleum Co., we then concluded that the Norwegian Special Tax was enacted:

> to take advantage of a new profit situation created by surging oil prices, and to receive a larger share of what Norway saw as extraordinarily high and unforeseen profits generated from Norwegian resources, and at the same time to allow petroleum companies to earn a reasonable profit.

[Id. at 292.]

Phillips Petroleum Co. v. Commissioner, supra, supports our finding and conclusion herein that PRT is not to be regarded as payment in exchange for specific economic benefits Exxon received under its North Sea licenses.

All of the PRT the character of which is in dispute in these cases was paid by Exxon with respect to oil production from fields licensed to Exxon before 1975 and before PRT was enacted. As one of respondent's experts acknowledges, Exxon did not receive any special benefits under its licenses, or otherwise, for paying PRT, and Exxon in later years, as a result of paying PRT, did not receive any special advantages in obtaining additional North Sea licenses.

The credible and persuasive evidence strongly supports and we conclude that all PRT paid by Exxon for the years in question constitutes taxes, not payments for specific economic benefits. * * *

We conclude that PRT constitutes a tax, that the predominant character of PRT constitutes an excess profits or income tax in the U.S. sense, and that PRT paid by Exxon to the United Kingdom for the years in issue is creditable under section 901 against Exxon's U.S. Federal income tax liability.

In light of our resolution of the above issues, we need not address Exxon's alternative argument that PRT qualifies under section 903 as a creditable tax in lieu of an income tax.

Explanation of Proposed Third Protocol to Proposed Income Tax Treaty Between the United States and the United Kingdom

Joint Committee on Taxation, June 6, 1979, JCS-24-79.

Article V. Petroleum Revenue Tax

The proposed protocol limits the extent to which the United States is required under the proposed treaty to allow a foreign tax credit for the U.K. Petroleum Revenue Tax (PRT). The pending treaty as approved by the Senate would in general have required the PRT to be treated as a creditable income tax, subject to the limitations on the foreign tax credit of U.S. statutory law. The proposed protocol would in general prevent excess PRT from offsetting U.S. tax on oil income from other countries.

The proposed treaty as approved by the Senate contains the general rule contained in many U.S. tax treaties under which the United States agrees that it will continue to allow its U.S. citizens and residents to claim a foreign tax credit (Code secs. 901 and 902) against the U.S. tax for the appropriate amount of income taxes paid to the United Kingdom. The credit (direct or indirect) allowed under the proposed treaty is subject to the limitations and in accordance with the provisions of U.S. law (as it may be amended from time to time without changing the general principle of allowing a foreign tax credit) applicable to the year in question.

The proposed treaty also provides that the PRT is to be treated as a creditable income tax for U.S. foreign tax credit purposes. It is the position of the Internal Revenue Service that the PRT is not an income tax in the United States sense and that therefore it would not be eligible for the U.S. foreign tax credit in the absence of the proposed treaty. In the view of the IRS, the PRT is more in the nature of a production or severance tax. Rev. Rul. 78-424, 1978-2 C.B. 197.

The PRT presently is imposed at a 45-percent rate on assessable profits from oil and gas extraction activities in the U.K. (including the North Sea) on a field-by-field basis. It is in addition to, and separate from, the regular U.K. corporate tax (and a 12.5-percent royalty payable on North Sea production). The amount of PRT paid is allowed as a deduction for purposes of computing the regular U.K. corporate income tax. Operating and capital losses from nonextraction activities are not allowed as deductions in computing the PRT. In addition, no deduction is allowed for interest or other financing costs. However, a special addition

deduction based on the amount of capital investment is provided to compensate for the disallowance of interest expenses in computing profits for purposes of the PRT. The aggregate amount payable to the U.K. Government in taxes and royalties on oil and gas extraction income is roughly 60 to 70 percent.

During the Senate's consideration of the proposed treaty, Senator Kennedy introduced a reservation which would have allowed a credit for the PRT only to the extent that U.S. tax attributable to U.K. oil and gas extraction income exceeded other U.K. taxes (such as the regular U.K. corporate income tax) on that income. (3) The intent of this reservation was to prevent U.S. oil companies from using the PRT as a credit against their U.S. tax liability on extraction income from other countries, such as OPEC nations. Senator Kennedy withdrew the reservation on the basis of assurances from the Treasury Department and the British Government that the issue would be dealt with in a protocol. (4)

The proposed protocol incorporates the substance of the Kennedy reservation and also applies a number of rules which are similar to provisions of U.S. domestic law limiting the foreign tax credit for foreign oil and gas income (Code sec. 907). To determine the extent to which a credit for the PRT will be allowed, the taxpayer first multiplies its U.K. income from the extraction of minerals from oil and gas wells for the taxable year by the maximum statutory U.S. tax rate applicable to a corporation (currently 46 percent). A credit for the PRT for the taxable year cannot exceed the difference (if any) between this product and other U.K. tax (such as the regular U.K. corporate tax) on that income.

If less than the full amount of the PRT is creditable under this provision, the protocol allows a 2-percent limited carryback or carryover of the excess. This is similar to provisions of U.S. law.

In addition to the limits on creditability of the PRT imposed with respect to the taxpayer's U.K. oil and gas extraction income, the protocol imposes comparable limitations on the creditablity of the PRT on income from the initial transportation, initial treatment and initial storage of minerals from oil and gas wells in the U.K. This concept is similar to the limitations of U.S. domestic law relating to the foreign tax credit on foreign oil related income. It applies to a narrower group of activities, however, because the PRT is not imposed on either oil-related activities. Moreover, gains from the sale or exchange of assets used in connection with these activities is not included because the PRT is not imposed on those gains.

Article V of the proposed protocol will not reduce the foreign tax credit which may be claimed for the PRT under U.S. statutory law if it is ultimately held that the PRT is a creditable income tax under that law. Article V of the protocol only imposes a limitation on the amount of the PRT which qualifies as a creditable foreign tax, as opposed to a royalty or noncreditable tax, if the taxpayer must resort to the provisions of the proposed treaty to obtain the credit. However, the taxpayer does not avoid the limitations of the U.S. statutory law by claiming the PRT under the treaty. Under paragraph (1) of Article 23 of the proposed treaty, the other limitations on creditability imposed by U.S. domestic law (in particular, those in Code secs. 904 and 907), as they are now in force or as they may be changed without changing the general principle of the foreign tax credit, will continue to apply in determining the amount of the foreign tax credit the taxpayer will ultimately receive as a result of payment of the PRT and other foreign taxes.

Questions

1. How did the court in Exxon conclude that the high UK petroleum revenue tax (PRT) on North Sea oil was not a direct or indirect payment for the right to extract the oil? If the high tax was not a payment for oil, why did the tax only apply to oil profits? Why was the tax applied oil field by oil field, with no losses allowable from one field (typically unsuccessful exploration costs) being available to offset gains from

successful oil fields? Why were deductions so constrained, and replaced, in part, with a deduction for a percentage of capital invested? That is, if the PRT was not intended as a royalty for the severance of oil, why was the PRT structured so as to operate more like a royalty than a normal income tax?

2. When the dual-capacity regulations were adopted in 1983, everyone inside and outside the government knew that the main issue was the tax treatment of oil royalties. The Treasury Department certainly knew about the PRT and certainly knew the position of the Internal Revenue Service with respect to that tax. Why then, do none of the examples in the dualcapacity regulations deal with oil cases? And why do the regulations allow any ambiguity about the status of the PRT as a disguised royalty?

3. Exxon and some other oil companies operating in the North Sea had initially entered into royalty contracts that turned out to be highly favorable after the OPEC oil shocks of the early 1970s, which raised the world price of oil substantially. The court found that the purpose of the PRT was to capture for the UK government the excess profits earned by Exxon from exploitation of the North Sea oil fields owned by the UK government. The court concluded from this finding that the levy was a tax and not a director indirect payment for the oil. Why? If the point of the tax is to capture the economic rent from exploitation of the oil field, isn't the tax, in substance, a payment for the oil? Would the court have treated an increase in the royalty rate as an income tax if the purpose of the increase in the royalty rate was to capture the excess profits? Why does the court believe that Exxon has satisfied its burden of proof to show that the tax is not a payment of the oil simply by showing that it is structured as a tax? Isn't the whole point of the dual-capacity regulations to distinguish taxes that are payments for benefits from taxes that are not payments for benefits?

4. Exxon could have avoided litigation over the character of the PRT as a payment for oil by electing the safe harbor provided in the regulations. Why do you suppose it declined to take advantage of the safe harbor?

5. When the safe-harbor rule was introduced in 1983 (during the Reagan administration), it reflected a major change from the temporary regulations adopted in 1980 (at the end of the Carter administration). That rule was widely criticized in tax reform circles for giving an undue benefit to oil companies. The prior regulations did not include Treas. Reg. § 1.901-2A. Instead, they provided an all or nothing rule—a taxpayer received no credit for any part of a tax if the taxpayer paying the tax had received a substantial economic benefit from the government even if some portion of the tax was a substitution for a real income tax. The dual-capacity rule allowed taxpayers to get the credit up to the amount that would have been due under the normal income tax. Here is the relevant language of Temp. Reg. § 4.901-2(b) (1980):

> (b) *Compensation for a specific economic benefit*—(1) *General rule*. A foreign charge imposed only on persons that do not receive any specific economic benefit from the foreign country is not compensation for a specific economic benefit. A foreign charge imposed on persons that receive a specific economic benefit from the foreign country is presumed to be compensation for a specific economic benefit. This presumption is rebutted only as provided in paragraph (b) (2) and (4) [relating to pension benefits under a social security tax] of this section.
>
> (2) *Same or similar charges*. A foreign charge imposed on persons that receive a specific economic benefit is not compensation for a specific economic benefit if—
>
> > (i) The same charge is also imposed on income of persons that do not receive any specific economic benefit from the foreign country;
> >
> > (ii) The amount of the charge paid by persons that receive the specific economic benefit is not significantly increased over what this amount would be if such persons were,

instead, subject to an income tax imposed by the foreign country only on income of persons that do not receive the specific economic benefit; or

(iii) It is demonstrated that no significant part of the charge is compensation for the specific economic benefit received.

Could Exxon have won its case under the above standard? Obviously Exxon can not satisfy tests (i) and (ii). How does the current rule, applicable to taxpayers not electing the safe harbor, differ from test (iii)?

6. Assume that the UK entered into a leasing arrangement with a company after the OPEC shocks that had the same terms as the Exxon lease. Would that fact show that the PRT was a charge for oil? Would it be likely that the UK would try to extract the fair market value for its oil by way of an arm's length royalty and also impose the PRT?

7. The Internal Revenue Service was prepared to allow a credit for a portion of the PRT under the U.S./U.K. tax treaty. The treaty provision had been controversial on a number of points, including the credit issue, as noted in the excerpt from the Joint Committee's explanation of the Third Protocol to the U.S./U.K. treaty. As that document indicates, it was the position of the Service as early as 1978 that the PRT was not a creditable income tax. Do you agree with the Service's position that the PRT is "more in the nature of a production or severance tax"?

§ 18.03.2. Determining Whether a Tax Is an Income Tax

A foreign tax will constitute an income tax for purposes of the foreign tax credit if it is likely to be imposed on net gain in its normal operation.[62] Whether a tax is likely to reach net gain is determined by comparing the foreign levy to the U.S. income tax. A tax that differs from the U.S. income tax in its predominant characteristics will not be classified as an income tax.[63]

The Treasury regulations establish three requirements that must be met in order for a foreign tax to be an income tax: (1) the realization requirement, (2) the gross receipts requirement, and (3) the net income requirement. Those requirements are discussed below. Also discussed below is that rule that disallows a credit for foreign taxes that discriminate against residents of countries granting a foreign tax credit. Such discriminatory taxes are commonly called soak-up taxes.

§ 18.03.2.1. Realization Requirement

A tax on realized income, as that phrase is understood in U.S. tax law, clearly would meet the realization requirement. Some modest departures from the U.S. concept of realized gain are also permitted. For example, an income tax that included in taxable income the imputed rent obtained from the use of a personal residence would meet the realization requirement as long as imputed rent was not a dominant feature of the tax system.[64]

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[62] Reg. § 1.901-2(b)(1) (2012). See *Biddle v. Comm'r,* 302 U.S. 573 (1938) (holding that the question of whether a tax is an income tax is to be determined according to U.S. tax concepts).

[63] See Reg. § 1.901-2(a)(1)(ii) (2012). See also *Bank of America National Trust & Savings Ass'n v. U.S.,* 459 F.2d 513, 519 (Ct. Cl. 1972), cert. denied, 409 U.S. 949 (1972) ("The important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives it").

[64] Cf. *F. W. Woolworth Co. v. U.S.,* 91 F 2d 973 (2d Cir. 1937), cert. denied, 302 U.S. 768 (1938) (holding that a U.K. tax was not a creditable income tax because it was imposed on imputed income from personal use of a residence). The reasoning that underlies that case is that credit for taxes on imputed income is not needed to avoid double taxation because the United States imposes no tax on such income.

Under the Treasury regulations, the realization requirement is construed liberally. A tax on unrealized gains will not lose its character as an income tax as long as the unrealized gains are measured by the difference between the value of the taxpayers' assets from the beginning to the end of the taxable period and adequate provision is made to prevent double taxation of unrealized gains when they are eventually realized.[65] A tax on a deemed distribution of marketable personal property, such as inventory items, also would pass the realization requirement,[66] as would a tax on deemed distributions from a branch to a head office.[67]

§ 18.03.2.2. Gross Receipts Requirement

To satisfy the gross receipts requirement, a tax generally must use gross receipts, defined according to U.S. tax concepts, as its starting point in defining taxable income.[68] That requirement may also be met by a tax imposed on the basis of some estimate of gross receipts, as long as the estimate is not likely to be on the high side.[69] For example, a tax assessed on 110 percent of the expenses of a management company performing services for its nonresident affiliates would satisfy the gross receipts test if the taxpayer could show that the estimate of gross receipts is likely to be no greater than the gross receipts that would be generated by arm's length transactions between the management company and its affiliates.[70] A tax on 105 percent of the fair market value of oil, however, would not meet the gross receipts test because 105 percent of market value is not a good estimate of the gross receipts to be received from the sale of oil. Thus the levy on oil would not qualify as an income tax.[71]

§ 18.03.2.3. Net Income Requirement

A foreign levy would satisfy the net income requirement if the taxpayer is permitted to make appropriate adjustments to gross receipts for expenses and other costs.[72] A qualifying tax on net income would permit a deduction for actual expenses and a reasonable allowance for capital recovery, or it would employ some indirect method of adjusting gross receipts that is at least as favorable to the taxpayer as traditional allowances for costs.[73]

Some delays in the timing of adjustments to gross receipts are permissible, although delays that are so substantial that they effectively destroy the value of an adjustment will cause the tax to fail the net income

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[65] Reg. § 1.901-2(b)(2)(i)(C) (2012). A tax on unrealized but accrued gains would conform to the Haig/Simons income concept, which many commentators take as their starting point in specifying the ideal tax base.

[66] Reg. §§ 1.901-2(b)(2)(i)(C)(1) (2012) and 1.901-2(b)(2)(iii) (2012). Prior law indicated that a foreign tax assessed on the transfer or deemed transfer of inventory items would not be classified as an income tax. See *Keasbey & Mattison v. Rothensies,* 133 F.2d 894 (3d Cir. 1943), cert. denied, 320 U.S. 739. See also Rev. Rul. 78-61, 1978-1 C.B. 22 1, declared obsolete by Rev. Rul. 84-172, 1984-2 C.B. 315.

[67] See Reg. § 1.901-2(b)(2)(iv)(Ex. 3) (2012).

[68] Reg. § 1.901-2(b)(3)(i)(A) (2012).

[69] Reg. § 1.901-2(b)(3)(i)(B) (2012). The regulations, somewhat inartistically, state that the tax must be "imposed on the basis of—(A) Gross receipts; or (B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value."

[70] Reg. § 1.901-2(b)(3)(ii)(Ex. 1) (2012).

[71] Reg. § 1.901-2(b)(3)(ii)(Ex. 3) (2012). The regulations suggest that such a tax might qualify as an in-lieu tax under IRC 903. To so qualify, it must satisfy the requirements of IRC §§ 901(e) and 907.

[72] Reg. § 1.901-2(b)(2)(i) (2012).

[73] Id. In *Texasgulf Inc. v. U.S.,* 17 Ct. Cl. 275 (1989), Ontario's mining tax was held not to qualify as a creditable income tax because of the limits it imposed on deductions from gross income.

requirement.[74] A tax that is structured so as to prevent losses in one activity carried on by the taxpayer from offsetting gains from another activity in the same trade or business generally would not satisfy the net income requirement.[75] For example, a tax that did not permit a company to net its gains and losses from oil and gas exploration in two separate contract areas of a country might not qualify as an income tax under the net income requirement.[76]

§ 18.03.2.4. Soak-up Taxes

With one exception, the entire amount of a tax payment must qualify as an income tax in order for any portion of the payment to be creditable.[77] The exception is for so-called soak-up taxes. A soak-up tax is a tax that generally qualifies as an income tax but that depends for its application, in whole or in part, on the availability of a foreign tax credit in the country of residence of the taxpayer. Soak-up taxes have been popular in some developing countries in order to prevent the benefits of tax incentives provided to foreign investors from inuring to the benefit of the fisc of the investor's home country.

To the extent that a levy operates as a soak-up tax, it will not be creditable. For example, assume that Country X generally imposes a withholding tax at a rate of 15 percent but imposes the tax at a 20-percent rate for residents of countries granting a foreign tax credit. Although a withholding tax generally would qualify as a creditable tax,[78] only three-quarters of the tax payments made under the tax would be creditable because one-quarter of the tax discriminates against residents of credit countries.[79]

The regulations do authorize loopholes in the soak-up tax rule. They classify a tax as an income tax even if the country imposing it systematically restricts its tax incentives to domestic subsidiaries owned by foreign investors residing in countries that do not grant a foreign tax credit.[80] In addition, a tax is not a soak-up tax even if the country imposing it grants a general tax holiday to subsidiaries owned by residents from noncredit countries and provides only a deferral of tax to subsidiaries owned by residents of credit countries, with the deferred tax becoming due when the parent company repatriates the profits of its subsidiary.[81]

The Treasury Department negotiated income tax treaties with Egypt and Israel that contained a provision authorizing a tax credit for soak-up taxes. The Senate ratified the treaties with an exception to the soak-up provision. Egypt was willing to accept the treaty without the soak-up provision, and the U.S./Egypt

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[74] Reg. § 1.901-2(b)(2)(i) (2012).

[75] Reg. § 1.901-2(b)(4)(ii) (2012). See Rev. Rul. 78-424, 1978-2 C. B. 197 (denying credit for U.K. oil tax).

[76] Reg. § 1.901-2(b)(4)(ii) (2012). The regulations state that failure to allow the netting of gains and losses is "one of the factors" leading to a disqualification of a tax under the net income requirement. No guidance is given as to how much weight is to be given to that factor.

[77] Some portion of a levy may not qualify as a tax under the dual-function levy provisions. That portion of the levy will not qualify for a credit. All of the dual-function levy that qualifies as a tax must qualify as an income tax, subject to the exception for soak-up taxes, for any of the levy to qualify for the credit.

[78] The regulations generally treat withholding taxes as in-lieu taxes.

[79] In Rev. Rul. 87-39, 1987-1 C.B. 180, the IRS ruled that a Uruguay withholding tax did not qualify for the credit because it discriminated against countries providing a foreign tax credit. The tax at issue was a 30 percent withholding tax on Uruguayan source dividends and profits paid or credited to non-Uruguayan shareholders. It was imposed only on recipients eligible for a foreign tax credit in their home country.

[80] Reg. § 1.901-2(c)(2)(Ex. 3) (2012).

[81] Reg. § 1.901-2(c)(2)(Ex. 4) (2012).

treaty went into force in 1981.[82] The U.S./ Israel treaty negotiated at the same time did not go into effect because the Israeli government would not accept it with the Senate modification. Israel and the United States renegotiated the treaty in later years, and it went into force at the end of 1994.

Bank of America v. U.S.

459 F.2d 513 (Ct. Cl. 1972)

Opinion of the Court (Davis, Judge)

For a domestic corporation, § 901 (a) and (b)(1) of the Internal Revenue Code of 1954 allows a credit against federal income taxes of "the amount of any income, war profits and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States * * *." Bank of America National Trust and Savings Association, organized under the laws of the United States with its principal office at San Francisco, seeks judgment in these consolidated cases for refund of income tax for its taxable years 1959, 1960, and 1961. It challenges the determination of the Internal Revenue Service that certain foreign taxes paid for these periods were not "income taxes" within § 901(b)(1), and hence not to be treated as foreign tax credits against plaintiff's income tax liability pursuant to § 901(a). . . . The foreign taxes involved were paid, for all three years, to the Kingdom of Thailand and the Republic of the Philippines, and also to the Philippines for 1958. For 1961, taxes were also paid to the Republic of Argentina.

In each of these countries, plaintiff conducted a general banking business from a branch office. These were located at Bangkok, Thailand; Manila in the Philippines; and Buenos Aires, Argentina. In each nation, this business included, but was not limited to, the making of commercial, real estate and personal installment loans, the rendering of trust department and property management services, foreign exchange transactions, the issuance of letters of credit, guarantees, travelers checks and cashiers' checks, and acceptance of trade paper.

With respect to this banking business, Bank of America paid the three jurisdictions various types of taxes. The findings detail the names of those imposts and the amounts paid. It is enough to say here that in each country plaintiff paid the general income tax imposed on corporations operating there. In addition, taxpayer paid other tolls.

Demand for credit under § 901 of most of these assessments was made either on the federal income tax returns or by refund claim. After consideration, the Revenue Service allowed (except for a small inadvertent error which the parties have corrected by stipulation) the following of the foreign taxes as credits against plaintiff's federal income tax liabilities for the taxable year: Thailand Companies Income Tax and Profit Remittance Tax, Philippines Tax on Foreign Corporations, and Argentina Corporation Income Tax and Excess Profits Tax. This treatment is not disputed. In addition, the parties have agreed that the Philippines Residence Tax was not creditable but was properly allowed as a deduction under § 164.

When the case was submitted to the trial commissioner, the following taxes remained in dispute:

Kingdom of Thailand: Business Tax, *Type 1* and *Type 2*, Municipal Tax, and Receipts Tax.

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[82] Egypt repealed its soak-up tax because of administrative problems in enforcing it; thus the Senate exception had only symbolic importance to Egypt. The Egyptian tax that created the treaty problem might not qualify as a soak-up tax under current law because of the loopholes in the definition of a soak-up tax introduced by the 1983 regulations. The author was an advisor to the Egyptian Ministry of Finance at the time the treaty was ratified by the Egyptian government.

Republic of the Philippines: Tax on Banks.

Republic of Argentina: Tax in Substitution of Surcharge on Free Transfer of Property, City of Buenos Aires Tax on Profit-Making Activities, and Contribution to the Bankers' Institute for Social Services.

The trial commissioner denied taxpayer the right to recover with respect to the Thailand Municipal Tax, the Thailand Receipts Tax, the Argentina Tax in Substitution of Surcharge on Free Transfer of Property, and the Argentina Contribution to the Bankers' Institute for Social Services. Plaintiff has not sought review of those rulings and thereby acquiesces in them. We agree with the trial commissioner's discussion on that aspect of the case, and in Part I of this opinion, *infra*, adopt it (with slight modifications) as our own.

The trial commissioner held, however, for plaintiff on the other taxes: the Thailand Business Tax, Type 1 and Type 2; the Philippine Tax on Banks; and the City of Buenos Aires Tax on Profit-Making Activities. We disagree with that position and in Parts II, III, and IV, *infra*, give our reasons for holding against plaintiff on those levies.

I.

With respect to the four foreign taxes (two imposed by Thailand and two by Argentina) which Trial Commissioner Hogenson believed not to be creditable under § 901, we concur that the Bank of America has failed to meet its burden of proof or persuasion that any of those assessments is an "income tax" accrued and payable to a foreign country. It is now settled that the question of whether a foreign tax is an "income tax" within § 901(b)(1) must be decided under criteria established by our revenue laws and court decisions, and that the foreign tax must be the substantial equivalent of an income tax as the term is understood in the United States. *Missouri Pacific R.R. v. United States*, 183 Ct. Cl. 168, 175, 392 F. 2d 592, 597 (1968); *Allstate Ins. Co. v. United States*, 190 Ct. Cl. 19, 27, 419 F. 2d 409, 413-14 (1969).

On the Thailand Municipal Tax and the Thailand Receipts Tax, plaintiff cites no provisions of the translated portions of The Revenue Code of Thailand attached to the stipulation of facts, nor are any provisions found there, which seem to pertain to those laws. There is no other testimony or evidence concerning the nature of the taxes. Taxpayer's position is that those taxes present no independent legal issues since allegedly each is calculated as a flat percentage of plaintiff's annual liability for the Thailand Business Tax, citing Rev. Rul. 70-21, 1970-1 Cum. Bull. 158, for the proposition that, in that situation, the creditability of the dependent foreign tax depends upon the creditability of the principal tax. In response to defendant's correct assertion that no evidence was adduced as to the nature of those taxes, nor as to the nature of plaintiff's liability for such taxes, plaintiff's reply was that the determination of foreign law is a question of law as to which the court and the trial commissioner may consider relevant materials from any source. Efforts by the trial commissioner to obtain a reliable and authoritative translation of such laws proved unsuccessful. Rule 125 cannot reasonably be interpreted to shift the burden onto the court or the trial

It is now settled that the question of whether a foreign tax is an "income tax" within § 901(b)(1) must be decided under criteria established by our revenue laws and court decisions, and that the foreign tax must be the substantial equivalent of an income tax as the term is understood in the United States.

commissioner to search for documentation necessary for determination of a question of foreign law, particularly in the circumstances where the litigant before the court conducts a business in the foreign country, subject to its laws. * * *

II.

There is greater difficulty in disposing of the three taxes the trial commissioner held creditable: the Thailand Business Tax, *Type 1* and *Type 2*; the Philippines Tax on Banks; the Buenos Aires Tax on Profit-Making Activities.

A.

From the unchallenged findings and the presentations of the parties, we are justified in assuming that these were all in substance levies on the taxpayer's gross income from its banking business carried on by its branch in the particular country. Plaintiff has not proved otherwise or offered to prove otherwise. Defendant now accepts that description of the tax.

Section 78 of the Thailand Business Tax defines persons engaged in business as those listed in the Business Tax Rate Schedule of The Revenue Code of Thailand, and states that such persons have the duty to pay business tax on the "gross takings" for each tax month at the rates provided in the schedule. Section 79 defines "gross takings" from the business of banking as (a) interest, discounts, fees or service charges, and (b) profit, before the deduction of any expense, from the exchange, purchase or sale of currency, issuance, purchase or sale of notes or foreign remittances.

As to the category of business designated as "banking," the Business Tax Rate Schedule describes such business as savings banks other than that of the government, commercial banking under the law on commercial banking or the business of those who regularly do business similar to that of a commercial bank such as lending money, giving guarantees, currency exchange, issuance, purchase or sales of notes, foreign remittance by various means.

The Business Tax Rate Schedule imposes taxes of two designated types described as follows:

Type 1 — Interest, discounts, fees or service charges.

Type 2 — Profit before the deduction of any expenditure from the exchange, purchase or sale of currency, issuance, purchase or sale of notes or foreign remittances.

For *Type 1* of the Business Tax on banking, the designated rate of tax is 2.5 percent of gross takings, and for *Type 2*, 10.5 percent of gross takings. Obviously, the tax is imposed upon a broad spectrum of the business activities of a bank.

The City of Buenos Aires Tax on Profit-Making Activities, in Article 115, imposes a tax on the gross receipts of banks, insurance, savings and loan and security and investment companies, and in Article 121 provides that, in the case of banks and other lending institutions, "the taxable amount shall be composed of interest, discounts, profits from nonexempt taxable securities and other revenue, resulting from profits and remuneration for services received in the course of the last business year."

The Philippines Tax on Banks provides in § 249 that there shall be collected a tax of 5 percent on the gross receipts derived by all banks doing business in the Philippines from interest, discounts, dividends, commissions, profits from exchange, royalties, rentals of property, real and personal, and all other items treated as gross income under § 29 of the National Revenue Code. Section 29 defines "gross income" as gains, profits, and income derived from any source whatever.

For none of the three taxes was the taxpayer permitted to deduct from gross income the costs or expenses of its banking business or of producing its net income.

B.

The problem, then, is whether such imposts on gross banking income, of this character, are "income taxes" under the foreign tax credit (§ 901(b)(1))—"income taxes" as we use that term in the federal system under our own revenue laws. (The bank does not contend that it is entitled to credit for these taxes, under § 903, as taxes "paid in lieu of a tax, on income, war profits, or excess profits otherwise generally imposed by any foreign country.")

There is consensus on certain basic principles, in addition to the rule that the United States notion of income taxes furnishes the controlling guide. All are agreed that an income tax is a direct tax on gain or profits, and that gain is a necessary ingredient of income. . . . Income, including gross income, must be distinguished from gross receipts which can cover returns of capital. *Doyle v.. Mitchell*, 247 U.S. 179, 185 (1918); *Allstate Ins. Co. v. United States*, 190 Ct. Cl. 19, 27, 419 F. 2d 409, 414 (1969); 1 Mertens, *Law of Federal Income Taxation* § 5.10 at 36-36 (1969). Only an "income tax," not a tax which is truly on gross receipts, is creditable.

We can also put aside as irrelevant to this case the frequent controversy whether the foreign tax is a direct income tax or a privilege, excise, or similar tax which happens to be measured by income. The Thailand, Philippine, and Argentine bank taxes, whether or not they were "income taxes" for foreign tax credit purposes, were admittedly direct levies and not franchise, privilege, or excise taxes. But they were not imposed upon and limited to net gain.

The trial commissioner and the taxpayer say that this kind of direct gross income tax is nevertheless allowable under § 901(b)(1) because, in their view, gross income taxation (apparently any type of gross income tax) falls under the United States concept of an income tax. They emphasize that the Supreme Court has suggested that the Sixteenth Amendment extends the federal taxing power to gross income (*New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); *Deputy v. du Pont*, 308 U.S. 488, 493 (1940)); that several federal taxing provisions are levied on gross income; that prior court decisions under the foreign tax credit have permitted use of certain foreign gross income assessments; and that Internal Revenue Service rulings have upheld the crediting of some foreign taxes levied on gross income. The generalization the plaintiff and the trial commissioner draw is that all gross income taxes (as distinguished from gross receipts levies) come within § 901(b).

For the reasons elaborated in this and the succeeding sections of this opinion, we cannot accept the position that all foreign gross income taxes, no matter whether or not they tax or seek to tax profit or net gain, are covered by that provision. True, the Supreme Court has indicated, somewhat cursorily, that Congress may impose gross income taxes, but the full ramifications of that observation are as yet unknown since Congress has not yet sought in its income tax legislation to disregard net gain entirely. On the contrary, from 1913 on, Congress has always directed the domestic levy at some net gain or profit, and for almost 60 years the concept that the income tax seeks out net gain has been inherent in our system of taxation. That is the "well understood meaning to be derived from an examination of the [United States] statutes which provide for the levying and collection of income taxes"—the basic test set forth in *Biddle v. Commissioner*, 302 U.S. 573, 579 (1938), for determining whether a foreign tax is an "income tax" under the foreign tax credit.

Similarly, it comports better with the dominant purpose of the credit to avoid or minimize double taxation of income . . . to refer to the actual system historically utilized by Congress in imposing domestic income taxes rather than to some potential and unused, though constitutionally permissible, scheme of gross income taxation. Where the gross income levy may not, and is not intended to, reach profit (net gain), allowance of the credit would serve only haphazardly to avoid double taxation of net income, since only the United States tax—under the concept followed since 1913—would necessarily fall upon such net gain. There would not then be any significant measure of commensurability between the two imposts (except by chance). See, also, Owens, *The Foreign Tax Credit* (1961) 85, 86.

We do not, however, consider it all-decisive whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing the profit. The important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives. In certain situations a levy can in reality be directed at net gain even though it is imposed squarely on gross income. That would be the case if it were clear that the costs, expenses, or losses incurred in making the gain would, in all probability, always (or almost so) be the lesser part of the gross income. In that situation there would always (or almost so) be some net gain remaining, and the assessment would fall ultimately upon that profit.

For instance, it is almost universally true that a wage or salary employee does not spend more on expenses incident to his job than he earns in pay. A foreign tax upon the gross income of an employee from his work should therefore be creditable by the employee under § 901(b)(1) despite the refusal of the other jurisdiction to permit deduction of job-related expenses. The reason is, of course, that in those circumstances the employee would always (or almost always) have some net gain and, accordingly, the tax, though on gross income, would be designed to pinch net gain in the end—and would in fact have that effect. In those circumstances, a loss (excess of expenses over profit) is so improbable, and some net gain is so sure, that the tax can be placed on gross income without any real fear or expectation that there will be no net gain or profit to tax. * * *

IV.

Do the three foreign taxes we are now discussing (Thailand Business Tax, *Type 1* and *Type 2*; Philippines Tax on Banks; Buenos Aires Tax on Profit-Making Activities) meet this test? Their coverage is summarized at the outset of Part II, *supra*, and there is little difficulty in concluding that they do not.

Each of the taxes is levied on gross income from the banking business and allows no deductions for the costs or expenses of producing the income. Any taxpayer could be liable whether or not it operated at a profit during the year. The only question is whether it is very unlikely or highly improbable that taxpayers subject to the impost would make no profit or would suffer a loss. Plaintiff has presented no proof to this effect and does not very strongly urge that proposition. Obviously, it and the other institutions subject to the taxes had substantial costs in their banking business, salaries and rent being the major items. The covered banks must also have had bad debts and defaults, and these would have to be taken into account in calculating annual net gain.

The three taxes were each imposed on banks generally, not merely on the successful ones. Banks do suffer losses in certain years, especially newly established banks, and some have even been known to fail. There is no reason to believe that banks in Thailand, the Philippines, and Argentina are any different. Nor can one say on this record that the three governments felt that net gain would always (or nearly so) be reached by these special banking levies, or that they designed these particular taxes to nip such net profit.

Each of the three jurisdictions had a general net income tax (comparable to ours, and admittedly creditable) which the Bank of America and other banks had to pay. That was the impost intended to reach net gain.

We cannot say, therefore, that there was only a minimal risk that the combination of a bank's expenses plus its bad debt experience (and other losses) would out balance its net gain or profits in any particular year—or that the foreign countries so considered. On the contrary, as with the insurance company in *Allstate*: "Plaintiff may have had a gain or it may have had a loss in operating its insurance [banking] business during the year in question, but this would not affect the premiums [banking] tax it had to pay." 190 Ct. Cl. at 28, 419 F. 2d at 414.

The result is that the plaintiff is not entitled to recover . . . and its petition must be dismissed . . . .

Note on *American Chicle* Fraction

Code section 78 requires U.S. corporations receiving a dividend from a foreign affiliate to "gross up" the amount of the dividend by the amount of the foreign income taxes associated with that dividend. The purpose of the gross-up rule is to tax American companies earning income abroad through foreign affiliates on the same amount of income that they would be taxable on if they had operated directly through a branch. For example, if P, a U.S. parent corporation, earned $100 through F, its foreign affiliate, and that $100 was taxable by a foreign country at a rate of 30 percent, then P, on receipt of a dividend of $70 from F, would include in its income the gross-up amount of $30. Thus P's net income from the foreign operation would be the same $100 earned by F.

The gross-up rule was adopted in 1962. Under the prior law, a U.S. corporation receiving a dividend from a foreign affiliate was taxable only on the amount of the dividend received. It was not allowed a foreign tax credit, however, for the foreign taxes of the affiliate that were attributable to the portion of the income used to pay the taxes. Assume, for example, that F, a foreign affiliate of P, had profits of $100, paid a foreign income tax on those profits of $30, and distributed the remaining profits of $70 to P as a dividend. P would be taxable on the dividend of $70 and would be able to claim a credit for foreign taxes of $21 ($70/$100 x $30). This rule was adopted by the tax authorities in the early 1930s and was validated by the Supreme Count in American Chicle Co. v. U.S., 316 U.S. 450 (1942). The *American Chicle* case was a victory for the government. The taxpayer was claiming the right to take a credit for the entire amount of the foreign taxes without grossing up the dividend.

American Chicle is a famous case involving two famous future Solicitor Generals of the United States. Counsel for the taxpayer in the American Chicle case was Erwin N. Griswold, then the dean of Harvard Law School. On the brief for the government was Archibald Cox. Cox became Solicitor General and a professor at Harvard. He achieved wide national recognition as the special prosecutor in the Watergate scandal—he was fired by then Solicitor General Robert H. Bork on orders of President Richard M. Nixon. Mr. Griswold, who served as Solicitor General in the Nixon administration, was himself embarrassed by a penumbra of the Watergate scandal, due to his alleged mishandling of matters relating to the merger of the Hartford Insurance Co. and ITT.

Questions

1. Why did the taxpayer in *Bank of America* encounter such difficulties in providing evidence to the court on the nature of the taxes paid to Thailand? Do you think it had good evidence that the taxes were actually paid? Who should bear the burden of proving the nature of a foreign tax? Of proving that a foreign tax was paid? See Code section 905(b). For a nice illustration of the proof problem, see *Continental Illinois Corp. v. Com'r*, T.C. Memo 1991-66, 61 T.C.M. 1916 (1991), rev'd F.2d 513 (7th Cir. 1993).

2. Are the current regulations under Code section 901, adopted in 1983, consistent with *Bank of America*? Is it fair to say that the 1983 regulations move away from the "pure" income tax test of *Bank of America*, and focus primarily on distinguishing "taxes" from "payments for an economic benefit"? A weakening of the income tax test puts increased pressure on the credit limitation rules. Can the limitation rules bear increased pressure?

3. The court in *Bank of America* describes the withholding taxes under Code sections 871 and 881 as "minor." Do you agree with that characterization? How do the regulations under Code section 901 treat foreign taxes that are comparable to those assessed under Code section 871 and 881? Why the change from the old rule, as expressed in *Bank of America*?

4. Is the court in *Bank of America* correct in its claim that the taxes imposed under Code sections 871 and 881 are almost certain to reach net income? What about the capital gains of nonresident aliens present in the United States for 183 days or more? Note that under the 1984 change in the residency rules, almost all aliens present in the United States for 183 days or more would be U.S. residents. That was not the situation when *Bank of America* was decided.

5. Is the result reached in *Bank of America* fair to the taxpayer and to its competitors? To the United States, Thailand, and the other governments involved? Does the decision result in double taxation?

6. Are the criteria outlined in *Bank of America* for identifying a creditable tax workable? What problems, if any, do you see in applying those rules?

7. Some tax advisors have proposed that the government of Colombia replace its income tax with a graduated consumption tax. This same advice is being given to some of the emerging countries of Eastern Europe. In general, the base of the consumption tax would be income minus savings. Assume that Colombia or Bulgaria adopted such a tax. Would it qualify as an "income tax" for purposes of the U.S. foreign tax credit? As an in-lieu tax? Assuming that the credit is not allowable, is that result appropriate? That is, does it make good sense for the U.S. government, through its unilateral credit rules, to encourage foreign governments to adopt income-based taxes rather than consumption-based taxes? Does the presence of foreign income taxes assist the United States in enforcing its own income tax?

8. A variety of proposals have been floating around for revising the U.S. corporate and individual income tax systems. Under one of these proposals (the so-called Hall-Rabushka plan), the corporate and individual income taxes would be replaced by a wage tax on individuals and an additive-type value-added tax on business that permitted a deduction for wages . Do you expect that the trading partners of the United States would grant their corporations operating in the United States a credit for such a tax? Would they be required to give the credit by treaty? Would such a tax qualify as a creditable income tax if imposed by Canada? Would it constitute an in-lieu tax?

9. Would the European VATs or the Canadian GST qualify as income taxes for purposes of the credit? Is there any substantive difference, from the perspective of U.S. tax policy, in a VAT and a graduated consumption tax of the type proposed for Colombia?

§ 18.04. Qualification as an In-Lieu Tax

Certain foreign taxes that do not qualify for a tax credit as income taxes may be creditable as taxes imposed as a substitute for, or in lieu of, foreign income taxes of general applicability.[83] The Code has allowed a credit for in-lieu taxes since 1942. For purposes of the limitation on the credit and for all other practical purposes, an in-lieu tax is treated as a tax that meets the definition of an income tax under Code section 901.

For a foreign levy to qualify as an in-lieu tax, three conditions must be met:

(1) The levy must be a tax, under the rules discussed above, and not a payment for a specific economic benefit;[84]

(2) The foreign country must have in force an income tax law that is otherwise generally imposed;[85]

(3) The levy must be a substitute, in whole or in part, for the generally applicable income tax.[86]

An in-lieu tax that otherwise would qualify for a foreign tax credit as a substitute for an income tax will not be creditable to the extent that it operates as a soak-up tax, as defined above. An in-lieu tax will be considered a soak-up tax to the extent of the lesser of (1) the amount of tax that would not have been imposed if the taxpayer's country of residence did not offer a foreign tax credit, or (2) the amount, if any, by which the foreign tax paid exceeds the amount the taxpayer would have paid under the generally applicable income tax.[87]

A gross income tax imposed on nonresidents as a substitute for a general income tax applicable to residents would qualify as an in lieu tax.[88] For example, a foreign withholding tax on periodical income, similar to the tax imposed by Code sections 871(a) and 881, would qualify as an in-lieu tax.[89] An excise tax imposed on a taxpayer in addition to an income tax would not qualify as an in-lieu tax.[90]

Prior to the 1983 regulations, few foreign taxes qualified as in-lieu taxes. The Internal Revenue Service, with some support in the case law, required that an in-lieu tax be intended by the foreign government as a substitute for a generally applicable income tax and that the amount due under the in-lieu tax approximate the amount that would have been due under the generally applicable income tax.[91] The 1983 regulations remove these requirements. They state that it is immaterial, in testing a levy as an in-lieu tax, what the intent

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[83] IRC § 903.

[84] Reg. § 1.903-1(a) (1983).

[85] Reg. § 1.903-1(b)(1) (1983).

[86] Id.

[87] Reg. § 1.903-1(b)(2) (1983).

[88] Reg. § 1.903-1(b)(3)(Ex. 1) (1983).

[89] Prior to the adoption of the 1983 regulations, withholding taxes on periodical income generally were classified as income taxes, not in-lieu taxes.

[90] Reg. § 1.903-1(b)(3)(Ex. 5) (1983).

[91] See Elisabeth A. Owens, *The Foreign Tax Credit* (1961) at 28-29. The Carter administration issued temporary regulations in 1980 that sought to codify the historical tests. See Reg. § 4.903-1 (T.D. 7739, 11-12-80).

of a country was in imposing it[92] or whether it is a reasonable approximation of the amount that would be due if the income tax were applicable to the taxpayer.[93]

The passing of the intent test and the reasonable-approximation test probably resulted in some expansion of the number of taxes that qualify as in-lieu taxes. The intent test presented some problems of administration because of the difficulties encountered in attempting to divine the intent of a sovereign government. The reasonable-approximation test was problematic because countries forced to employ an in-lieu tax instead of an income tax are unlikely to have the information necessary to determine whether the revenues from the in-lieu tax are approximately equal to the revenues that they would have obtained from an income tax.

The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal

7 *American Journal of Tax Policy* 207-247 (1988) at 241-247

by Karen Nelson Moore

Recommendation to Repeal Section 903

Section 903 should be repealed. Enacted initially when unfairness was perceived if a foreign tax credit was denied where a foreign country's tax system was not modeled after the United States net income tax, the "in lieu of" provision has become a potentially significant and unwarranted loophole that can eviscerate the modern efforts at refining the definition of what taxes qualify as creditable income taxes. Repeal of section 903 is a relatively narrow step; a broader proposal, which finds some support in this research but needs further consideration, would be to eliminate the credit for any foreign taxes and replace it with a deduction for all foreign taxes.

The rationales for the foreign tax credit . . . can be summarized as the incidence or shifting of tax burden theory, and the relief of double taxation theory. Neither theory can justify allowing a foreign tax credit for taxes paid in lieu of income taxes.

The incidence or shiftability theory patently fails as a basis for the section 903 credit, since there is no support for the proposition that taxes qualifying under section 903 tend not to be shifted or shiftable. Indeed, the recent economics literature . . . concludes that the corporation income tax may well be at least partially shifted. This raises doubt as to the continued vitality of this theory as an explanation for the creditability of foreign income taxes. A *fortiori*, it undermines the vitality of this theory as a grounds for the creditability of foreign taxes paid in lieu of income taxes because in lieu of taxes are likely to be at least as shiftable as income taxes, and may be fully shiftable to others than the taxpayer.

The double taxation theory is also suspect as an explanation for the section 903 credit. At base, this theory is a somewhat vague equitable theory that accommodation should be made when two countries are taxing the same income. If Congress had stopped with section 901, and limited the foreign tax credit simply to foreign income taxes, the double taxation theory could be viewed as coherent: double income taxation occurs only when income is taxed twice; property taxes or excise taxes do not constitute income taxes and hence the continued presence of such foreign taxes does not require a credit but can be accommodated by

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[92] Reg. § 1.903-1(a) (1983).

[93] Reg. § 1.903-1(b)(1) (1983). IRC §§ 901(e) and 907 would override the in-lieu regulations for certain taxes on oil related income.

a deduction similar to the deduction for United States state and local property taxes or for the deduction for various costs of business.

Section 903 allows a chink in the armor formerly limiting the credit simply to foreign income taxes. By permitting a credit for any foreign taxes paid in lieu of foreign income taxes, section 903 in effect says that all sorts of non-income taxes will nonetheless qualify for the tax credit, as long as they substitute for otherwise generally applicable income taxes. Apart from the substitution requirement there are no limitations on creditability that are relevant for the purposes of this discussion.

Of course it can be argued that the substitution requirement of section 903 means that the other foreign tax imposed must take the place of an income tax and therefore the same United States tax treatment is appropriate. However, given the absence of a comparability requirement, so that there is no mandate that the foreign tax imposed must approximate in size the income tax that would otherwise be imposed, there is no assurance that horizontal equity principles are indeed being satisfied. Nor is there assurance that there is only double taxation of income involved.

Compare, for example, five different situations. In the first situation, foreign country Z imposes a United States-type income tax on all corporate income and generates a certain dollar-equivalent of taxes. In the second situation, foreign country Z, in order to raise the same dollar total as in situation one, imposes both an income tax and a property tax on all property. In the third situation, foreign country Z, which has in effect a generally imposed income tax, decides to exempt companies in a certain industry from such income tax if they pay a patrimony (property) tax that amounts in dollar terms to the total of income and property taxes involved in situation two. In the fourth situation, country Z decides that it wants to raise more revenue and so imposes a patrimony tax in lieu of an income tax that will raise substantially more revenue than would be raised if the generally applicable income tax had been applied to the particular industry involved in situation three. In situation five, foreign country Z has never had an income tax but raises the same dollar amount of taxes as in situation one, two, and three through a patrimony tax.

Under the law as it exists today, the full amount of the income taxes in situation one would be creditable under section 901, and the full amount of the patrimony taxes in situations three and four would be creditable under section 903. However, in situation two only the income tax would be creditable, and only a deduction would be available for the property tax. No tax would be creditable in situation five.

This current framework is not sensible. It results in no credit for a property tax that is imposed in addition to an income tax (or where there is no income tax), but a full credit where the property tax is imposed in place of an income tax. It results in a disparate treatment of taxpayers with the same income and same total tax bill, simply because of the foreign country's choice of tax structure. It can result, as in situation four, in a larger total foreign tax credit simply because the foreign country has had the foresight to substitute for a relatively small income tax a relatively larger patrimony tax. Or it can result in no foreign tax credit at all, as in situation five, because of a country's choice of tax structure. In light of horizontal equity concerns it is inappropriate even in light of the relief of double taxation theory to perpetuate the availability of a credit for foreign taxes paid in lieu of income taxes. The double taxation theory simply supports continued relief, as through the foreign tax credit, for double taxation of income, not for taxes other than income taxes.

When the foreign tax credit for foreign taxes paid in lieu of income taxes originated, a concern expressed to Congress was the relative lack of sophistication of other countries' tax systems leading to their use of tax structures different from the United States concept of net income tax. Not only has that situation changed, with many foreign countries now having developed quite sophisticated tax structures, but also the approach of section 903 as it has evolved is inappropriately broad. Assuming the continued validity of the

foreign tax credit for foreign income taxes, the proper way to account for unsophisticated taxes based on gross income would be to expand the definition of creditable foreign income taxes to include income taxes computed on a gross income basis. Such taxes could be creditable whether in substitution for or in addition to some other income tax computed in a fashion more similar to our own.[94] This suggestion would not allow a credit for a tax such as a property tax that is not based on a general concept of income.

Restricting the foreign tax credit to foreign income taxes as defined in section 901 and section 901 Regulations would possibly lead other countries to adjust their tax structures to be more focused on an income tax similar to that of the United States than they might otherwise prefer. Although this might be viewed as somewhat coercive of other countries, that risk should be evaluated in comparison to the risks and practical effects that can occur under the current system. There is an incentive, if the section 903 provision remains as currently construed in the Regulations and rulings, for foreign countries to impose a general income tax, perhaps at a relatively low rate of tax, and substitute for that income tax a higher alternative tax based on whatever revenue generating concept the country wishes to utilize. This is similarly coercive, in that it encourages a foreign country to adopt a generally imposed income tax similar to that of the United States. But it also has the disadvantage of permitting the foreign country to divert taxes from the United States Treasury to its own treasury at will, the effect of the section 903 rule allowing a credit for United States taxpayers for otherwise uncreditable taxes, simply by forgiving the payment of income tax and raising the tax rate of the otherwise uncreditable tax. That conduct of the foreign country and that resulting benefit to the United States taxpayer should not be endorsed, when other taxpayers paying similar taxes in addition to their regular income tax are denied a credit.

A possible response to these equity and theoretical problems, and to the practical problems inherent in deciding that some but not all foreign taxes should qualify for the foreign tax credit is to recommend that the credit should be afforded for all foreign taxes paid by United States taxpayers. This suggestion has been made by Professor Isenbergh in his thoughtful and provocative article.[95]

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[94] The Final Regulations treat such taxes as creditable under section 903; under the proposal made in this article for repeal of section 903 such withholding taxes could either be automatically eligible for a credit under section 901 or could be creditable under section 901 only upon a showing that they approximate net income. See Isenbergh, [*The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 TAX L. REV. 227 (1984)] at 280-81. Since the United States income tax law imposes gross basis withholding taxes on certain kinds of U.S. source income of nonresident alien individuals and foreign corporations (IRC §§ 871(a), 881(a) (1986)), it would be more sensible in any event to consider gross basis taxes as creditable income taxes under section 901 of the Code rather than include them under section 903 as taxes in lieu of income taxes.

[95] After a detailed evaluation of the history of determining creditable taxes, Isenbergh summarized his conclusion:

> The present rules for creditable taxes require an elaborate and often scholastic dissection of foreign tax systems to determine whether they adhere closely enough to norms of taxation derived from our own. The undertaking is immensely difficult, uncertain, and easily undermined.

Isenbergh, *supra* note [94] at 285. His recommendation was to provide a credit for all foreign taxes, i.e., to delete the word "income" from section 901. Recognizing the possibility of a substantial revenue loss, he also proposed a per country limitation on the credit as opposed to the current overall limitation. (In the 1986 Tax Reform Act, Congress rejected the per country proposal of President Reagan and instead adopted a separate baskets of income approach to the overall limitation in an effort to restrain abuse of the foreign tax credit.) Isenbergh also proposed to follow whatever characterization a foreign country gave to a tax, thereby allowing foreign countries at will to characterize their royalty payments as creditable taxes. *Id.* at 289-90. Finally he believed that his proposal would mesh well with, but would not require, the elimination of deferral which he also recommended. *Id.* at 292-93.

This Article demonstrates the absence of theoretical justification for section 903, and also questions the theoretical soundness of the foreign tax credit for foreign income taxes under section 901. In light of these theoretical problems, plus the practical concerns outlined by Professor Isenbergh, the appropriate approach would be to consider the elimination of the tax credit even for income taxes, not its expansion to encompass all taxes and indeed all payments, even royalties, to foreign countries. However, as noted in text, in light of the ongoing debate about the macroeconomic effects of the foreign tax credit, this Article simply proposes the elimination of the section 903 credit for taxes paid in lieu of income taxes at this time; after repeal of section 903 and after further economic analysis of the implications of substituting a deduction for the section 901 credit, consideration of the repeal of section 901 would be appropriate.

However, such an approach would treat United States taxpayers with foreign source income much more favorably than United States taxpayers with simply domestic source income, who may take only a deduction for the various taxes they pay such as state and local income and property taxes. Moreover, this favorable treatment is especially unwarranted, in light of the continued benefits of the deferral of United States tax on foreign source income generated by foreign subsidiaries of United States corporate taxpayers.

The appropriate first step in reforming the treatment of the creditability of various foreign taxes is to eliminate section 903. Section 903 is not based on valid theoretical justifications. Moreover, it has the potential, as interpreted under current Regulations and rulings, for overwhelming the careful tailoring that has been developed in the section 901-2 Regulations pertaining to the qualification as an income tax under section 901. Repeal of section 903 will place some pressure on the Regulations defining income taxes, in that taxpayers will more urgently feel the need to qualify under section 901 when the safe harbor of section 903 is taken away.[96] Nonetheless, this slight increase in pressure is worthwhile for the benefits of theoretical soundness that will result. Moreover the new section 901-2 Regulations are carefully crafted and have been thoroughly considered; they should not be eviscerated by the broadbrush provision of the section 903 credit. If further careful tailoring is necessary to avoid double taxation of income by providing for a credit for a tax other than an income tax in a particular situation, the tax treaty mechanism also could be utilized to provide specific relief.[97]

The theoretical problems of developing a convincing rationale for the foreign tax credit for taxes paid in lieu of income taxes have also produced some question whether a valid justification for any foreign tax credit, even for foreign income taxes, remains. The development of economics studies suggesting that corporate income taxes are indeed shifted and shiftable leads to the question why should the foreign tax credit for foreign income taxes be retained. Repeal of section 901 would be an alternative way to resolve the practical problems identified by Professor Isenbergh in determining the creditability of a variety of foreign taxes. However, advocacy of repeal of section 901 cannot rest solely on rejection of the theory of tax shifting. Since section 901 has been a cornerstone of our tax jurisprudence for 70 years, its continuation in our tax structure should be evaluated on many grounds in addition to theoretical soundness . . . . The consequences to United States involvement in foreign business, macroeconomic concerns, and foreign policy concerns must all be evaluated before a considered recommendation can be made for repeal of section 901. These other concerns are not significant in the case of section 903, which historically has been a minor, but is now becoming an increasingly significant source of foreign tax credits taken by United States taxpayers.

Since no valid theoretical justification for the continuation of section 903 exists, and since the Regulations and rulings in the 1980s suggest that section 903 is fast becoming a mechanism for avoiding the considered judgment as to what foreign taxes constitute true income taxes that are creditable under section 901, it is clear that section 903 should be repealed. It is no longer justifiable in terms of sophistication of other countries; it is not well-tailored to avoid double taxation of income; and it does not meet the economists' test of not being a shiftable tax. It would be wise to repeal section 903 before its potential as a loophole in the foreign tax credit requirements becomes even more fully and frequently utilized. ◊

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[96] Thus, for example, if section 903 is repealed, the framework for treating foreign gross basis withholding taxes will need to be reconsidered. See supra note [94].

[97] *See generally* Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 *Tax L. Rev.* 1 (1982).

§ 18.05. Establishing the Amount of Creditable Tax Paid

A taxpayer can claim a credit for a foreign income tax only if its has paid or accrued the tax or is deemed to have done so. Section 18.05.1 discusses issues that arise in determining whether the taxpayer has paid the foreign tax. Section 18.05.2 discusses the evidence that a taxpayer must provide to show that it paid or properly accrued a foreign tax. Section 18.05.3 deals with the disallowance of a credit for taxes that were paid but were then rebated.

§ 18.05.1. Amount Paid

The amount of foreign tax for which credit may be claimed under Code Section 901 is the amount of creditable income tax paid by the taxpayer to the foreign government. A cash-basis taxpayer has the right to elect whether to claim the credit when it is paid or when it accrues.[98]

A tax is not considered to be paid to a government for foreign tax credit purposes unless the payment is compulsory.[99] The taxpayer is expected to make all reasonable efforts to mitigate the tax in order for it to qualify as a compulsory payment.[100] Consider, for example, P, a U.S. corporation, that makes sales of inventory property to F, a wholly owned subsidiary organized in Country A, at a price less than the arm's length price. The result is an underpayment of U.S. taxes by P and an overpayment of Country A taxes by F. The Internal Revenue Service makes a proper adjustment in P's income under Code section 482. P cannot claim an indirect credit for the excess taxes paid by F to Country A unless F makes reasonable efforts to obtain a refund of those taxes.[101]

The taxpayer is not required to exhaust ineffective remedies.[102] In the example above, F would not need to make a claim for refund of excess taxes paid to Country A if the adjustment made by the Service occurred after the period for claiming refunds had passed in Country A.[103] In addition, taxpayers are allowed to make reasonable elections to reduce their tax liabilities over time without jeopardizing the credit.[104]

Consider, for example, P, a U.S. corporation engaged in business in Country B. Country B allows taxpayers to elect to deduct their capital expenditures for depreciable property either in the year of acquisition or over some longer period. P elects the longer period because it expects that it will not have adequate income in the current year to fully utilize the deduction. That election would not cause the taxes paid in the current year to Country B to be disqualified for the credit.[105]

An amount is not considered "paid" if the taxpayer can reasonably expect that the tax will be refunded or forgiven, directly or indirectly.[106] Assume, for example, that a withholding agent in Country A withholds 25 percent of a payment to PCo, a U.S. company. Country A has a tax treaty with the United States that limits the withholding rate to 10 percent. PCo can reasonably expect that 60 percent of the tax withheld will be

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[98] IRC § 905(a).

[99] Reg. § 1.901-2(e)(5) (2008).

[100] Id.

[101] 101Reg. § 1-901-2(e)(5)(ii)(Ex. 2) (2008).

[102] Reg. § 1.901-2(e)(5)(i) (2008).

[103] Reg. § 1.901-2(e)(5)(ii)(Ex. 4) (2008).

[104] Reg. § 1-901-2(e)(5)(i) (2008).

[105] Reg. § 1.901-2(e)(5)(ii)(Ex. 5) (2008).

[106] Reg. § 1.901-2(e)(2)(i) (2008).

rebated in accordance with the treaty. Thus only 40 percent of the tax withheld will be considered as paid for purposes of claiming a foreign tax credit.[107]

§ 18.05.2. Proof of Payment

The traditional rule is that a taxpayer will be allowed to claim a foreign tax credit on its tax return for withholding taxes in the year those taxes were withheld, whether or not those taxes have been paid over to the government in that year.[108] The allowance of the credit is only tentative, however, and is disallowed if the withholding agent fails to make actual payment in a subsequent year or if the tax is paid and then refunded.[109] The Internal Revenue Service has broad authority to require detailed evidence that a withholding tax was actually paid.[110] Congress has strongly suggested that positive proof of payment be required in situations like the Brazilian rebate plan discussed in section18.05.3, below, or, indeed, in any situation in which the borrower is obligated to pay the taxes imposed on the taxpayer.[111] The high level of proof is imposed to reduce the otherwise serious risk that a withholding agent and a dishonest taxpayer will fraudulently conspire to generate a credit for fictitious taxes or that a withholding agent, acting fraudulently or with the tacit approval of the foreign government, will pocket the withholding tax.

In *Continental Illinois*,[112] the Tax Court held that a U.S. bank claiming credit for taxes allegedly paid to foreign governments by its borrowers must prove, with strong evidence, that the borrowers actually made the payments. In that case, the U.S. bank entered into various net loan agreements with foreign borrowers. The typical agreement obligated the borrower to pay the U.S. bank an agreed amount of interest net of foreign taxes. The borrower assumed all responsibility for making payment of all foreign taxes due on the interest income of the bank.

No contemporaneous efforts were made by the U.S. bank to determine whether its borrowers were paying over to the foreign tax authorities the withholding taxes allegedly due. In some cases, it did not even know for certain whether it (or its borrower) were legally obligated to pay the withholding taxes. It did not impose on the borrower the obligation to provide it with tax receipts from the government. Indeed, the court found that the bank refrained from requesting proof of payment for competitive reasons—an intimation that some borrowers would not take out loans from foreign banks that inhibited their fraudulent retention of "withheld" taxes. The U.S. bank made no effort to obtain proof-of-payment from the foreign governments that allegedly received the withholding taxes.

The court did accept as strong secondary evidence certain affidavits signed by the borrowers that "stated that the foreign withholding taxes were both withheld and paid to foreign tax authorities." These statements were solicited (on form letters prepared by the U.S. bank) after the bank's attempts to obtain tax receipts from its borrowers were almost completely unsuccessful. The confidence placed by the court in the

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[107] Reg. § 1.901-2(e)(2)(ii)(Ex. 1) (2008).

[108] *Lederman v. Comm'r,* 6 T.C. 991 (1946) (holding that the taxpayer can claim credit for tax withheld by a withholding agent on proof of withholding, where the withholding agent was prevented by war conditions from making the payment to the government). *See* Reg. § 1.901-2(f)(1) (1991) (generally treating taxes withheld on wages as paid by the wage earner).

[109] *Lederman v. Comm'r,* 6 T.C. 991 at 999 (1946); *Pacific Metals Corp. v. Comm'r,* 1 T.C. 1028 (1943).

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

[111] See Report 99-841, H.R. 3838, 99th Cong., 2d Sess. (Conference Committee Report H, Sept. 18, 1986) at 11-594. See also General Explanation of the Tax Reform Act of 1986 (1987) at 914-915.

[112] *Continental Illinois Corp. v. Comm'r,* TC Memo 1991-66.

reliability of the affidavits is surprising, given its unsympathetic statement of the facts and its apparent understanding of the high risks of tax fraud inherent in the net loan arrangements.

The Seventh Circuit, expressing a concern about the conversion of the foreign tax credit into the "foreign fraud credit," reversed the Tax Court's holding that the Internal Revenue Service had abused its discretion in rejecting the secondary evidence offered by Continental Illinois. It stated:

> The regulations require that the taxpayer submit "the receipt for each such tax payment," or in lieu thereof "a photostatic copy of the check, draft, or other medium of payment showing the amount and date thereof, with certification identifying it with the tax claimed to have been paid, together with evidence establishing that the tax was paid for taxpayer's account as his own tax on his own income." Treas. Reg. §§ 1.905-2(a)(2), 2(b)(1). The borrowers' letters did not comply with these straightforward requirements. We cannot imagine on what basis the requirements might be thought an abuse of the Internal Revenue Service's necessarily broad power to prescribe the methods of proving entitlement to lucrative tax benefits.[113]

The above quotation makes no reference to Treasury regulation section 1.905-2(b)(3), which authorizes the Internal Revenue Service to accept secondary evidence of payment in its discretion. The Seventh Circuit might be read as suggesting that the Service's authority to reject secondary evidence is not subject to court review. Despite this possible glitch in the Seventh Circuit's opinion, its message to the Tax Court is clear—the Tax Court had overstepped its authority in accepting inconclusive secondary evidence of payment of a tax over the objection of the Service.

The Tax Court seems to have gotten the message. In *Norwest Corp.*,[114] the Tax Court refused to hold that the Service had abused its discretion under the regulations in failing to accept the taxpayer's secondary evidence that a withholding tax had in fact been paid. In so doing, the Tax Court pointedly observed that "it is within the district director's discretion to decide whether the secondary evidence presented is sufficient." The court did not concede that it was changing its ways. It distinguished its own opinion in *Continental Illinois* and may be read as mildly chiding the Seventh Circuit for its failure to discuss Treasury regulation section 1.905-2(b)(3). Despite these atmospherics, the Tax Court has clearly (and appropriately) retreated from its misguided position in *Continental Illinois*.

From a policy perspective, the Service should be extremely reluctant to accept secondary evidence that a foreign withholding tax has been paid over to the foreign government. Its authority to do so is clearly granted under Code section 905(b). Before accepting secondary evidence from a taxpayer, the Service should require the taxpayer to demonstrate a good-faith and contemporaneous effort to obtain direct proof of payment. Evidence obtained from a withholding agent after the running of the limitation period on assessment should never be accepted. In addition, the Service should be free to reject secondary evidence if that evidence does not preclude a realistic possibility of fraud either by the taxpayer or the withholding agent.

§ 18.05.3. Rebates and Subsidies

A tax that is paid and then rebated should not be treated as a tax paid. In effect, the rebated tax is not a tax in that the taxpayer receives a specific economic benefit in exchange for the payment, namely the rebate. Even if the payment might constitute a tax, however, it will not constitute a tax paid if it is rebated, directly or

[113] *Continental Illinois v. Comm'r,* 998 F.2d 513 (7th Cir. 1993), rev'g TC Memo 1991-66.

[114] *Norwest Corp. v. Comm'r,* TC Memo 1995-453.

indirectly.[115] As discussed below, this commonsense result was reached by the courts and has been reaffirmed by Congress.

Some governments have attempted to induce foreigners to invest in their country by assessing on them a tax that generally would qualify for the credit and then rebating that tax, directly or indirectly, to the investor. For example, Brazil adopted a tax provision that nominally imposed a withholding tax of 25 percent on foreign lenders and then rebated most of that tax to the Brazilian borrower as an interest subsidy. Rebated taxes of that nature do not qualify for the credit.[116]

A levy will be considered a subsidy rather than a tax if the levy is rebated, directly or indirectly, to the taxpayer or its affiliates.[117] A levy may also be a subsidy if an unrelated person engaging in a transaction with the taxpayer receives a rebate of the tax paid by the taxpayer as a result of that transaction.[118]

The rebate issue first surfaced in 1976, when the Internal Revenue Service issued a private letter ruling that permitted taxpayers to claim the credit for a Brazilian withholding tax notwithstanding an indirect rebate of that tax.[119] In 1978, the erroneous private ruling was revoked through a public ruling.[120] In 1986, Congress adopted Code section 901(i) that affirmed the result reached in the ruling.

Although the indirect subsidy issue was resolved definitively by statute for post-1986 years, it has continued to be litigated with respect to tax years prior to the enactment of Code section 901(i). For the most part, the courts have upheld a denial of the credit under the applicable Treasury regulation and under their interpretation of the general language of Code section 901(b)(1), which grants a credit for taxes actually paid or accrued.[121] In *Bankers Trust New York*,[122] however, the taxpayer convinced the Court of

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[115] IRC § 901(i).

[116] Reg. § 1.901-2(e)(3)(iv)(Ex. 1) (2008); see also Reg. § 1.901-2(e)(3)(iii) (2008), codified by the 1986 tax act in IRC § 901(i). Rev. Rul. 78-258, 1978-1 C.B. 239, modified by Rev. Rul. 89-119, 1989-2 C.B. 132, holds the rebated withholding tax in the Brazilian rebate scheme was not a creditable tax. The theoretical grounds for denying a credit for indirectly rebated taxes are developed in Michael J. McIntyre, "The Foreign Tax Credit and the Brazilian Rebate," *Tax Notes,* Jan. 23, 1978, p. 67, and "Response to Comments of Messrs. Guttentag and Nauheim," *Tax Notes,* April 3, 1978, p. 354.

[117] Reg. § 1.901-2(e)(3)(i)(A) (1991). In *West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186 (1994), the U.S. Supreme Court conflated a State tax and a subsidy financed by the tax to hold that the tax violated the dormant Commerce Clause. In effect, the Court rejected a "technical taxpayer" rule for purposes of constitutional analysis.

[118] IRC § 901(i) and Reg. § 1.901-2(e)(3)(i)(A) and (ii) (2008).

[119] Priv. Ltr. Rul. 7611239900A (Nov. 22, 1976). The author has been told by a Brazilian tax official that the ruling was issued after an informal agreement was reached between U.S. Treasury Secretary William Simon and the Brazilian government after a visit by Simon to Brazil.

[120] Rev. Rul. 78-258, 1978-1 C.B. 239, modified by Rev. Rul. 89-119, 1989-2 C.B. 132, holds the rebated withholding tax in the Brazilian rebate scheme was not a creditable tax. The theoretical grounds for revoking the private ruling and denying a credit for indirectly rebated taxes are developed in Michael J. McIntyre, "The Foreign Tax Credit and the Brazilian Rebate," *Tax Notes,* Jan. 23, 1978, p. 67, and "Response to Comments of Messrs. Guttentag and Nauheim," *Tax Notes,* April 3, 1978, p. 354.

[121] For the fate of the Brazilian subsidy in the Tax Court, see *Nissho Iwai American Corp. v. Comm'r,* 89 T.C. 765 (1987) (holding that the lender cannot claim a credit for taxes rebated to the borrower but can claim a credit for taxes actually paid by the borrower on its behalf) and *Continental Illinois Corp. v. Comm'r,* TC Memo 1988-318 (same holding, relying on the 1980 temporary regulations). The position of the Tax Court in *Continental Illinois Corp.* was upheld by the 11th Circuit in *Citizens and Southern Corp. v. Comm'r,* 900 F.2d 266 (per curiam, 1990). See also *First Chicago Corp. v. Comm'r,* TC Memo 1991-44, 998 F.2d 513 (7th Cir. 1993) (same holding); *Norwest Corp. v. Comm'r,* TC Memo 1992-282 (slightly different facts and arguments, same holding), 69 F.3d 1404 (8th Cir. 1995) ("We think the regulation reasonably interprets the statutory language "paid or accrued" to mean circumstances in which the foreign tax, here the local tax on interest payments made to foreign lenders, has in substance been paid").

[122] *Bankers Trust New York v. U.S.*, 225 F.3d 1368 (2000), rehearing and rehearing en banc denied, 2000 U.S. App. LEXIS 34016.

Appeals for the Federal Circuit that it was bound by the so-called Mexican Railroad Car cases, decided by the Court of Claims (predecessor of the Court of Claims), to allow a credit for the rebated taxes.[123]

The Mexican Railroad Car cases are not good precedent for deciding Brazilian rebate cases. In the Mexican Railroad Car cases, certain U.S. railroads paid a negotiated tax payment to Mexico, with a Mexican railway serving as the withholding agent. That tax was then paid by the Mexican government to the Mexican railway as a subsidy. The U.S. tax authorities argued, *inter alia*, that under the special facts of that case, there was no actual payment of tax to the Mexican government. The focus of the Court of Claims in those cases was on that argument. The Court of Claims, quite reasonably, rejected the argument, holding that the Mexican withholding mechanism was similar to U.S. withholding mechanisms. The U.S. tax authorities did not contend that the rebate was part of a tax avoidance scheme designed to subvert the purposes of the credit. From the facts of the case, it appears that the Mexican taxes was born by the U.S. taxpayers and that the rebate went entirely to the benefit of the Mexican railway. As a result, there was no discussion in those cases of how a rebate to the withholding agent, under some conditions, might nullify the economic effect of the tax payment, as occurred with the Brazilian rebates.

The Federal Circuit did not attempt to distinguish the Mexican Railroad Car cases from the case before it, Nor did it undertake an analysis of those cases to determine if they were correctly decided. In its view, the only issue before it was whether a rebated tax is a tax paid for purposes of Code section 901(b). It concluded that the Mexican Railroad Car cases had decided this issue for the taxpayer. Although it acknowledged that the subsequent Treasury regulation took a contrary position, it held that it is required by the *Neal* case[124] to ignore an otherwise valid regulation if the regulation is inconsistent with a prior decision of the court, notwithstanding the questionable merits of the prior decision.

From a public policy perspective, the Federal Circuit's position is unwise—the Secretary should not be precluded from properly interpreting a statute under an unambiguous congressional grant of authority because some court has previously interpreted that statute improperly. Indeed, from a policy perspective, a court should give due deference to a regulation even if it considers both the regulation and its prior decision to be valid. The Federal Circuit, however, concluded that it was required by the *Neal* case to give binding effect to the Mexican Railroad Car cases, which it understood as having settled the rebate issue.[125]

The anti-rebate regulation has been interpreted occasionally outside the context of the Brazilian rebate scheme. A payment to a U.S. pilot under the Berlin Promotion Law for living and working in Berlin was

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[123] See *Chicago, Burlington, & Quincy R.R. Co. v. U.S.*, 197 Ct. Cl. 264, 455 F.2d 993 (Ct. Cl. 1972) (allowing a credit for a tax actually collected by the Mexican government and subsequently paid as a subsidy to the Mexican railway that had acted as the withholding agent in collecting the tax); *Missouri Pac. R.R. Co. v. U.S.*, 204 Ct. Cl. 837, 497 F.2d 1386 (Ct. Cl. 1974) ("That Mexico elected to appropriate the proceeds of the levies to the benefit of its domestic rail carriers does not mean that the sums involved were not collected from the plaintiff as a tax").

[124] *Neal v. U.S.*, 516 U.S. 284 (1996) ("Once we have determined a statute's meaning, we adhere to our ruling under the doctrine of *stare decisis*, and we assess an agency's later interpretation of the statute against that settled law.").

[125] Whether the U.S. Supreme Court intended the broad reading of *Neal* given by the Federal Circuit is at best unclear. In *Neal*, the Court was asked to decide whether a revised sentencing guideline governed the calculation of the weight of LSD in determining a minimum sentence under a federal sentencing statute. The revised guideline used a method of measuring the weight of LSD that excluded some portion of the weight of the medium used to transport the LSD. The Court had previously held that for purposes of setting a minimum sentence, the statute required that the full weight of the LSD and the medium be taken into account. The Court concluded that the revised guideline was not intended to apply in setting the minimum sentence. It also concluded that the guideline would be an invalid regulation it if had been so intended. The Court then added that it would have evaluated the guideline in light of its own prior interpretation of the statute if the guideline had been intended to govern instead of giving the deference usually given to regulations. It certainly did not imply that it would have made no serious effort to reconcile an otherwise valid regulation with its prior decision before holding the regulation invalid.

not treated as a rebate for purposes of computing the foreign tax credit.[126] The court offered little explanation for its decision, and it dealt with taxable years before the effective date of the 1980 and 1983 regulations. A Netherlands investment tax credit was treated as a reduction in taxes paid, thereby reducing the allowable foreign tax credit.[118]

A variation on the rebate theme was presented to the courts in the *Xerox* case.[119] The issue is that case was whether the taxpayer could claim a foreign tax credit for advance corporation taxes (ACT) paid to the United Kingdom when those taxes were assigned by Xerox to its U.K. affiliates and used by the affiliates to offset U.K. taxes otherwise due. The U.S. tax authorities acknowledged that the taxpayer was entitled to the credit when the taxes were paid. Article 23 of the U.S./U.K. treaty explicitly provided that the ACT would be treated by the United States as a creditable income tax. The issue for the court was whether the taxpayer must recompute its allowable credit under Code section 905(c) when it assigned the ACT to its affiliates. The taxpayer argued that the treaty precluded the United States from invoking section 905(c). The lower court sided with the U.S. tax authorities. Its decision was overturned by the Federal Circuit, which decided for the taxpayer.

The following simplified example illustrates the issue in *Xerox*. XCo receives a dividend of $1,000 from RCo, its U.K affiliate. Under U.K. law, RCo is required to pay the ACT of $150 on behalf of XCo to the U.K. government. The U.S./U.K. tax treaty provides that the ACT is a creditable tax, and XCo claims the credit. Up to this point, there is no dispute between the taxpayer and the U.S. tax authorities.

The dispute arises because the U.K. government allows a taxpayer that has paid ACT to use that tax to offset the general corporate income tax imposed on it or to assign it to an affiliated company. In effect, XCo received a coupon from the U.K. government with a face amount of $150 that it could use to offset U.K. taxes imposed on itself or on other members of its corporate group. XCo assigns this right (in effect, transfers the coupon) to S-1, its U.K. affiliate. S-1 earns income of $600, is subject to a U.K. tax of $200, and used the right received from XCo to reduce its U.K. corporate tax to $50. The question for the court in *Xerox* was whether XCo must recompute its allowable credit and treat the use of its ACT by S-1 as an indirect rebate of the ACT.

As a matter of tax policy, XCo should be required to recompute its foreign tax credit. Otherwise it receives a double benefit for the same tax. The assignment right that XCo received from the U.K. government has a value of $150, as shown by the fact that it was used to reduce S-1's taxes by that amount. As the U.S. tax authorities recognized, under the rebate theory, S-1 should be treated as having paid U.K. tax of $200 ($50 in cash and $150 by relinquishing the right assigned to it by XCo). XCo should be permitted at some future date to claim a credit for the $200 of taxes deemed paid by S-1 when S-1 distributes the profits with respect to which the tax was deemed paid.

In *Xerox*, the Federal Circuit concluded that the U.S./U.K. treaty prevented the United States from requiring the taxpayer to recompute the credit under Code section 905(c). In reaching that result, it asserted, incorrectly, that double taxation would result if it did not read the treaty as prohibiting a recomputation. No language in the treaty expressly prevented the application of section 905(c). The normal treaty result, therefore, would have been that U.S. domestic law would control. In the court's view, however, allowing U.S. domestic law to control in this case would frustrate the purpose of the U.S./U.K. tax treaty.

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[126] *Foley v. Comm'r,* 87 T.C. 605 (1986).

[118] Rev. Rul. 86-134, 1986-2 C.B. 104.

[119] *Xerox v. U.S.,* 41 F.3d 647 (Fed. Cir. 1994), *rev'g* 14 Cl. Ct. 455 (1988).

A related issue arose in one of several cases involving Compaq Computer Corp.[120] The same U.K. ACT was at issue. As in *Xerox*, the taxpayer paid the ACT and assigned to its affiliates the right to use it to offer the U.K. regular corporate tax by the amount of the ACT paid. The affiliates made full use of the ACT. The U.S. tax authorities argued that this use of the ACT constituted an indirect rebate of the base within the meaning of Code section 901(i) and the regulations under section 905(c). Again the taxpayer prevailed. The court followed *Xerox* in its interpretation of the treaty. It also concluded that the assignment of the right to a tax rebate by the taxpayer to its U.K. affiliates was not the type of subsidy that section 901(i) was intended to reach.

§ 18.06. Abuse of the "Technical Taxpayer" Rule

The underlying premise of the foreign tax credit is that a U.S. person generally should be exempt from U.S. residence taxation on an item of foreign source income to the extent that the person has already borne the burden of an equivalent income tax in the country of source.[121] The foreign tax credit rules, however, generally do not attempt to determine whether a U.S. taxpayer has in fact borne the burden of a foreign income tax. Instead, those rules have customarily been applied to permit a U.S. person to take a direct foreign tax credit if that person is the formal payer of the foreign income tax. U.S. corporations may take an indirect or deemed paid foreign tax credit if their foreign affiliate is the formal payer of the foreign income tax.[122] This customary rule is often referred to as the "technical taxpayer" rule. In the typical case, it is a sensible rule that promotes certainty and administrative economy.

Unfortunately, in some special cases, the technical taxpayer rule is open to a wide range of abuses because its application would allow the formal taxpayer to claim the credit for a foreign income tax even if that person unquestionably did not bear the burden of the tax. One clear type of abuse is called "dividend dumping." Congress prohibited taxpayers, other than securities firms, from obtaining the tax benefits of dividend dumping in certain specified situations by adopting Code section 901(k) as part of the 1997 tax act.[123] The following example illustrates one of the many possible methods of dividend-dumping blocked by section 901(k).[124]

TCo, a U.S. corporation, purchases stock in a foreign company from P, a tax-exempt U.S. pension fund. A dividend of $50 is about to be paid on that stock, and that dividend will attract a foreign withholding tax of $10. The purchase price of the stock, with dividend attached, is $1,042. Soon after TCo's purchase, the dividend is paid, and TCo becomes liable, as expected, for a foreign withholding tax of $10. Soon thereafter, TCo sells the stock back to P for $1,000 in accordance with a pre-existing understanding. Of the $1,042 that TCo paid to P for the stock, $1,000 represents its underlying value. The $42 dollars paid in excess of that underlying value represents the value of the $50 dividend, net of the expected $10 withholding tax, plus a service fee of $2 paid to P for participating in the arrangement.

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[120] *Compaq Computer Corp. v. Comm'r,* 113 T.C. 363 (1999), 1999 U.S. Tax Ct. LEXIS 52.

[121] For discussion, see Michael J. McIntyre, "Separate Basket Limitations in Theory and in Practice," 12 *Tax Notes Int'l* 57-64 (Jan. 1, 1996), reprinted in 70 *Tax Notes* 1393-1399 (March 4, 1996).

[122] See Reg. § 1.901-2(f) (2012) ("person by whom tax is considered paid . . . is the person on whom foreign law imposes legal liability for such tax").

[123] IRC § 901(k).

[124] For a similar example and a discussion of IRC § 901(k), see Juliann Avakian Martin, "Foreign Tax Credit Holding Period Proposal Generates Comment," 75 *Tax Notes* 1038-1041 (May 26, 1997).

In computing its U.S. taxes prior to the enactment of Code section 901(k), TCo would claim a loss of $42 on its sale of the stock to P for $1,000. It also would claim a foreign tax credit for the $10 withholding tax. Assuming a U.S. corporate tax rate of 35 percent, TCo would expect to obtain a tax benefit from the overall set of transactions of $24.70. Of that amount, $14.70 ($42 × 0.35) would come from the claimed deduction of $42 for the loss on the sale of the stock to P. The remaining $10 would come from claiming the foreign tax credit. TCo would be taxable on the grossed-up dividend of $50, resulting in a U.S. tax of $17.50. Thus under pre-1997 law, TCo would expect to obtain a net tax benefit of $7.20 ($24.70 – $17.50) for an out-of-pocket cost of $2. The end result of the hocus-pocus is that TCo took the foreign tax credit of $10 that it had purchased from P for $2 and then included the credit in income under the gross-up rule.

To block tax avoidance of the type illustrated above, current law prohibits a taxpayer from taking a foreign tax credit for withholding taxes in such cases unless the taxpayer meets certain holding period requirements.[125] In general, the taxpayer claiming the credit must have held the stock on which the dividend was paid for a 15-day period just prior to the payment of the dividend, and it must bear the risk of gain or loss on the stock during that period.[126] The holding period is extended to 45 days for dividends on certain preferred stock.[127] Without the credit, the transaction illustrated above would result in an overall loss to TCo. of $2.

Code section 901(k) should make dividend dumping both difficult and risky for the class of transactions at which it is targeted. That reform, however, has limited application. It does not eliminate opportunities for trafficking in credits outside its fixed time periods, and it does not even close off the loophole for U.S. securities firms,[128] which have heavily exploited dividend dumping in the past. More fundamentally, section 901(k) is narrowly targeted at one particular type of tax avoidance and does not attempt to provide a general remedy to the problems created by the technical taxpayer rule.

In one of several cases involving Compaq Computer Corp. that reached the Tax Court in 1999, the U.S. tax authorities were successful in getting the Tax Court to prevent dividend dumping in a case not covered by Code section 901(k). They lost the case, however, on appeal. In *Compaq*,[129] the taxpayer bought over $800 million of stock in a company that was about to pay a dividend. It then immediately sold the stock ex-dividend, holding title just long enough to be the owner of record when the dividend was paid. A withholding tax of 15 percent of the dividend was imposed by the Netherlands. The taxpayer sought to claim a foreign tax credit and to deduct a loss on the sale of the stock ex-dividend. Applying the business purpose test, the Tax Court concluded that in substance the taxpayer had engaged in a shell game motivated entirely by tax considerations.[130]

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[125] The holding period rules are modeled on the rules against dividend stripping contained in IRC §§ 246 and 1059.

[126] IRC § 901(k)(1)(A).

[127] IRC § 901(k)(3).

[128] See IRC § 901(k)(4) (carving out an exception for securities firms).

[129] *Compaq Computer Corp. v. Comm'r,* 113 T.C. 214 (1999), rev'd 277 F.3d 778 (5th Cir. 2001).

[130] For a substance-over-form result in favor of the tax authorities, see *ACM Partnership v. Comm'r,* TC Memo 1997-115, aff'd in relevant part 157 F.3d 231 (3rd Cir. 1998), cert. denied, 119 S. Ct. 1251 (1999) (loss disallowed on sale of foreign partnership interest when loss was engineered for tax purposes by manipulating the installment sales rules and partnership rules); for a case essential identical to *Compaq* decided on appeal in favor of the taxpayer see IES v. Comm'r, 253 F.3d 350 (8th Cir. 2001), reh'g denied, reh'g, en banc, denied, Alliant Energy Corp. v. United States, 2001 U.S. App. LEXIS 24929 (8th Cir. Oct. 1, 2001), rev'g 1999 U.S. Dist. LEXIS 22610 ("it is clear the transactions did not change IES's economic position except for the transactions having resulted in the transfer of the claim to the foreign tax credit to IES.").

On appeal, the Fifth Circuit concluded that "transactions of the sort at issue here have economic substance and a business purpose." Its reasoning in the case is odd in the extreme. As the facts above indicate, the taxpayer was engaged in a form of economic arbitrage that was profitable solely on account of the tax benefits it hoped to obtain. Its sole objective was to purchase foreign tax credits from an exempt taxpayer at a discount and use those transferred credits to reduce its own tax liability. Under these facts, the Tax Court had no difficulty concluding that the transaction lacked economic substance, The Fifth Circuit claimed that the Tax Court's analysis was flawed because, in determining that the taxpayer could not make a profit aside from the tax benefit, the Tax Court "ignored the $3.4 million U.S. foreign tax credit that Compaq claimed." The Tax Court certainly understood that the transaction was profitable after taxes. The whole point of an economic analysis is to determine whether the transaction would make any sense apart from the tax benefits that the taxpayer hoped to obtain. It is beyond debate that this transaction was designed from the start solely to obtain some tax benefits and that it would not have been profitable, or have offered any prospect of profit, aside from those tax benefits.[131]

The following example illustrates a more general problems of tax avoidance arising from the technical taxpayer rule. Assume that UCo, a U.S. corporation, establishes KCo, a wholly-owned subsidiary, in Country K, receiving all of the stock of KCo in exchange for a contribution to capital of $1. KCo sells a hybrid financial instrument to Mr. K, a resident of Country K, for $9,999. That hybrid instrument is viewed as equity under the tax laws of Country K and as debt under the tax laws of the United States. As a result of the sale of that instrument to Mr. K, KCo has capital to invest of $10,000. That amount is invested in Country K and yields a return for the year of $2,000. KCo pays tax of $600 to Country K on that income and distributes 99.99 percent of the after-tax investment proceeds, or $1,399.86, to Mr. K. That payment is interest under U.S. tax laws and a dividend under Country K's tax laws. The remaining after-tax proceeds of $0.14 are distributed to UCo as a dividend.

Country K uses an imputation system for integrating its corporate and personal income tax. Under that system, income taxes paid at the corporate level are viewed as an advanced payment of the shareholder income tax. A shareholder receiving a dividend from a corporation is entitled to a tax credit against his personal tax liability for his deemed share of the corporate tax associated with the dividend. Under the facts above, the payment of $1,399.86 received by Mr. K is characterized as a dividend under Country K's tax laws, and Mr. K becomes entitled to a credit against his personal tax liability for 99.99 percent of the corporate tax of $600 paid by KCo. Thus Mr. K is able to reduce his personal tax liability by $599.94 as a result of the distribution received from KCo.

Because Mr. K is viewed as the holder of a debt instrument under U.S. tax law, he is not viewed as the formal taxpayer with respect to any of the taxes paid by KCo. The formal taxpayer is KCo itself. On the distribution of $0.14 to UCo, UCo becomes entitled to a foreign tax credit for the $600 in taxes deemed

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[131] For a detailed analysis of the *Compaq* case that supports the result reached by the Tax Court, see David N. Shaviro, "Economic Substance, Corporate Tax Shelters, and the *Compaq* Case," 22 *Tax Notes Int'l* 1693-1720 (Oct. 9, 2000). For a biting criticism of the Fifth Circuit's opinion, see Daniel N. Shaviro & David A. Weisbach, "The Fifth Circuit Gets It Wrong in *Compaq v. Commissioner*," 94 *Tax Notes* 511-518 (January 28, 2001) (characterizing Judge Jones's critique of the Tax Court opinion as "embarrassing"). See also William A. Klein & Kirk J. Stark, *Compaq v. Commissioner*—Where Is the Tax Arbitrage, 25 *Tax Notes Int'l* 1353-1359 (March 25, 2002) (contending that the transactions involved did not involve classical tax arbitrage but rather economic arbitrage and offering an alternative analytical approach "in an effort to identify the source of the problem and the doctrine that is needed to treat the transaction as a nullity"); Daniel N. Shaviro & David A. Weisbach, "Cross-Border vs. Domestic Dividend-Stripping: An Illusory Distinction," 25 *Tax Notes Int'l* 1435-1436 (April 1, 2002) (suggesting that the distinction made by Klein and Stark between economic arbitrage and tax arbitrage is not meaningful). See also Michael J. McIntyre, "A Vote in the *Compaq* Debate," 94 *Tax Notes* 1716 (March 25, 2002) (siding with Shaviro and Weisbach).

paid on that dividend by KCo.[132] Or at least that would be the taxpayer's position. The result is that UCo is claiming a credit for an amount that is 600 times as great as its investment of $1 in KCo, notwithstanding the fact that its actual tax burden is only 14 cents.

Whether the tax authorities, in the absence of regulatory action, would be able to overturn the result sought by the taxpayer in the above example is unclear. To do so, they must be able to convince the courts that the customary application of the technical taxpayer rule is improper in this case and that general anti-avoidance doctrines are applicable. On tax policy grounds, that argument has obvious merit, in that application of the technical taxpayer rule under these facts is fundamentally inconsistent with any conceivable Congressional intent in adopting the credit.[133] It is also inconsistent with the structure of the credit rules, most particularly the limitation rules of Code section 904(d).

As discussed above, the courts have ignored the technical taxpayer rule to defeat a tax avoidance scheme designed by the Brazilian government. Under that scheme, the Government of Brazil imposed a withholding tax of 25 percent on interest payments made by a Brazilian company to a U.S. investor. It then rebated a substantial portion of that tax to the Brazilian payer of the interest. The U.S. courts concluded that only the portion of the tax that was not rebated was creditable, notwithstanding the fact that the U.S. investor was the formal taxpayer with respect to the entire tax. By analogy, the courts might conclude that the use of the corporate income tax by Mr. K in the above example to offset his personal tax liability amounted to a rebate of the corporate tax. Under that approach, KCo would be viewed as the "taxpayer" on only that portion of the tax ($0.14) that imposed an economic burden on it.

The rule denying the credit with respect to rebated taxes was initially adopted by the courts without regulatory or statutory support. That rule has now been incorporated into the regulations and the Code. Code section 901(i) denies a credit when a tax is used, directly or indirectly, to provide a subsidy to any person who is a party to the set of transactions that gave rise to the tax. Country K's imputation scheme results in a rebate of the corporate income tax to Mr. K, who is a party to the set of transactions giving rise to the tax on KCo. That rebate could be viewed as a prohibited subsidy. The regulations under section 901(i) define the term "subsidy" in terms of the benefit conferred, directly or indirectly, on a party to the set of transactions, without reference to whether the U.S. taxpayer received a benefit from the subsidy or the foreign country intended to grant a subsidy.[134] Thus there is respectable legal authority for defeating the tax avoidance scheme set forth in the above example under the statutory authority of section 901(i).

Many countries use imputation systems, thereby providing U.S. corporations with many opportunities to engage in the type of tax avoidance illustrated above. It appears that many U.S. corporations, with the assistance of securities firms, are utilizing such schemes to generate billions of dollars in improper credits. Obviously the foreign tax credit system cannot survive such abuses for very long.

Reform of the technical taxpayer rule should not be limited to the two types of abuses illustrated above. What is needed is a general anti-avoidance rule, promulgated by statute or regulation. An

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[132] KCo's taxable income, under U.S. tax concepts, is $600.14 ($2,000 of gross income minus an allowable deduction for "interest" of $1,399.86). The amount of its undistributed earnings is $0.14 (pre-tax earnings of $600.14 minus tax of $600). Under IRC § 902(a), UCo is deemed to have paid KCo's post-1986 taxes of $600, multiplied by a fraction, the numerator of which is the dividend of $0.14 and the denominator of which is KCo's post-1986 undistributed earnings of $0.14. The result is $600 ($600 × $0.14/$0.14).

[133] Although the statutory tax rate in Country K is only 30%, the effective tax rate under U.S. tax concepts would be 99.98% (tax of $600 divided by taxable income of $600.14) if the technical taxpayer rule is allowed to apply. That result is nonsensical.

[134] Reg. § 1.901-2(e)(3)(ii) (1991).

appropriate statute or regulation would prohibit taxpayers from claiming a credit whenever the transaction generating the credit would not make good economic sense aside from the potential credit benefits.

In 2008, the Internal Revenue service issued complex temporary and proposed regulations that would deny the credit with respect to what it refers to as "structured passive investment arrangements"on the ground that the foreign payment at issue is not "compulsory" and thus not a a "tax" but rather a voluntary payment.[135] The regulations are narrowly drown to cover a tiny subset of potential abuses of the technical taxpayer rule. An arrangement must met various conditions specified in the temporary regulations for the related credit to be denied. The regulations contain nine examples. Here is simplified version of one of them.[136]

PCo, a U.S. corporation, forms a subsidiary, FCo, in France by transferring $1.5 billion to FCo in exchange for FC's stock. PCo has another French subsidiary, GCo. FCo loans $1.5 billion to GCo. PCo then sells its stock in FCo to XCo, an unrelated French company, for $1.5 billion, with a written agreement that PCo will repurchase the FCo stock for $1.5 billion in five years. Under French law, the sale of FCo to XCo is treated as legitimate sale that passes ownership of FCo to XCo. Under U.S. law, the sale-repurchase transaction is treated as a collateralized loan of $1.5 billion from XCo to PCo, and FCo is treated as still being a subsidiary of PCo. GCo, which owes FCo $1.5 billion, pays FCo $120 million in interest. FCo pays a French tax on that amount of $36 million and distributes the remaining $84 million to XCo (its parent company under French law). XCo is not taxable on that $84 million "intercompany dividend" under French law.

Leaving aside the anti-avoidance rule in the proposed regulation, FCo would be treated under U.S. law as having received interest income of $120 million from GCo and having paid an income tax to France of $36 million. FCo's after-tax income of $84 would be subpart F income, taxable to PCo as a deemed dividend, and PCo would be entitled to an indirect foreign tax credit of $36 million for the taxes paid by FCo (and deemed paid by PCo). PCo also would be treated as having made an interest payment of $84 million to XCo on the "collateralized loan" transaction. As a result, PCo would have no net income ($84 million subpart F income minus $84 million interest deduction) and a foreign tax credit of $36 million.

The proposed regulations would undo this result intended by PCo in the above example. Those regulations would treat the arrangement described above as a structured passive investment arrangement. As a result, the payment to France would be characterized as a voluntary payment. since the payment is not a tax, it would not be eligible for a foreign tax credit.

Guardian Industries Corp. v. United States

477 F.3d 1368 (Fed. Cir. 2007)

Opinion: Dyk, Circuit Judge.

In this case Guardian Industries Corp., a Delaware corporation, is the parent company of a group of subsidiaries in the United States, referred to collectively as "Guardian," which have elected to file a consolidated return. One of Guardian's domestic subsidiaries, Interguard Holding Corp. ("IHC") is the sole shareholder of Guardian Industries Europe, S.a.r.l. ("GIE"), a Luxembourg company. In 2001, the Internal

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[135] Reg. § 1.901-2T(e)(5)(iv) (2008).

[136] Reg. § 1.901-2T(e)(5)(iv)(D)(Ex.1) (2008).

Revenue Service ("IRS") approved an election by GIE under Treas. Reg. § 301.7701-3(a) [Ed. check-the-box regulations] to be treated as a foreign eligible entity with a single owner and to be disregarded as an entity separate from IHC. GIE holds a controlling interest in and is the parent of a number of Luxembourg subsidiaries. The question here is whether Guardian can claim a credit for certain foreign taxes paid by GIE.

For tax year 2001, GIE paid 3,429,074 Euros in Luxembourg income taxes ("loi de l'impôt sur le revenu" or "LIR") on behalf of itself and its subsidiaries. Guardian had first filed its 2001 tax return treating the Luxembourg tax paid by GIE on behalf of itself and its subsidiaries as allocable *pro rata* among GIE and its subsidiaries, and claimed a credit only for that portion of the tax allocable to GIE itself. Then, in an amended U.S. tax return for tax year 2001, Guardian, pursuant to I.R.C. § 901, claimed it was entitled to a credit in the amount of Luxembourg taxes paid by GIE on behalf of both itself and its subsidiaries. Having obtained no action on its request for a refund, Guardian filed a complaint in the Court of Federal Claims claiming entitlement to a refund of taxes paid.

The government made two arguments in the Court of Federal Claims, relying on two regulations. The first regulation provides in relevant part that "[t]he person by whom tax is considered paid for purposes of [I.R.C.] section[]901 . . . is the person on whom foreign law imposes *legal liability* for such tax, even if another person (e.g., a withholding agent) remits such tax." Treas. Reg. § 1.901-2(f)(1) (emphasis added). The government argued that, under Luxembourg law, GIE's subsidiaries were legally liable for taxes on the income they had earned, even though GIE paid those taxes on the subsidiaries' behalf, and that therefore Guardian was not entitled to a foreign tax credit with respect to those taxes. The second regulation provides that if a corporation and its subsidiaries are jointly and severally liable for a tax under foreign law, then each entity is liable "for the amount of the foreign income tax that is attributable to its portion of the base of the tax." Treas. Reg. § 1.901-2(f)(3). With respect to this regulation the government argued that, under Luxembourg law, GIE and its Luxembourg subsidiaries were jointly and severally liable for the LIR tax, and consequently that Guardian could not obtain a credit for taxes paid by GIE on the subsidiaries' behalf.

The Court of Federal Claims, relying on the text of the Luxembourg statutes and regulations and on reports and declarations of several well-qualified experts in Luxembourg law presented by both sides, concluded that Luxembourg law did not make GIE and its subsidiaries jointly and severally liable for the taxes under Treas. Reg. § 1.901-2(f)(3). While the Court of Federal Claims stated that GIE, the parent, was liable for the tax, it did not address in any detail the government's other argument that, under Treas. Reg. § 1.901-2(f)(1), the subsidiaries, and not the parent, were "the person on whom foreign law imposes legal liability for such tax." The Court of Federal Claims granted summary judgment for Guardian and entered judgment in Guardian's favor in the amount of $ 2,729,268.00 for overpayments, with interest. The government timely appealed. We have jurisdiction pursuant to 28 U.S.C. § 1295(a)(3) (2000).

DISCUSSION

On appeal the government does not challenge the determination of the Court of Federal Claims that, under Luxembourg law, GIE and its subsidiaries are not jointly and severally liable for the taxes paid by GIE, and that consequently, Treas. Reg. § 1.901-2(f)(3) does not require apportionment of the tax. Rather, the government's sole argument is that, pursuant to Treas. Reg. § 1.901-2(f)(1), GIE did not have "legal liability" for the tax imposed on its subsidiaries within the meaning of the regulation, and, therefore, Guardian cannot claim a credit for the tax imposed on GIE's subsidiaries. "We review the Court of Federal Claims' decisions on summary judgment and conclusions of law without deference." *Old Stone Corp. v. United States*, 450 F.3d 1360, 1367 (Fed. Cir. 2006).

As noted, Treas. Reg. § 1.901-2(f)(1) states in relevant part that "[t]he person by whom tax is considered paid for purposes of [I.R.C.] section[] 901 . . . is the person on whom foreign law imposes legal liability for such tax, even if another person (e.g., a withholding agent) remits such tax." The regulation on its face distinguishes between two situations. In one the person paying the tax is merely a withholding agent (or similarly, a remittance agent) and is paying the tax on behalf of another person who is legally liable for the tax. In the other the person paying the tax is the person with "legal liability for such tax." Treas. Reg. § 1.901-2(f)(1).

The line separating a person who is liable for the tax and a person who is merely a withholding or remittance agent is a difficult one to draw, and the regulation itself provides no guidance. Rather, the regulation mandates an inquiry into "foreign law" to determine which situation exists. Treas. Reg. § 1.901-2(f)(1). The determination of foreign law is a question of law which we review *de novo*. . . .

II

The government argues that the parent here should be treated as a mere collection or remittance agent, relying on several Tax Court cases involving foreign tax credits. In virtually all of these cases the tax years in question predated the adoption of section 1.901-2 of the regulations in 1983, *see* 48 Fed. Reg. 46,272 (October 12, 1983), and the decisions did not interpret the regulation. Rather they appeared to apply generally the same test later incorporated in the regulations. * * *

Since the regulation points us to the "foreign law" to determine which entity has legal liability for the tax imposed, we turn to the specific provisions of Luxembourg law.

III

[Ed.The court quoted the following provision of Luxembourg law as key to the case: "The parent company is liable for corporate income tax corresponding to taxable income of the group."] The statement that the parent company is "liable" seems dispositive, since Treas. Reg. § 1.901-2(f)(1) points to "the person on whom foreign law imposes legal liability for such tax." Thus paragraph (4) of the Grand Ducal decree seems to conclusively answer the question posed by Treas. Reg. § 1.901-2(f)(1) by providing that the parent company—GIE in this case—is the party "liable" for the tax. * * *

IV

However, the government argues that Treas. Reg. § 1.901-2(f)(1) creates a regime under which the party liable for the tax within the meaning of the regulation is the party that earns the income under Luxembourg law. The government explicitly argues that "'the person on whom foreign law imposes legal liability for such tax' [] is the person whose income is subject to the tax, not the person who is legally responsible for paying the tax." The government points out that the testimony of Guardian's own expert, Mr. Carlo Mack, established that the income being taxed under Luxembourg law is the income of the subsidiaries, and that under Luxembourg law, "[t]he tax law doesn't provide an effective transfer of income earned by the subsidiaries." *Id.* at 31. Similarly, the government's expert, Mr. Elvinger, testified that the income of the subsidiaries is not attributed to the parent under Luxembourg law. Thus, the government argues, since the subsidiaries earn their income under Luxembourg law, they should be treated as "liab[le]" for the tax on that income under the Treasury regulation. Treas. Reg. § 1.901-2(f)(1).

We reject the government's argument. There is no indication that the applicable Treas. Reg. § 1.901-2(f)(1) contemplates an inquiry into which party earns the income under foreign law. . . . The Treasury has

the ability to draft a regulation that specifically calls for such a regime, and it has not done so here.[137] In fact, Treas. Reg. § 1.901-2(f)(3), requiring allocation of the credit where the liability is joint and several, specifically requires that the allocation be based on the "amount of the foreign income tax that is attributable to [a person's] portion of the base of the tax." Tellingly no similar language appears in Treas. Reg. § 1.901-2(f)(1).

The government finally argues that we should adopt its "earnings" interpretation of the regulation because that interpretation, in its view, would further the policy of the foreign tax credit, which is to avoid double taxation. *See United States v. Goodyear Tire and Rubber Co.,* 493 U.S. 132, 139, 110 S. Ct. 462, 107 L. Ed. 2d 449 (1989) (describing the purpose of the foreign tax credit as "protection against double taxation"). The government contends that that purpose would be frustrated by allowing Guardian to claim a credit in 2001 for taxes paid by the subsidiaries, when the income of the subsidiaries has never been taxed in the United States.

The government's appeal to the policy underlying the foreign tax credit is unavailing. The government's argument appears to assume that if its proposed "earnings" test were adopted, the allowance of the credit would avoid double taxation. We fail to see why this would be so. United States taxation of the income of a disregarded foreign subsidiary does not depend on the provisions of foreign law as to which entity "earns" the income. Thus under an "earnings" regime the credit could be available even if there were no United States tax on the income giving rise to the credit. In any event, the regulation is clear on its face, and we must interpret it as written.

We therefore hold that, based on the text of the relevant regulations and the Luxembourg laws, GIE is the party liable for the tax under Luxembourg law, within the meaning of Treas. Reg. § 1.901-2(f)(1), and that consequently the Court of Federal Claims correctly held that the government was obligated to pay the refund.

Questions

1. Do you think that "rebated" taxes, as provided in the corporate integration systems of countries such as the United Kingdom, are properly creditable? Is credit blocked under Code section 901(j) and Reg. § 1.901-2(e)(3)?

2. Does Code section 901(k) reflect sound tax policy? Why do you suppose it was so slow in coming?

3. What is the proper use of the "plain meaning" doctrine of statutory interpretation? Does it matter, in applying that doctrine, whether that statute is a simple or complex one? How should a court establish the plain meaning? Should it look to context, as supplied by the legislative history? By contemporaneous rules or regulations? By commentators? By other courts? Any difference in applying that doctrine to the interpretation of Treasury Regulations?

4. Is the plain meaning doctrine a pro-taxpayer doctrine, used to justify results that cannot be justified by reference to tax policy or legislative intent? Is the doctrine a one-way street, to by invoked by the taxpayer

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[137] The Treasury has recently proposed modifying Treas. Reg. § 1.901-2(f)(1). 71 Fed. Reg. 44,240 (Aug. 4, 2006). The new regulation would provide that "[i]ncome tax . . . is considered paid for U.S. income tax purposes by the person on whom foreign law imposes legal liability for such tax. In general, foreign law is considered to impose legal liability for tax on income on the person who is required to take the income into account for foreign income tax purposes." *Id.* at 44,243. We take no position on whether this new regulation, if adopted, would provide that the party liable for the tax is the party that, under foreign law, earns the income taxed. [Ed. No action has been taken on this proposed regulation as of February 28, 2010.]

but not by the tax authorities? Would *SDI Netherlands* have been decided for the taxpayer under a plain meaning approach?

5. In *Guardian Industries*, the law of Luxembourg, a famous tax haven, allows the parent company of a Luxembourg consolidated group to be treated as the entity legally liable for the tax imposed by Luxembourg on the income of the affiliated companies. In that case, the parent company checked the box to be treated as a branch of its U.S. parent. This "foreign branch" then claimed the credit for the tax attributed to it under Luxembourg law. The income of the affiliated companies was not subject to U.S. tax. As a result, Guardian was able to claim a credit for taxes paid to Luxembourg with respect to income that was not subject to U.S. tax. Obviously, this result is contrary to the purpose of the foreign tax credit. Was the court in *Guardian Industries* correct in its interpretation of U.S. law? Was it correct that the regulation is clear on its face so that a discussion of policy was inappropriate?

6. The court in *Guardian Industries* noted that Reg. § 1.901-2(f)(3), which deals with two or more related persons, such as a husband and wife or a corporation and its subsidiaries, that are jointly and severally liable for a tax, provides that each taxpayer is treated as liable for the tax for purposes of the credit in proportion to its share of the income with respect to which the tax was imposed. This is the answer that the government asserted was intended as the general rule under Reg. § 1.901-2(f)(1). The court found it "telling" that Reg. § 1.901-2(f)(1) did not include the link set forth in Reg. § 1.901-2(f)(3). What is telling about the failure of Reg. § 1.901-2(f)(1) to include the specific statement contained in Reg. § 1.901-2(f)(3)? The court seems to believe it shows that the regulation writers did not want the result provided in Reg. § 1.901-2(f)(3). Is that inference warranted? Is it totally nonsensical to draw such an inference?

7. How should the government respond to its loss in *Guardian Industries*? See Code section 909, added in 2010.

Chapter 19
Indirect or Deemed-Paid Credit

U.S. corporations frequently conduct foreign investment and business operations abroad through affiliated corporations organized under the laws of a foreign country. Such foreign affiliates typically pay foreign income taxes on their taxable income. Code section 902 grants an indirect, or deemed-paid, foreign tax credit to U.S. corporations earning taxable income through foreign affiliates for the foreign income taxes paid by those affiliates on their income. A U.S. corporation may claim the indirect credit when its foreign affiliate distributes its earnings and profits as a dividend.

The rules governing the allowance of an indirect credit are explained in the sections below. Section 19.01 describes the basic rules. To simplify the presentation of those rules, the assumption is made throughout that section that the foreign affiliate paying foreign income taxes has not accumulated any earnings and profits prior to the year in which it pays a dividend to its U.S. corporate shareholder. In such circumstances, a U.S. corporation receiving a dividend from a foreign affiliate would obtain an indirect credit under Code section 902 only for foreign income taxes paid in the current taxable year.

Many foreign affiliates of U.S. corporations retain some or all of their earnings and profits for some period after the taxable year in which those profits were earned. In such circumstances, tracing rules are necessary for associating foreign income taxes paid by a foreign affiliate with the dividends received by its U.S. parent corporation. Section 19.02 describes those tracing rules.

The basic tracing rule used in the Code for associating dividends received from a foreign affiliate with foreign income taxes paid by that affiliate was adopted by the 1986 tax act. Under that tracing rule, foreign income taxes paid after 1986 by a foreign affiliate are attributed pro rata to the post-1986 undistributed earnings of that foreign affiliate. The post-1986 undistributed earnings of a foreign affiliate are its earnings and profits accumulated from the end of 1986 to the end of the taxable year in which the dividend is distributed, undiminished by dividends paid during that taxable year. The definition of post-1986 undistributed earnings depends upon the definition of earnings and profits. Section 19.03 discusses that latter definition.

§ 19.01. General Rules

The indirect credit is generally available only to U.S. corporations receiving dividends from a foreign corporation. A foreign corporation that is able to generate an indirect credit for a U.S. corporate shareholder is referred to in this chapter as a foreign affiliate of that corporate shareholder. Except in quite unusual circumstances, resident individuals and citizens cannot claim an indirect credit.[138]

A U.S. parent corporation is allowed to claim an indirect credit at the time it receives a dividend from its foreign affiliate. The amount of the creditable tax is the percentage of the qualifying income tax paid, or deemed paid, by the foreign affiliate that is attributable to its earnings and profits distributed as a dividend

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[138] Under some conditions, an individual can elect to be treated as a corporation, and thus qualify for the indirect credit, with respect to certain liquidating distributions taxable under IRC § 1248 and certain deemed-paid dividends from a CFC taxable under subpart F. See IRC §§ 962 and 1248(b).

to the U.S. parent.[139] To qualify for the credit, the foreign tax paid by the foreign affiliate must satisfy the requirements for a creditable income tax or in-lieu tax set forth in chapter 18.

Section 19.01.1, below, explains how the indirect credit works in the simple case of a wholly owned foreign subsidiary distributing all of its after-tax profits to its U.S. parent corporation in the year the profits are earned. That section also explains the so-called gross-up rule. Under that rule, a U.S. corporation claiming an indirect credit is taxable not only on the dividend it receives from its foreign affiliate but also on the foreign income taxes associated with that dividend.

The indirect credit may be taken by a U.S. corporation for foreign income taxes paid by a foreign corporation if certain ownership tests are met. Under these tests, credit may be taken with respect to foreign income taxes paid by foreign corporations owned directly by the U.S. corporation or owned indirectly through ownership of stock of other foreign corporations in a chain of foreign corporations. Section 19.01.2 discusses these stock ownership requirements.

Section 19.01.3 describes the conditions under which a U.S. corporation may claim a credit for foreign income taxes paid by second-tier through sixth-tier foreign corporations. Section 19.01.4 explains how a U.S. corporation would compute its allowable credit when it receives a dividend of less than the full amount of its foreign affiliate's earnings and profits for the year.

For simplicity, the assumption is generally made in sections 19.01.1 through 19.01.4 that the earnings and profits of a foreign affiliate for the current taxable year are equal to its taxable income minus its foreign income taxes paid. In real life, the Code requires certain adjustments in the earnings and profits of a corporation to take account of economic gains excluded from the definition of taxable income. The effects on the indirect credit of such adjustments are described in section 19.01.5.

§ 19.01.1. Computing the Indirect Credit: The Simple Case

The indirect credit allows a U.S. corporation operating abroad through a foreign affiliated corporation to claim a credit for foreign income taxes paid by that affiliate. The credit reduces the U.S. tax otherwise imposed on dividends received from a foreign affiliate by the amount of the foreign income taxes paid on the profits distributed by the affiliate as a dividend. According to the leading commentators, the purpose of the indirect credit is to "equalize the tax burden on domestic corporations operating abroad through subsidiary foreign corporations with the tax burden on domestic corporations operating abroad directly."[140]

In fact, the indirect credit cannot achieve the purpose set forth above because of differences unrelated to the credit in the tax treatment of branch profits and profits earned through a foreign affiliate. One major difference is that income earned through a branch is taxable in the year earned, whereas income earned through a foreign affiliate is not taxable unless it is received as a dividend. Thus taxable income earned through a foreign affiliate enjoys a deferral benefit whenever the foreign affiliate is subject to an effective tax rate below the U.S. rate and retains some portion of its taxable income beyond the taxable year in which it was earned.

The Code also applies different source of income rules to profits earned directly by a U.S. corporation and profits earned indirectly through a foreign affiliate. The profits of a U.S. corporation derived from operations within the United States generally would be classified as U.S. source income, even if that

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[139] An indirect credit is not allowed on the receipt of a liquidating dividend from a foreign affiliate if the dividend is taxed as a capital gain. The special capital gains rate for corporations was repealed in the 1986 tax act. See IRC § 1248.

[140] Elisabeth A. Owens & Gerald T. Ball, *The Indirect Credit* (1975) at 4.

corporation also earned substantial income through the operation of a foreign branch. In contrast, the source of income derived by a U.S. corporation through a foreign affiliate generally is treated as dividend income, with the source determined by reference to the place of incorporation of the foreign affiliate. Thus, a foreign affiliate that earned a portion of its income (less than 25 percent) from business operations within the United States would generate foreign source income for its U.S. parent company on that U.S.-related income,[141] whereas the identical U.S.-related income earned directly by the U.S. corporation would be U.S. source income.[142]

The Code rules governing the indirect credit are designed to achieve a more limited purpose than the one set forth above. That limited purpose is to equalize the U.S. tax imposed on the foreign source taxable income of a U.S. corporation earned through a branch with the U.S. tax imposed on an equal amount of taxable income earned through a foreign affiliate and distributed by that affiliate to the U.S. corporation.[143] To advance this limited purpose, the Code requires U.S. corporations claiming an indirect credit for taxes paid by a foreign affiliate to include in income not only the amount of the dividend they receive from that affiliate but also the amount of the foreign income taxes that are attributable to that dividend.[144]

The process of increasing the taxable income of a U.S. corporation by the amount of the foreign income taxes attributable to a dividend received by that corporation from a foreign affiliate is referred to as "grossing up" the dividend. The amount taxable on account of this gross-up rule is called the gross-up amount. The following example illustrates the operation of the indirect credit, including the operation of the gross-up rule, in the case of a dividend received from a wholly owned foreign subsidiary.

Example 19.1: Grossing up a Dividend

PCo and QCo are both U.S. corporations. PCo has a wholly owned foreign subsidiary, FCo, that earns foreign source taxable income of $100. QCo earns foreign source taxable income of $100 directly. FCo and QCo both paid a foreign income tax of $25. FCo's earnings and profits are $75, computed by subtracting the $25 of foreign taxes paid from its taxable income of $100. FCo distributes those earnings and profits to PCo as a dividend.

QCo has a tentative U.S. tax liability of $35 (35% of $100) and can claim a direct credit of $25 for its foreign taxes paid. Its final U.S. tax liability is $10 ($35 minus $25). PCo also has a final U.S. tax liability of $10, computed as follows:

(1) Dividend received by PCo from FCo $75

(2) Foreign taxes paid by FCo that are associated with the dividend paid to PCo (gross-up amount) 25

(3) Taxable income of PCo (line (1) + line (2)) 100

(4) PCo's tentative U.S. tax (U.S. tax rate × line (3)) 35

[141] If a foreign affiliate earned more than 25 percent of its income over a three-year testing period from business operations within the United States, a portion of its dividends would have a U.S. source.

[142] Resourcing rules may prevent a U.S. corporation from changing the source of income derived in the United States by channeling that income through a foreign affiliate. The resourcing rules, however, have limited applicability.

[143] This purpose has little intuitive appeal. Thus, the indirect credit rules designed to achieve it have little appeal.

[144] IRC § 78. The gross-up rule is now widely accepted as a proper part of the U.S. indirect credit system and is used by virtually all foreign governments that provide an indirect credit. When the rule was adopted in 1962, however, major segments of the U.S. tax community protested bitterly, claiming its enactment would violate U.S. treaty obligations and the U.S. Constitution.

(5) Indirect credit for foreign taxes paid by FCo (lesser of line (2) and line (4)) 25

(6) Net U.S. tax on PCo (line (4) – line (5)) 10

(7) Total U.S. and foreign income taxes paid by PCo (line (2) + line (6)) 35

In the example above, the effect of the gross-up rule is to make PCo taxable on an amount equal to the taxable income earned by FCo. Without the gross-up rule, PCo would have avoided tax on that portion of FCo's taxable income that FCo used to pay its foreign income taxes.

The gross-up rule does not eliminate all differences in the tax treatment of foreign source taxable income earned by a U.S. corporation through a foreign branch and taxable income earned through a foreign subsidiary and received as a dividend. The amount taxable to a U.S. corporation on a distribution from a foreign affiliate and the amount of the foreign income taxes associated with such a dividend depends on the amount of the foreign affiliate's earnings and profits. Under the facts of *Example 19.1*, the earnings and profits of the foreign affiliate equaled its taxable income minus its foreign income taxes paid. Section 19.01.5, below, describes the effects on the indirect credit when that relationship between the earnings and profits and the taxable income of a foreign affiliate does not exist.

§ 19.01.2. Ownership Requirements

A foreign affiliate, some or all of whose shares are owned by a U.S. parent corporation, is called a first-tier foreign corporation.[145] A foreign affiliate owned indirectly by a U.S. parent through its ownership of voting shares of a first-tier foreign corporation is called a second-tier foreign corporation. A third-tier foreign corporation is one owned indirectly by a first-tier foreign corporation through its ownership of voting shares of a second-tier foreign corporation.[146] This pattern continues indefinitely, so that a sixth-tier foreign corporation is one owned by a fifth-tier foreign corporation.

Under certain conditions, a U.S. parent corporation can claim credit for income taxes paid by foreign affiliates that qualify as first-tier through sixth-tier corporations.[147] Taxes paid by foreign affiliates more remote from the U.S. parent company than the sixth tier are not eligible for the indirect credit.

To claim a credit for taxes paid by a first-tier foreign corporation, the U.S. parent corporation must hold shares representing 10 percent or more of the voting stock of that corporation.[148] To qualify for an indirect credit for taxes paid by second-tier and third-tier foreign corporations, the U.S. parent corporation must own indirectly at least 5 percent of the voting stock of the foreign corporation that paid the tax.

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[145] In general, the U.S. corporation must own the stock of the foreign affiliate directly. Stock that a U.S. corporation owns through ownership of a partnership interest, however, is counted as being owned by the U.S. corporation.

[146] Reg. § 1-902-1(a)(2)–(4) (2009).

[147] When the indirect credit was adopted in 1918, only taxes paid by a first-tier foreign corporation could qualify for the indirect credit, and the U.S. parent corporation was required to own a majority of the shares in its first-tier corporation. In 1942, the indirect credit was extended to taxes paid by wholly owned second-tier corporations. In 1951, the 10% rule was introduced for first-tier subsidiaries and a 50% rule was introduced for second-tier subsidiaries. In 1971, the indirect credit was extended to taxes paid by third-tier subsidiaries, and the present ownership rules were introduced. See Elisabeth A. Owens & Gerald T. Ball, *The Indirect Credit* (1975) 30-31. In 1997 the credit was extended through the sixth tier, under rules described in the text.

[148] IRC § 902(a). Related U.S. corporations that form an affiliated group cannot pool their stock ownership in a foreign affiliate to meet the 10-percent voting stock requirement. See *First Chicago NBD Corp. v. Comm'r*, 135 F.3d 457 (7th Cir. 1998), aff'g sub nom *First Chicago Corp. v. Comm'r*, 96 T.C. 421 (1991) (upholding Rev. Rul. 85-3, 1985-1 C.B. 222 and giving "respectful consideration" to positions taken by the tax authorities in a revenue ruling).

In addition, each foreign corporation in the corporate chain, beginning with the first-tier foreign corporation and ending with the foreign affiliate that paid the tax, must be owned directly, to the extent of 10 percent of its voting stock, by the corporation above it in the chain.[149]

The rules for claiming credit for fourth-tier, fifth-tier, and sixth-tier foreign affiliates are stricter than the rules described above. In addition to the 10-percent ownership rule, the Code requires that the foreign corporation be a controlled foreign corporation (CFC) and that the U.S. taxpayer be a U.S. shareholder with respect to that CFC.[150] In the typical case, the U.S. taxpayer would own indirectly more than 50 percent of the stock of the fourth-, fifth-, or sixth-tier corporation. Credit is not permitted for any period that the lower-tier corporation was not a CFC.[151]

The example below illustrates the operation of the stock ownership requirements for claiming the indirect credit. The example describes the case of a U.S. parent company (first tier), a foreign subsidiary of that company (second tier) and a subsidiary of the foreign subsidiary and a sub-subsidiary of the parent (third tier). A similar pattern occurs for subsidiaries beyond the third tier up to the sixth tier.

Example 19.2: Stock Ownership Requirements

PCo, a U.S. corporation, owns 30 percent of the voting stock of foreign corporation FCo. FCo, in turn, owns 35 percent of the voting stock of foreign corporation SCo. SCo owns 40 percent of the voting stock of foreign corporation TCo. Each of the foreign corporations in the corporate chain is owned, to the extent of 10 percent or more of its voting stock, by the corporation directly above it in that chain. PCo has the required 5 per cent or more indirect ownership in SCo, the second-tier foreign corporation, but not in TCo, the third-tier corporation, determined as follows:

(1) PCo's direct ownership in FCo (first tier) 30.0%

(2) PCo's indirect ownership in SCo (second tier) (35% of 30%) 10.5%

(3) PCo's indirect ownership in TCo (third tier) (40% of 10.5%) 4.2%

PCo can take a credit for income taxes paid by FCo and SCo, but it cannot take a credit for taxes paid by TCo because its ownership interest in TCo (4.2 %) is less than 5 percent.

An analogy to the direct credit cannot justify an indirect credit for taxes paid by foreign affiliates that are not wholly owned by the U.S. corporation claiming the credit. A branch, after all, is necessarily owned in full by the corporation of which it is a part. The rules allowing an indirect credit for affiliates owned only in part by the U.S. corporation claiming the credit have traditionally been defended by analogy to the dividends received deduction. Like the dividends-received deduction, the indirect credit eliminates multiple levels of taxation at the corporate level while preserving the dual taxation of corporate income at the corporate and individual shareholder levels.

Taxpayers may invoke the analogy to the dividends received deduction to call into question any minimum ownership requirements for claiming the credit for taxes paid by a foreign affiliate. The present ownership requirements are generally justified on grounds of administrative economy. The credit rules might be too complex to administer if they were applied to holders of portfolio stock. Of course an

[149] IRC § 902(b).

[150] IRC § 902(b)(2).

[151] Id.

argument might also be made that the rules governing the dividends received deduction are too liberal. Some commentators have suggested that a corporation receiving a dividend from another corporation should meet some minimum ownership requirements to qualify for the dividends received deduction.[152]

A full dividends-received deduction is not available except for dividends received by a corporation from a member of its corporate group. For other corporations, that deduction was limited for many years to 85 percent of dividends paid. Recent reforms have reduced the deduction to 70 percent of dividends paid in the general case.[153] A deduction for 80-percent of dividends received is permitted for distributions from so-called 20-percent owned corporations.[154] Thus an analogy to the dividends received deduction would suggest that U.S. corporations receiving a dividend from a foreign affiliate should get something less than a full indirect credit if they own less than 100 percent of the stock of that affiliate.[155]

A foreign corporation partially owned by a U.S. corporation might be analogized to a partnership. That analogy suggests that the ownership rules are inappropriate, absent administrative constraints, because a U.S. corporation is allowed to claim a credit with respect to its share of the foreign income taxes paid by a foreign partnership without reference to any minimum ownership rules. The weakness in the analogy is that a partner typically is taxable currently on the income earned by the partnership.

§ 19.01.3. Credit for Taxes Paid by Second-Tier through Sixth-Tier Foreign Corporations

The indirect credit granted to a U.S. parent corporation for taxes paid by its second-tier through sixth-tier foreign corporations operates according to the same principles as the credit for taxes paid by a first-tier corporation. The foreign income taxes of second-tier and lower-tier corporations become available for a credit when the earnings and profits with which they are associated are received as a dividend by the U.S. parent.

To compute the deemed-paid credit with respect to foreign income taxes paid by a second-tier foreign corporation, the U.S. parent corporation must make three calculations. *First*, it must compute the amount of foreign income taxes paid by the second-tier corporation that are deemed to be paid by the first-tier corporation, following the method illustrated in *Example 19.1*. *Second*, the U.S. parent must take the sum of (1) the foreign income taxes deemed paid by the second-tier corporation and (2) the foreign income taxes actually paid by the first-tier corporation.

The *third* and final step is for the U.S. parent corporation to gross up the dividend it received from the first-tier foreign corporation by the amount of the first-tier and second-tier foreign income taxes that it is deemed to have paid. This three-step procedure is illustrated in the example below. For a distribution of profits from a lower-tier corporation, the same pattern is followed, but with an additional step to take account of the taxes paid with respect to earnings and profits distributed by the lower-tier foreign corporation.

Example 19.3: Distributions from a Second-Tier Corporation

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[152] See American Law Institute, FEDERAL INCOME TAX PROJECT-SUBCHAPTER C, "Reporter's Study of the Taxation of Corporate Distributions" (1982) at 354-355 (Reporter's Proposal R3), reproduced in relevant part in Michael J. McIntyre, Frank E.A. Sander & David Westfall, READINGS IN FEDERAL TAXATION (1983) at 608-622.

[153] IRC § 243(a)(1). [17]IRC § 243(c).

[154] See IRC § 243.

[155] The credit given against the minimum tax previously provided for less than a full credit for taxes paid by a foreign affiliate.

PCo, a U.S. corporation, has a wholly owned first-tier foreign subsidiary FCo, which in turn has a wholly owned second-tier foreign subsidiary SCo. For the taxable year, SCo has taxable income of $400 and pays foreign income taxes of $100. It has earnings and profits for the year of $300 ($400 minus $100) and has no accumulated earnings and profits. It distributes $300 to FCo as a dividend.

During the same taxable year, FCo has net business profits of $500 and the dividend from SCo, for total taxable income of $800. It pays foreign taxes of $200, and its earnings and profits for the year are $600 ($500 + $300 – $200). FCo distributes $600 to PCo as a dividend. The indirect credit available to PCo for the income taxes paid by FCo and SCo is $300, computed as follows:

(1)	Earnings and profits of SCo	$300
(2)	Dividend paid by SCo to FCo	300
(3)	Foreign income taxes paid by SCo and deemed-paid by FCo	100
(4)	Earnings and profits of FCo	600
(5)	Dividend paid to PCo by FCo	600
(6)	Foreign taxes paid by FCo	200
(7)	Foreign taxes actually paid by FCo and deemed paid by FCo (line (6) + line (3))	300
(8)	Foreign income taxes deemed paid by PCo (line (7))	300

Assuming that PCo has no taxable income aside from the dividend from FCo, its net U.S. tax is $15, computed as follows:

(9)	Dividend received by PCo (line 5)	$600
(10)	Foreign taxes deemed paid by PCo (line (8), gross-up amount)	300
(11)	Taxable income of PCo (line (9) + line (10))	900
(12)	Tentative U.S. tax (U.S. tax rate × line (11))	315
(13)	Credit for foreign taxes (lesser of line (10) and line (12)	300
(14)	Net U.S. tax (line (12) – line (10)	15

§ 19.01.4. Dividends Comprising a Fraction of the Earnings and Profits of the Distributing Foreign Corporation

In many circumstances, a U.S. corporation will receive as a dividend less than all of the earnings and profits of its foreign affiliate, either because the foreign affiliate retains some of its profits or because the U.S. corporation is not the only shareholder of the foreign affiliate. When a U.S. corporation receives only a portion of a foreign affiliate's profits, the U.S. parent is entitled to an indirect credit for that portion of the foreign income taxes associated with the dividend it has received.

The amount of the foreign income taxes associated with a dividend received by a U.S. corporation from a foreign affiliate is that portion of the foreign income taxes attributable to the earnings and profits out of which the dividends were paid. That amount, which is the amount qualifying for an indirect credit, can be

determined from the following formula: C = T × D/P where C is the amount of the indirect credit, T is the amount of the foreign income taxes paid by the foreign affiliate, D is the amount of the dividends received by the U.S. corporation, and P is the earnings and profits of the foreign affiliate out of which the dividend was paid. The example below illustrates the operation of that allocation formula in the case of a U.S. corporation received a distribution of a fraction of the earnings and profits of a chain of foreign affiliates.

Example 19.4: Allocation of Foreign Taxes to Dividends Paid

PCo, a U.S. corporation, has a wholly owned first-tier foreign affiliate, FCo, which in turn has a wholly owned second-tier foreign affiliate, SCo. For the taxable year, SCo has taxable income of $390, pays foreign income taxes of $80, and has earnings and profits for the year of $310 ($390 minus $80). SCo has no accumulated earnings and profits.

SCo distributes a dividend of $155 to FCo. During the same year, FCo also has net business profits of $255, for total taxable income of $410 ($155 + $255). FCo pays foreign income taxes of $110. Its earnings and profits for the year are $300 ($410 – $110), and it has no accumulated earnings and profits. FCo pays a dividend to PCo of $200. PCo can claim an indirect credit of $100 for the foreign income taxes paid by FCo and SCo, computed as follows:

(1)	Foreign income taxes paid by SCo	$80
(2)	Dividend paid by SCo to FCo	155
(3)	Earnings and profits of SCo	310
(4)	Portion of foreign income taxes paid by SCo that are allocated to the dividend paid to FCo and are deemed paid by FCo (line (1) × line (2)/line (3))	40
(5)	Foreign income taxes actually paid by FCo	110
(6)	Foreign taxes paid by FCo and paid by SCo that are deemed paid by FCo (line (4) + line (5))	150
(7)	Dividend paid by FCo to PCo	200
(8)	Earnings and profits of FCo	300
(9)	Portion of foreign taxes paid and deemed paid by FCo allocated to the dividend received by PCo and deemed paid by PCo (line (6) × line (7)/line (8))	100

If PCo has no taxable income aside from the dividend from FCo, its net U.S. tax is $5, computed as follows:

(10)	Gross-up amount (line (9)	$100
(12)	Taxable income of PCo (line (7) + line (10))	300
(13)	Tentative U.S. tax (U.S. tax rate × line (12))	105
(14)	Indirect credit for foreign income taxes paid or deemed paid by FCo and deemed paid by PCo (line (9))	100
(15)	Net U.S. tax (line (13) – line (14))	5

A U.S. parent corporation owning less than 100 percent of the stock of a foreign affiliate would not be entitled to a credit for the entire tax paid by the affiliate. Under the allocation formula set forth above ($C = T \times D/P$), the U.S. parent corporation would receive a credit only for the amount of the foreign income taxes associated with the dividend it received. The example below illustrates the operation of that formula when a U.S. corporation owning a fraction of the stock of a foreign affiliate receives a dividend paid out of a fraction of the entire earnings and profits of the foreign affiliate.

Consider PCo, a U.S. corporation, that owns 50 percent of FCo, a foreign corporation. FCo pays foreign income taxes of $100 on its taxable income of $500. FCo's earnings and profits for the current year are $400 ($500 minus $100), and it has no accumulated earnings and profits. FCo distributes one-half of its after-tax profits of $400 to its shareholders, with PCo receiving a dividend of $100. Under the allocation formula presented above, PCo would be allowed an indirect credit of $25 ($100 × $100/$400). The effect of this formula is to allocate $50 of the taxes paid by FCo to the $200 of earnings and profits distributed as a dividend, and then to allocate that $50 among the shareholders of FCo in proportion to their stock holdings.[156]

Prior to 1976, a U.S. parent receiving a dividend from a foreign affiliate applied a different method of computing the indirect credit if the source of the income of the foreign affiliate paying the dividend was a developing country. That method, generally applicable to all dividends prior to 1962, was established in the *American Chicle* case.[157]

Under the *American Chicle* method, the gross-up amount was not included in the income of the U.S. corporation claiming the indirect credit, and the foreign income taxes paid with respect to the gross-up amount were not creditable. Although widely understood to be faulty, the *American Chicle* method was retained in 1962 for dividends paid out of earnings and profits derived from developing countries. Congress was led to believe that the limited retention of the *American Chicle* method would provide an incentive to investment in such countries. That method still has some application for profits earned before 1976.[158]

§ 19.01.5. Consequences of a Disharmony Between Earnings and Profits and After-Tax Taxable Income

The term "after-tax taxable income" is used here to refer to the taxable income of a foreign affiliate, computed according to U.S. tax concepts, reduced by the foreign income taxes paid with respect to that income. The discussion in sections 19.01.3 and 19.01.4 — indeed, through this book — is based on the simplifying assumption that the earnings and profits of a foreign affiliate for any taxable year are equal to its after-tax taxable income for that year. This assumption is unrealistic. Under the Code, many adjustments must be made to after-tax taxable income in calculating the earnings and profits of a corporation. In general, the Code requires a taxpayer to include in its earnings and profits the amount of certain tax preference items

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[156] In *Vulcan Materials Co. v. Comm'r*, 96 T.C. 410 (1991), aff'd without op., 959 F.2d 973 (11th Cir. 1992), Vulcan received a dividend from TVCL, a Saudi Arabian corporation in which Vulcan owned 48% of the stock. The Saudi government owned 32% of the stock and the remaining 20% was owned by U.S. persons. The Saudi government imposed its corporate income tax only on the portion of the profits of TVCL attributable to its U.S. shareholders. In effect, it rebated the portion of the taxes attributed to its share of the profits as an untaxed contribution to capital. The question in the case was whether Vulcan should include the entire accumulated profits of TVCL in the allocation formula or only that portion of the profits (68%) on which a Saudi tax was actually imposed. Vulcan argued for the lower number and was sustained by the courts. Although that result would be appropriate if TVCL were organized as a partnership, it is questionable under the actual facts of the case. The IRS continues to contest the result.

[157] *American Chicle Co. v. U.S.,* 316 U.S. 450 (1942).

[158] For an explanation and criticism of the rules applicable to distributions from income arising in developing countries prior to 1976, see Elisabeth A. Owens & Gerald T. Ball, *The Indirect Credit* (1975) at 102-110.

and to reduce its earnings and profits by nondeductible expenditures that reduce economic gains. The definition of earnings and profits is discussed briefly in section 19.03. This part explains the problems with the indirect credit that arise when the amount of the earnings and profits of a foreign affiliate and the amount of its after-tax taxable income diverge. It also offers a partial solution to those problems. The nature of those problems is illustrated by the following example.

Consider PCo, a U.S. corporation, that owns all of the stock of a foreign affiliate, FCo. During the taxable year, FCo earns taxable income of $100 and tax-exempt income of $50. It pays foreign income taxes of $25 on its taxable income. FCo's earnings and profits for the year are $125, computed by adding the $50 of tax exempt income[159] to the taxable income of $100 and subtracting therefrom the foreign income taxes paid of $25.

FCo distributes $75 to PCo as a dividend. That amount is equal to FCo's after-tax taxable income ($100 minus $25). PCo is taxable on the $75 received, to the extent it constitutes a dividend, and on the gross-up amount. The entire $75 is a dividend because FCo's earnings and profits exceed that amount.

The gross-up amount, taxable to PCo as additional income on receipt of a dividend from FCo, equals the foreign income taxes associated with the earnings and profits out of which the dividend was paid. The foreign income taxes paid by FCo are allocated pro rata to its earnings and profits. The result is that $15 are allocated to the $75 distributed as a dividend ($25 × $75/$125). That is the gross up amount. The amount taxable to PCo is $90 ($75 + $15), and the amount of the indirect credit is $15. PCo's tentative U.S. tax is $31.50 (35% of $90), and its net U.S. tax is $16.50 ($31.50 – $15).

If PCo, in the example above, had directly earned the taxable income of $100, it would have been taxable on $100 and would have been allowed a direct credit of $25. Its tentative U.S. tax would have been $35, and its net U.S. tax would have been $10. Thus the use of a foreign affiliate rather than a foreign branch cost PCo $6.50 ($16.50 minus $10) in taxes.

The U.S. tax due on taxable income earned through a foreign affiliate is a function of the taxable income of the branch. In contrast, the U.S. tax due on taxable income earned through a branch is a function of the dividend received, the gross-up amount, and the amount of the indirect credit. These amounts are functions of the earnings and profits of the foreign affiliate, not of its taxable income, except in the special case of a foreign affiliate whose earnings and profits equals its after-tax taxable income.

In the example above, the use of earnings and profits rather than after-tax taxable income to determine the gross-up amount and the amount of the indirect credit worked to the disadvantage of the U.S. corporation.[160] In other circumstances, however, the current rules would favor the taxpayer, as the following example illustrates.

Assume that FCo, the foreign affiliate in the example above, had earned taxable income of $100, paid foreign income taxes of $25, and had a deduction allowable against earnings and profits but not against taxable income of $15. Its earnings and profits would be $60 ($100 minus $25 minus $15) instead of the $125 of earnings and profits in the example above. Assume also that FCo distributed its earnings and profits of $60 to PCo, its U.S. parent corporation, as a dividend. In that event, the foreign income taxes allocated to the dividend would be $25 ($25 × $60/$60), and PCo would have received an indirect credit for that

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[159] See Reg. § 1.312-6(b) (1960) (requiring exempt income to be included in the computation of earnings and profits).

[160] A well-advised U.S. corporation might be able to avoid the unfavorable result described in the text by arranging to earn its exempt income directly instead of channeling it through the foreign affiliate.

amount. PCo would be taxable on a dividend of $60, which would be grossed up by the $25 of taxes deemed paid. PCo's taxable income would be $85 ($60 + $25), and its tentative U.S. tax would be $29.75 (35% of $85). PCo would pay net U.S. taxes of $4.75 ($29.75 – $25).

For another example of how the use of earnings and profits to determine the gross-up amount and the indirect credit is favorable to the taxpayer, assume that FCo, the foreign affiliate discussed above, had taxable income of $100 and tax exempt income of $50. It paid a foreign income tax of $60. Its earnings and profits were $90 ($100 + $50 minus $60). FCo paid PCo, its U.S. parent corporation, a dividend of $40, which equals its after-tax taxable income ($100 minus $60). The gross-up amount, which equals the foreign income taxes associated with the dividend, would be $26.67 ($60 × $40/$90). PCo would be taxable on $66.67 ($40 + $26.67), and its tentative U.S. tax would be $23.33 (35% of $66.67). It would pay no U.S. tax, and it would have an excess credit of $3.34 ($26.67 – $23.33).[161]

The differences illustrated above in the treatment of branch profits and profits earned through a foreign affiliate cannot be eliminated entirely as long as foreign affiliates are taxable as separate entities. Unwarranted differences could be reduced, however, and the indirect credit rules could be made more coherent, by severing the rules governing the indirect credit from the rules governing the taxation of dividends. Dividends would continue to be defined in terms of distributions out of earnings and profits. The gross-up amount and the amount of the indirect credit of the U.S. parent corporation would be determined, however, by reference to the after-tax taxable income of its foreign affiliate.

In a reformed indirect credit system, all distributions would be presumed to be made out of the accumulated after-tax taxable income, to the extent thereof, of a foreign affiliate. The accumulated after-tax taxable income of a foreign affiliate would be defined as the sum of (1) its after-tax taxable income for prior years, reduced by distributions of after-tax taxable income made in prior years, and (2) its after-tax taxable income for the current year. Foreign income taxes would be allocated pro rata to the accumulated after-tax taxable income of the foreign affiliate. The gross-up amount would be the amount of the foreign income taxes associated with the after-tax taxable income of the foreign affiliate that was received by the U.S. corporation.

Consider, for example, a U.S. corporation, PCo, that has a wholly owned foreign affiliate, FCo. FCo earns $100 of taxable income and pays a foreign income tax of $25. If FCo distributes to PCo its after-tax taxable income of $75, PCo will be taxable on the amount that constitutes a dividend. That amount depends on the amount of FCo's earnings and profits. The gross-up amount, however, would be $25 in the reformed system, determined without reference to FCo's earnings and profits. The amount of the indirect credit would also be $25.

The reforms outlined above would not equalize the U.S. tax burden imposed on U.S. corporations operating through foreign branches with the U.S. tax burden on otherwise similarly situated corporations operating through foreign affiliates. Income earned through a foreign subsidiary might still benefit from deferral and might have its source changed from U.S. source income to foreign source income. In addition, the amount taxable to a U.S. corporation on a distribution from a foreign affiliate would still depend on the earnings and profits of the foreign subsidiary. Under the reformed rules, however, the limited purpose of the indirect credit set forth in section 19.01.1 generally would be achieved. Foreign source taxable income

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[161] An excess credit would be useful to PCo if it had other foreign source taxable income subject to foreign income taxes at an effective rate below the U.S. rate and that other income was in the same limitation basket as the dividend from FCo.

earned by a U.S. corporation through a branch would bear the same U.S. tax as taxable income earned through a foreign affiliate and distributed as a dividend to its U.S. parent corporation.

§ 19.02. Attributing Taxes Paid to Current and Accumulated Earnings and Profits

When a foreign affiliate having only current earnings and profits pays a dividend to its U.S. parent corporation, the U.S. parent corporation is allowed an indirect credit for the portion of the foreign income taxes paid by the foreign affiliate that are attributable to the dividend paid. The amount of the foreign income taxes attributable to a dividend paid out of a fraction of the earnings and profits of a foreign affiliate can be determined by an allocation formula. As explained in section 19.01.4, above, and illustrated by *Example 19.4*, the indirect credit (C) allowable to a U.S. parent corporation equals the amount of the current foreign income taxes paid by the foreign affiliate (T) multiplied by the ratio of the dividend paid (D) to the current earnings and profits of the foreign affiliate (P). That is: $C = T \times D/P$.

The rules governing the indirect credit for dividends paid by a foreign affiliate out of its accumulated earnings and profits are analogous to the treatment of dividends paid out of current earnings and profits. The same allocation formula is used, but the terms T and P are generalized. P becomes the current and accumulated earnings and profits out of which the dividend is paid, and T becomes the amount of the foreign income taxes paid by the foreign affiliate that are attributable to those earnings and profits.

Since 1987, dividends paid by a foreign affiliate to its U.S. parent corporation are traced to a pool of its post-1986 undistributed earnings, and post-1986 foreign income taxes are allocated pro rata to those earnings and profits. The post-1986 earnings pool is the sum of (1) the foreign affiliate's current earnings and profits, determined as of the end of its taxable year and undiminished by current dividends, and (2) its undistributed earnings and profits that have been accumulated since the start of 1987.[162] Post-1986 foreign income taxes are the foreign income taxes paid in the current year or in any taxable year beginning after 1986, but excluding any foreign income taxes associated with previously distributed dividends.[163] The example below illustrates the operation of these tracing rules.

Example 19.5: Dividends Paid out of Post-1986 Undistributed Earnings

PCo, a U.S. corporation, has a wholly owned foreign subsidiary, FCo. FCo pays a dividend of $100 to PCo in year 3. FCo has taxable income of $50 in year 3. It pays a foreign income tax of $20 on that income, and its earnings and profits for the year are $30 ($50 – $20). In year 2, FCo had taxable income of $100 and paid a foreign income tax of $50 on that income. Its earnings and profits for year 2 were $50 ($100 – $50). It had taxable income of $60 in year 1 and paid no taxes with respect to that income. Its earnings and profits for year 1 were $60.

FCo made no distribution to PCo in years 1 and 2. Years 1, 2, and 3 are all post-1986 years. Under these facts, PCo will be deemed to have paid foreign income taxes of $50 with respect to the dividend of $100 received from FCo in year 3, computed as follows.

(1) Dividend received by PCo from FCo in year 3 .... $100

[162] IRC § 902(c)(1).

[163] IRC § 902(c)(2).

(2) Current earnings and profits of FCo (year 3) 30

(3) Foreign income taxes paid by FCo in year 3 20

(4) Earnings and profits of FCo in year 2 50

(5) Foreign income taxes paid. by FCo in year 2 50

(6) Earnings and profits of FCo in year 1 60

(7) Foreign income taxes paid in year 1 0

(8) Pool of post-1986 undistributed earnings (line (2) + line (4) + line (6)) 140

(9) Pool of post-1986 foreign income taxes (line (3) + line (5) + line (7)) 70

(10) Amount of foreign income taxes paid by FCo and deemed paid by PCo (line (9) × line (1)/line (8)) 50

The current and accumulated earnings and profits of a foreign corporation are pooled, for purposes of attributing foreign taxes to a dividend, even if the foreign corporation has current earnings and profits and also has a deficit in its accumulated earnings and profits. Consider, for example, PCo, a U.S. corporation, that organizes FCo, a wholly owned foreign subsidiary, in year 1. For that year, FCo has a deficit in its earnings and profits of $50 and pays no foreign taxes. In year 2, FCo has profits of $ 100 and pays a foreign income tax of $20. It distributes $30 to PCo. That $30 will be taxable to PCo as a dividend, On receipt of the dividend, PCo will be entitled to an indirect credit of $12 ($20 × $30/($100 – $50)).[164]

A special rule applies in computing post-1986 undistributed earnings and post-1986 foreign taxes if a first-tier. second-tier, or lower-tier foreign corporation has been acquired after 1986. Under the special rule, profits and taxes that accrued in years prior to the year of acquisition are ignored in computing post-1986 undistributed earnings.[165]

If a U.S. corporation receives a distribution from a foreign affiliate in excess of its post- 1986 undistributed earnings, then the excess portion of the dividend will be traced to pre-1987 years, to the extent of the foreign affiliate's earnings and profits accumulated prior to 1987. Dividends attributable to pre-1987 years will be governed by the rules in effect prior to the adoption of the 1986 tax act. In general, those rules trace a dividend to the most recently accumulated earnings and profits of the foreign affiliate paying the dividend.[166] This last-in-first-out (LIFO) tracing method had long been criticized for the inequitable results that it produced in some common cases.

The inequitable results under the LIFO method sometimes favor the government and sometimes favor the taxpayer. For a result favoring the taxpayer, consider PCo, a U.S. corporation, that receives a dividend of

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[164] See General Explanation of the Tax Reform Act of 1986 (1987) at 907. For another example, assume that FCo had a deficit of $100 in its earnings and profits in year 1 but that otherwise the facts are as described in the text. FCo's post-1986 accumulated earnings would be zero. The $30 received by PCo would be taxable as a dividend, nevertheless, because FCo has current earnings and profits. See IRC § 316(a)(1). PCo cannot claim an indirect credit for any taxes paid by FCo because the distribution is not allocable to post-1986 earnings and profits. See Id. This result is appropriate if FCo's deficit in its earnings and profits resulted form an operating loss in year 1. In that case FCo would have been allowed a loss carry-over in year 2 in a tax system designed according to U.S. tax concepts and would have had no income tax to pay in that year.

[165] IRC § 902(c)(3).

[166] IRC § 902(c). Dividends paid in the first 60 days of a year are deemed to be paid out of the profits of the preceding year or years for pre-1987 years. This rule does not apply for post-1986 years.

$400 from FCo, its wholly owned foreign affiliate. FCo has no post-1986 undistributed earnings, but it had earnings and profits of $400 in 1986 and in 1985. FCo paid foreign taxes of $200 in 1986 and paid no foreign income taxes in 1985. Under the LIFO method, PCo is treated as having received the $400 dividend out of FCo's 1986 profits and is entitled to an indirect credit of $200. That result is unfair to the government, and it would be especially unfair if FCo had manipulated the timing of its income to obtain that result.[167] For a result favoring the government, assume that FCo, the foreign affiliate in the above example, paid no taxes in 1986 and paid $200 in foreign income taxes in 1985. Otherwise the facts are the same. On a distribution of $400 by FCo, PCo would not be allowed any indirect credit because the distribution is presumed to be made out of FCo's accumulated earnings and profits for 1986 under the LIFO method. That result is unfair to the taxpayer.

Prior to the adoption of the 1986 Code, there was some question as to whether the statutory phrase "accumulated profits" referred to accumulated earnings and profits, computed according to U.S. tax concepts, or to accumulated profits determined under foreign law, The Internal Revenue Service and most commentators took the position that accumulated profits was to be determined under U.S. tax concepts. The Service's position was tested and ultimately sustained by a unanimous Supreme Court in *Goodyear Tire.*[168] The result in *Goodyear Tire* is important for distributions made out of pre-1987 accumulated profits but has no impact on distributions out of post-1986 earnings.

§ 19.03. Determining the Earnings and Profits of a Foreign Corporation

The earnings and profits of a foreign corporation, for the purpose of computing the indirect credit, are to be computed according to the rules provided for computing earnings and profits under subpart F and under the currency translation rules of Code section 986.[169] Under subpart F, earnings and profits generally are to be computed "according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the [tax authorities]."[170] Thus the starting point in determining the earnings and profits of a foreign corporation is the general definition of earnings and profits applicable to a domestic corporation.

Unfortunately, the Code does not provide comprehensive rules for determining the earnings and profits of a domestic corporation. Code section 312 provides a list of adjustments that corporations must make in computing their earnings and profits, but it does not state how earnings and profits are to be

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[167] Apparently many taxpayers were manipulating the timing of their foreign source taxable income to increase the amount of their indirect credit. See General Explanation of the Tax Reform Act of 1986 at 869 (describing the so-called rhythm method of dividend distributions from foreign affiliates). The following example illustrates the operation of the rhythm method. Consider PCo, a U.S. corporation, that has two foreign affiliates, F-1 and F-2, organized in Country A. Country A has an income tax imposed at the rate of 17%. The affiliates each would have taxable income of $100 per year under normal circumstances and would pay $17 of income taxes on that income. In fact, however, they manipulate their deductions and their realizations of income, so F-1 pays $34 of foreign income taxes in odd numbered years and nothing in even numbered years. F-2 does the opposite. F-1 and F-2 would pay a dividend to PCo in their high-tax years. Under these conditions, PCo would argue that it was entitled to an indirect credit of $34 per year. This gambit clearly will not work under the reformed rules.

[168] U.S. v. Goodyear Tire & Rubber Co., 493 U.S. 1095 (1990), rev'g 856 F.2d 170 (Fed. Cir. 1988), and reinst'g 14 Cl. Ct. 23 (1987).

[169] IRC § 902(c)(1) (incorporating by reference the rules of IRC § 964, relating to earn ings and profits of a CFC under subpart F, and IRC § 986, relating to translations of foreign currencies into U.S. dollars).

[170] IRC § 964(a).

computed in the first instance. The regulations under that section clarify and augment the list of adjustments, again without giving a general definition.[171]

According to established practices, the current and accumulated earnings and profits of a domestic corporation are to be determined from the books of account it regularly maintains for reporting its profits and losses to its shareholders.[172] The account books must be maintained in accord with generally accepting U.S. accounting standards. The earnings and profits figures appearing on the account books must be adjusted so as to conform with tax accounting requirements, including the specific requirements of Code section 312 and the regulations thereunder.

To conform with tax accounting requirements, the figures used in computing the earnings and profits of a domestic corporation generally must agree with the figures used in computing taxable income. Subject to many exceptions, the earnings and profits of a domestic corporation for a taxable year would equal its taxable income for that year, increased by certain tax preference amounts and decreased by certain deductions for expenditures that reduce the corporation's net worth. Taxable income would be increased, for example, by the amount of the corporation's tax exempt income[173] and by the excess of its accelerated depreciation over normal depreciation.[174] The most important reduction in taxable income would be for the amount of income taxes paid.[175]

The accumulated earnings and profits of a domestic corporation generally would be the sum of its earnings and profits for all years prior to the current taxable year, reduced by the amount of its distributions to shareholders during those years.[176] Some special rules apply for certain tax-free distributions of stock and securities as part of a corporate reorganization,[177] and to distributions of appreciated property[178] and property subject to liabilities.[179]

With some modifications, a procedure similar to that set forth above would be followed in computing the earnings and profits of a foreign corporation. According to the regulations under Code section 964(a), the foreign corporation would prepare a profit and loss statement from the account books used to report to shareholders, with adjustments necessary to conform with U.S. accounting principles and tax accounting standards.[180] A special adjustment would be needed to translate the profit and loss statement into U.S. dollars for transactions conducted in a foreign currency.[181] Again with many exceptions, the foreign cor-

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[171] Commentators have compensated for the lack of a coherent definition of earnings and profits in the Code and regulations by providing their own definition. See Boris Bittker & James Eustice, *Federal Income Taxation of Corporations and Shareholders* (1987) at 7-9 to 7-24.

[172] This starting point is implicit in the discussion in Reg. § 1.312-6 (1960).

[173] Reg. § 1.312-6(b) (1960).

[174] IRC § 312(k).

[175] Neither the Code nor the regulations specifically authorize a reduction in earnings and profits for taxes paid, apparently because everyone understands that taxes would be excluded from earnings and profits under generally accepted accounting standards. See Rev. Rul. 63-63, 1963-1 C.B. 10 (approving a deduction for domestic income taxes) and Rev. 66-336, 1966-2 C.B. 110 (approving a deduction for foreign income taxes).

[176] IRC § 312(a).

[177] IRC § 312(d).

[178] See IRC § 312(b).

[179] IRC § 312(c).

[180] See Reg § 1.964-1 (2009).

[181] Reg. § 1.964-1(a)(3) (2009).

poration would have to be able to reconcile its earnings and profits figures with the figures used to compute its taxable income.

Three rules that apply in computing the earnings and profits of a domestic corporation are not applicable in computing the earnings and profits of a foreign corporation. *First*, a foreign corporation generally is not required to adjust its earnings and profits for the accelerated depreciation it may have taken in computing its taxable income.[182] This rule is not very important for foreign corporations operating exclusively in foreign countries because accelerated depreciation is not allowable on property used predominantly outside the United States.[183]

Second, a foreign corporation does not need to make an adjustment in its books of account to conform those books with accepted U.S. accounting principles and accepted tax accounting practices unless the adjustment is material.[184] This special rule sometimes frees foreign corporations that have kept their books according to the requirements of foreign law from the trouble and expense of maintaining another set of books computed according to U.S. accounting standards. Unfortunately, it also weakens the ability of the Internal Revenue Service to prevent foreign corporations from manipulating their earnings and profits figures for tax advantage.

Third, foreign corporations are prohibited from taking a deduction, in computing their earnings and profits, for any illegal bribe, kickback, or other payment that would be unlawful if made by a U.S. person.[185] The purpose of this rule is to take away the tax benefits that U.S. persons otherwise would obtain from making illegal payments through a foreign corporation. U.S. taxpayers are not allowed to deduct such illegal payments in computing their taxable income.[186]

The computation of earnings and profits of a foreign corporation often depends upon various taxpayer elections, such as the election of a particular method of accounting. Elections by a U.S. taxpayer on behalf of a foreign corporation under its control (CFC) must be made as soon as the computation of the CFC's earnings and profits becomes significant for U.S. tax purposes.[187] Minority shareholders of a CFC cannot make an election on behalf of that corporation.[188]

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[182] See IRC §§ 964(a) (defining earnings and profits for purposes of subpart F) and 312(k)(4) (exempting a foreign corporation from adjusting its earnings and profits for accelerated depreciation unless that corporation derives over 80% of its gross income from U. S. sources).

[183] IRC § 168(g).

[184] Reg. § 1.964-1(a) (2009)

[185] IRC § 964(a) and Reg, § 1.964-1 (a)(2) (2009). The prohibited illegal payments are described in IRC § 162(c).

[186] See IRC § 162(c).

[187] Reg. § 1.964-1(c)(6) (2009). A list of events that would cause a CFC's earnings and profits to have U.S. tax significance is contained in Reg. § 1.964-1(c)(6) (2009).

[188] Reg. § 1.964-1(c)(4)(iii) (2009).

In 1992 the Internal Revenue Service issued proposed regulations under Code section 964(a) that would allow taxpayers to compute the earnings and profits of foreign corporations without making the adjustments generally required under the uniform capitalization rules of Code section 263A. In addition, foreign corporations that keep their books in accordance with U.S. generally accepted accounting principles typically would not be required to compute their depreciation deductions according to the Code rules.[189] Section 964(a) states that the earnings and profits of a foreign corporation "shall be determined according to rules substantially similar to those applicable to a domestic corporation." The 1992 proposed regulations appear to conflict with this statutory language. Those proposed regulations were withdrawn in 2011 and new proposed regulations, more in accord with the statutory language, were issued.

§ 19.04. Review Problem

XCo is a U.S. corporation. It owns 40% of the voting stock of F-1. F-1 owns 60% of the voting stock of F-2, and F-2 owns 30% of the voting stock of F-3. F-1, F-2, and F-3, are all foreign corporations organized under the laws of Country Y. For the current year, F-3 has earnings and profits of $1,000 from manufacturing operations. It pays an income tax of $500 (50% rate) on those profits to Country Y and distributes the balance of $500 to its shareholders, with F-2 receiving $150. F-2 also receives interest income of $200 from an unrelated foreign bank, bringing its total income to $350. F-2 does not have to pay tax on the $150 dividend from F-3, but it does pay income tax of $100 (50% rate) on its $200 interest income. F-2 distributes all of its after-tax income of $250 pro rata to its shareholders, with F-1 receiving $150. F-1 has no other income and pays no income taxes.

F-1 distributes all of its after-tax income of $150 to its shareholders, with $60 distributed to XCo. Country Y imposes a 10-percent withholding tax on dividends paid to foreign shareholders. As a result, F-1 must withhold $6 on the distribution of $60 to XCo. Thus XCo receives $54 from F-1.

Leaving aside limitation issues, what is the amount of the creditable income taxes paid or deemed paid by XCo with respect to the distribution received from F-1?

[189] Prop. Reg. § 1.964-1(c)(1)(iii) (2011).

Chapter 20
Limitations on the Credit

§ 20.01. General (Overall) Limitation on the Credit

Section 20.01, below, gives some historical background on the various limitations on the foreign tax credit that the Code has imposed over the years. Section 20.02 describes the general limitation on the credit currently provided under Code section 904. Section 20.03 discusses the arguments for and against the cross crediting of foreign taxes imposed by one country against the U.S. tax on income derived in another country.

§ 20.01.1. Background

When the foreign tax credit provisions were adopted in 1918, there was no limitation on the credit. That is, a U.S. person paying a qualifying foreign income tax could reduce its U.S. tax liability by the amount of the foreign tax, even if the result was the elimination, in whole or in part, of U.S. taxes on U.S. source income. In 1921, an overall limitation on the credit was adopted. An overall limitation, called the general limitation since the adoption of the 1986 tax act, prevents foreign income taxes from offsetting U.S. taxes on U.S. source taxable income.

Consider, for example, a U.S. corporation, P, that derives $100 of taxable income from U.S. sources and $200 of taxable income from foreign sources. The foreign source income is subjected to a foreign income tax of $120. The U.S. tentative tax on the worldwide income of P is $105 (35% of $300). Allowing a credit for the full amount of the foreign income taxes would eliminate all U.S. taxes on P.

A general (overall) limitation-would prevent P, in the example above, from claiming a credit greater than $70. This limitation would allow the United States to collect $35 from P on its U.S. source income of $100. A foreign income tax that cannot be claimed as a credit against U.S. taxes because of the limitation on the credit is called an excess credit. In this example, P would have an excess credit of $50 ($120 – $70) because of the general limitation.[190]

A per-country limitation was introduced as an addition to the general limitation in 1932. The per-country limitation, at least in theory, prevents foreign income taxes imposed by one country from offsetting the U.S. tax on U.S. source income or on income derived in another foreign country.[191] From 1932 to 1954 a taxpayer had to satisfy both limitations to qualify for a foreign tax credit.

In 1954, the general limitation was repealed, leaving the per-country limitation as the only limitation on the credit. In 1961, the general limitation returned, but as an alternative, at the election of the taxpayer, to the per-country limitation. In 1975, Congress repealed the per-country limitation for oil companies, largely to prevent oil companies from deducting the losses of their foreign branches against U.S. source income. In 1976, Congress extended that repeal to all taxpayers, making the general limitation mandatory.

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[190] Excess credits may be carried back one year and carried forward ten years. See IRC § 904(c).

[191] As explained in section 20.03, below, the per-country limitation was easily avoided in practice through the use of so-called mixer companies — a holding company that received dividends from affiliates in two or more countries and then paid a "mixed" dividend to the U.S. parent.

In 1985, the Reagan administration proposed that the per-country limitation be adopted as a mandatory replacement for the general limitation.[192] That proposal was not accepted by Congress. Other than the change in its name from the overall limitation to the general limitation, the general limitation was continued under the 1986 tax act. The 1986 act adopted some special limitations, however, that prevent some perceived abuses of the general limitation. The special limitations are described in section 20.02.

There are two important tax consequences of employing a general limitation rather than a per-country limitation. One consequence is that taxpayers are allowed to credit taxes imposed on income derived in one country against the U.S. tax imposed on income derived in another country. In theory, a per-country limitation prevents such cross crediting of foreign taxes.[193] From 1932 to 1961, cross crediting was not allowed. It was allowed from 1918 to 1932 and for years following 1961.

The other major consequence of employing the general limitation is that it forces taxpayers suffering losses in one country and gains in another to net the foreign losses against the foreign gains in computing the limitation on the foreign tax credit. The per-country limitation, in contrast, does not require such netting.

Consider, for example, a U.S. corporation, P, that has foreign branches in Country A and Country B. P earns taxable income of $200 in the United States and $100 in Country A; it incurs a loss of $100 in Country B. P's worldwide taxable income is $200 ($200 + $100 – $100), and its U.S. tax liability, computed without reference to the credit, is $70 (35 percent of $200). Under the per-country limitation, P would be allowed a credit of $35 for the tax paid to Country A, reducing the tax owed to the United States to $35 ($70 – $35). Under an overall limitation, P would not be allowed any foreign tax credit because its limitation on the credit would be zero ($70 × ($100 – $100)/$200).

From 1918 to 1954, netting of foreign losses was required under the Code. From 1961 to 1976, the taxpayer could avoid netting, but only by giving up the benefit of cross crediting foreign taxes. As part of the 1976 tax act, Congress adopted a special recapture rule for foreign losses. Since 1976, netting of foreign losses has been required, and foreign losses are subject to the recapture rule.

§ 20.01.2. Operation of the General Limitation

To maintain its revenues from income taxes imposed with respect to U.S. source taxable income, the United States limits the amount of foreign taxes that may be claimed as a credit in any year to the proportion of the tentative U.S. tax attributable to foreign source taxable income.[194] The mechanism for so limiting the credit is called the general limitation. It is expressed by the following formula:

$$\textbf{General Limitation} = \textbf{Tentative U.S. Tax} \times \frac{\textbf{General Limitation Taxable}}{\textbf{Worldwide Taxable Income}}$$

General limitation taxable income in the above formula is the taxpayer's foreign source taxable income minus its taxable income subject to the passive basket limitation described in chapter 21. The separate basket limitation is applied before the general limitation. For a taxpayer having no income subject to the passive basket limitation, the numerator of the above formula would be the taxpayer's foreign source taxable

[192] See PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985) (Treasury II) at 389. A similar proposal was made in an earlier Treasury report. See Treasury Department, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH — GENERAL EXPLANATION OF THE TREASURY DEPARTMENT PROPOSALS, Vol. II (1984) (Treasury I) at 339-342.

[193] Some commentators refer to the cross crediting of foreign taxes as averaging of foreign taxes because cross crediting allows taxpayers to receive a credit for the average of foreign effective tax rates.

[194] IRC § 904(a).

income. For simplicity, the assumption is made in this section that taxpayers do not have any income subject to the passive basket limitation.

The fraction, general limitation taxable income over worldwide taxable income, in the above formula is referred to as the general limitation fraction. The limitation fraction cannot exceed one.[195] Thus the limitation fraction would be one in the case of a taxpayer having general limitation taxable income equal to or in excess of worldwide taxable income.[196]

To compute the numerator of the general limitation fraction, the U.S. taxpayer must determine the source of its gross income and also the source of its deductions.[197] Without changing its worldwide taxable income, a taxpayer can increase the limitation fraction-and thereby raise the limitation on creditable taxes-by increasing the amount of its gross income characterized as foreign source gross income or by reducing the amount of its deductions attributable to foreign source gross income.

The Code provides detailed rules for determining the source of gross income. Those rules are described in chapters 11-14. No comparable source rules for deductions are included in the Code. To fill the statutory void, the Treasury Department has issued regulations governing the source of deductions. Those rules are designed in large measure to reduce the amount of deductions that U.S. taxpayers otherwise would attribute to U.S. source gross income for purposes of computing the limitation on the credit. The source of deduction rules are described in chapter 15.

The general limitation permits taxpayers to take a credit for foreign taxes paid with respect to foreign source taxable income up to the amount of tax that the United States would impose on the foreign income in the absence of the foreign tax.[198] The operation of this limitation is illustrated in the example below.

Example 20.1: General Limitation

PCo, a U.S. corporation, earns gross income from U.S. sources of $300 and gross income from Country A sources of $150. It has deductions of $100 attributable to U.S. gross income and deductions of $50 attributable to Country A gross income. The United States imposes a corporate tax at a 35 percent rate, and Country A has a 55 percent corporate income tax rate, applicable to foreign corporations on income arising within Country A. PCo would be permitted a credit for $35 of the Country A tax under the general limitation, computed as follows:

(1) Country A source gross income $150

(2) Deductions attributable to Country A income 50

(3) Taxable income from Country A (line (1) – line (2) 100

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[195] See IRC § 904(a) (stating, in effect, that foreign source taxable income in the numerator of the limitation fraction cannot exceed worldwide taxable income).

[196] Foreign source taxable income would exceed worldwide taxable income whenever the taxpayer's U.S. source taxable income was negative, due to losses.

[197] In computing the limitation on the credit, individuals, estates, and trusts are not allowed to take a deduction for personal exemptions. IRC § 904(b)(1). Allowing a deduction for the personal exemptions would have no effect on the limitation fraction, on the assumption that the deduction would otherwise be allocated ratably to foreign and domestic source income, computed without reference to the personal exemption. See Elisabeth A. Owens, *The Foreign Tax Credit* (1961) at 249.

[198] On the assumption that the U. S . corporate tax rate is a flat 35%, the tentative U. S. tax is worldwide taxable income times 35%. By eliminating worldwide taxable income from both the denominator and numerator of the general limitation formula, the formula can be reduced to foreign source taxable income times 35%. This simplified limitation formula does not hold true if the taxpayer's foreign source taxable income exceeds its worldwide income because the limitation fraction cannot exceed 1.

(4) U.S. source gross income 300

(5) Deductions attributable to U.S. income 100

(6) Taxable income from U.S. (line (4) – line (5)) 200

(7) Worldwide taxable income (line (3) + line (6)) 300

(8) Country A tax (Country A tax rate × line (3)) 55

(9) Tentative U.S. tax (U.S. tax rate × line (7)) 105

(10) Limitation on credit (line (9) × line (3)/line (7) 35

(11) Amount allowable as credit (lesser of line (8) and line (10)) 35

(12) Net U.S. tax (line (9) – line (11)) 70

(13) Amount of Country A tax not allowed as a credit (line (8) – line (11)) 20

PCo could increase the limitation on its credit if it could rearrange its affairs to get more of its taxable income characterized as foreign source taxable income. That result might be accomplished either by characterizing more of its gross income as foreign source gross income or by attributing more of its deductions to U.S. sources. If PCo were able to shift $50 of gross income from the U.S. to foreign sources and $20 of deductions from foreign sources to the United States for U.S. tax purposes without changing its Country A tax, the limitation on the credit would increase to $55 and the net U.S. tax would decrease to $50, computed as follows:

(14) Revised Country A source gross income (line (1) + $50) $200

(15) Revised deductions attributable to Country A income (line (2) – $20) 30

(16) Revised taxable income from Country A (line (14) – line (15)) 170

(17) Revised limitation on the credit (line (9) × line (16)/line (7)) 59.50

(18) Revised amount allowable as a credit (lesser of line (8) and line 17)) 55

(19) Revised net U.S. tax (line (9) – line (18)) 50

§ 20.01.3. Cross Crediting Under the General Limitation

The general limitation does more than simply subordinate U.S. jurisdictional claims based upon the taxpayer's residence to the jurisdictional claims of the country of source. Because the amount of the general limitation is a function of the taxpayer's total foreign source taxable income, U.S. persons can use tax credits generated in countries with tax rates higher than the U.S. effective rate to offset the U.S. residence tax otherwise due from income derived from countries where the effective rate is below the U.S. rate. As a result of such cross crediting of foreign taxes, the United States relinquishes residence claims that are not in conflict with the jurisdictional claims of the country of source. The example below illustrates this feature of the general limitation.

Example 20.2: Cross Crediting under the General Limitation

PCo, a U.S. corporation, has U.S. source taxable income of $100, Country A source taxable income of $100, and Country B source taxable income of $100. The effective tax rates in the United States, Country A, and Country B are, respectively, 35 percent, 55 percent. and 10 percent. Under these

conditions, PCo would be permitted a credit for the full amount of the foreign taxes paid under the general limitation, calculated as follows:

(1)	*Country A source taxable income*	*$100*
(2)	*Country B source taxable income*	*100*
(3)	*Total foreign source taxable income (line (1) + line (2))*	*200*
(4)	*U.S. source taxable income*	*100*
(5)	*Worldwide taxable income (line (3) + line (4))*	*300*
(6)	*Country A tax (55% of line (1))*	*55*
(7)	*Country B tax (10% of line (2))*	*10*
(8)	*Total foreign taxes (line 6) + line (7))*	*65*
(9)	*Tentative U.S. tax (U.S. tax rate × line (5))*	*105*
(10)	*Limitation on credit (line (9) × line (3)/line (5))*	*70*
(11)	*Foreign taxes allowed as credit (lesser of line (8) and line (10))*	*70*
(12)	*Net U.S. tax due (line (9) – line (11))*	*40*

In the example above, the taxes due the United States with respect to U.S. source taxable income is $35. The U.S. taxes that would be due on foreign source taxable income, after ceding primary jurisdiction to the countries of source, is zero for income arising in Country A and $25 for income arising in Country B. The sum of the taxes that the U.S. would collect if it ceded tax jurisdiction only to the country of source is $60 ($35 + $25), which is $20 more than the net U.S. tax collected from PCo after allowance of the credit for foreign taxes under the general limitation. The lower U.S. tax results from the taxpayer using foreign taxes paid on its Country A income to offset U.S. taxes otherwise due on its Country B income.

The United States could prevent the cross crediting of foreign taxes in the example above, and thereby preserve its residence jurisdiction over income arising in Country B, by limiting the credit for taxes paid with respect to income arising in a foreign country to the tentative U.S. tax attributable to that income. The mechanism for achieving that end is called the per-country limitation. The per-country limitation for taxes paid to Country A is expressed by the following formula:

$$\textbf{Per Country Limitation} = \textbf{Tentative U.S. Tax} \times \frac{\textbf{Country A Taxable Income}}{\textbf{Worldwide Taxable Income}}$$

The application of the above formula to the facts of *Example 20.2* would result in a credit of $35 for Country A taxes and a credit of $10 for Country B taxes, for a total allowable credit of $45. The total U.S. taxes collected would be $60, which is $20 more than the amount collected under the general limitation.

The Treasury Department, in its 1984 tax reform proposals (Treasury I), made three independent arguments, all valid, in favor of replacing the general limitation with a per-country limitation.[199] The first argument is that cross crediting of foreign taxes is inconsistent with the basic policy of the credit. That policy,

[199] The Treasury arguments paraphrased in the text have been modified somewhat to conform to the terminology used in this book.

according to Treasury I, is to eliminate double taxation of transnational income by ceding U.S. residence jurisdiction over the foreign source income of U.S. persons to the country of source. Cross crediting is inconsistent with this policy because it causes the United States to relinquish its right to tax foreign income to which it has a legitimate claim under its residence jurisdiction even though the imposition of that tax would not conflict with the legitimate source claims of any country.

The second Treasury argument against the overall limitation is made on fairness grounds. To obtain the benefits of cross crediting, a U.S. person must satisfy two conditions. It must have derived taxable income in a foreign country that is taxed at an effective rate above the U.S. rate, and it must have derived foreign source taxable income elsewhere that is subject to an effective tax rate below the U.S. rate. Some U.S. persons can satisfy both conditions. Other U.S. persons having equal incomes and otherwise being in comparable circumstances can satisfy the first condition but not the second. The result is a violation of horizontal equity.

Treasury's third argument against the general limitation is that it provides U.S. persons having excess foreign tax credits with an undesirable incentive for foreign investment. For such taxpayers, an addition to their foreign source taxable income would be free of U.S. taxes because their excess credits would be used to offset the tentative U.S. tax on that additional income. To the extent that they could also avoid paying foreign taxes on their foreign source income, or could pay foreign taxes at an effective rate below the U.S. rate, they would have a tax incentive to invest abroad. Under a per-country limitation, U.S. persons having excess credits would also have an incentive to earn foreign source taxable income, but only if the income would be sourced in the country where their excess credits had been generated and the foreign effective tax rate on such income would be lower than the U.S. rate. As a practical matter, a separate basket limitation for passive income would solve that latter problem in most cases.

Consider for example, PCo, a U.S. corporation having excess foreign tax credits of $500 generated by taxes paid to a high-tax foreign country. PCo is planning to operate a new business either in the United States or in a low-tax foreign country. Under a general limitation, PCo would have a tax incentive to operate the new business in the low-tax country because the U.S. tax otherwise imposed on the foreign source income generated by that business would be offset by P's excess foreign tax credits. PCo would not have an incentive to operate the new business in the low-tax country under a per-country limitation. It would have an incentive to operate the new business in the high-tax country, but only if that country would tax the income generated by the new business at an effective rate below the U.S. rate.

The incentive for foreign investment is particularly strong, under a general limitation and a per-country limitation, for U.S. persons holding investment assets. Such persons generally can control the source of the income generated by those assets by giving the assets a foreign situs, and they generally can avoid substantial foreign tax on such income by earning it in a tax haven jurisdiction or by claiming the benefits of a tax treaty. The Reagan administration would have removed this incentive by adopting the per-country limitation and by imposing a separate basket limitation on certain passive investment income. The separate basket limitation rules adopted in the 1986 act are a substantial refinement of the Reagan administration proposal.

Congress rejected the Reagan administration's proposal for a per-country limitation when it enacted the 1986 reforms. It asserted that the averaging of foreign effective tax rates through cross crediting of foreign income taxes is "consistent with the integrated nature of U.S. multinational operations abroad."[200]

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[200] See General Explanation of the Tax Reform Act of 1986 at 862.

There is no merit to the claim that multinational companies are entitled to a general limitation because they operate integrated businesses abroad. Indeed, it is hard to understand the point of that claim.[201]

Although the per-country limitation would appear to be correct in theory, it can be fairly criticized on practical grounds. During the years when the per-country limitation was in effect, well-advised taxpayers routinely cross credited foreign income taxes through perfectly legal tax avoidance techniques.

One popular method used by multinational companies to cross credit foreign taxes under the per-country limitation was to funnel foreign source taxable income through a foreign holding company. Under long-standing Treasury regulations that have now been removed, the source of a dividend from a foreign affiliate is the country in which the affiliate is organized, and the taxes paid by that affiliate are deemed to be paid to the country in which the affiliate is organized.[202] By conducting their foreign operations through subsidiaries of a foreign holding company, a U.S. parent corporation would end up receiving all of its foreign source taxable income from a single foreign corporation. That corporation would be deemed to have paid the total foreign taxes to its country of incorporation and to have earned all of the foreign income of the affiliated chain of corporations in that same country.

As an example of the use of foreign affiliates to defeat the policy goal of the per-country limitation, consider a variation on the facts of *Example 20.2*, above. PCo, the U.S. corporation in that example, has organized a first-tier foreign affiliate, F-1, in Country L, a low-tax jurisdiction. F-1, in turn, has organized two foreign subsidiaries of its own, F-2A and F-2B. Both of these corporations are second-tier foreign corporations with respect to PCo. PCo earns $100 of U.S. source taxable income and has no other income other than the foreign source taxable income distributed by F-1.

F-2A is organized under the laws of Country A, earns $100 of taxable income in that country, and pays $55 in creditable income taxes to Country A. F-2B is organized under the laws of Country B, earns $100 of taxable income in Country B and pays creditable income taxes to Country B of $10. F-2A and F-2B distribute their after-tax profits of $135 ($45 + $90) to their common parent, F-1. F-1 then distributes those profits to PCo as a dividend. PCo is taxable on $200 of foreign source taxable income — the dividend of $135 plus the grossed-up amount of $65. PCo also has $100 of U.S. source taxable income, for total worldwide taxable income of $300. Its tentative U.S. tax is $105 (35% of $300).

Under these conditions, PCo is deemed to have paid taxes of $65 to Country L and to have Country L source taxable income of $200 under the Treasury regulations. The per-country limitation applicable to Country L would be $70 (35% of $300 × $200/$300), and the $65 of taxes attributable to Country L would be allowed to offset the tentative U.S. tax of $105. Thus PCo would pay net U.S. tax of $40 ($105 – $65). That result is identical to the result achieved in *Example 20.2* under the general limitation.

Congress could prevent cross crediting under the per-country limitation by adopting anti-avoidance measures. In particular, Congress could require taxpayers to determine the source of dividends and other distributions from foreign corporations by reference to the source of the income out of which those distributions were made. It also could require that foreign taxes be treated as paid to the country that

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[201] The fact that a business is integrated does not mean that taxes imposed on one part of the business by one country should be treated as if they were taxes imposed by another country on another part of the business. By that logic, companies that operated an integrated business in the United States and abroad would be allowed to cross credit foreign taxes against the U.S. taxes imposed on their U.S. source income. In addition, taxpayer would be required to prove they were operating an integrated business to be allowed to cross credit.

[202] Reg. § 1.902-1 (h)(1) and (2) (2009). Look-through rules now trace a dividend back to the foreign affiliate that initially earned the income out of which the dividend to the U.S. parent corporation was paid.

received the tax payment. The Reagan administration proposed the adoption of such look-through rules as part of its 1985 proposal for a return to the per-country limitation.[203] As the Reagan administration acknowledged, the look-through approach can create some relatively minor problems when a foreign country imposes tax on the worldwide income of the foreign affiliate of a U.S. company. A solution would be to treat foreign source income with respect to which a credit is claimed as having its source in the country that imposed the tax on it.

Critics of the per-country limitation assert that the look-through rules necessary to put teeth into the per-country limitation would be too complex to be workable. Congress did adopt look-through rules, nevertheless, as part of the 1986 reforms. These rules, applicable to distributions from controlled foreign corporations, are designed to prevent taxpayers from avoiding the separate basket limitations through the use of devices similar to those used to defeat the per-country limitation. The rules are indeed complex. The per-country look-through rules would have some additional wrinkles, but the general level of complexity would be about the same. Because of the matching of source of income with payment of the tax on that income, some simplification gains could be anticipated.

The complexity of the look-through rules is greatest for multinational businesses that conduct their foreign operations through complex chains of foreign entities. A major reason for the establishment of those complex chains has been to minimize foreign and domestic tax liabilities. Complex reform measures that eliminate tax avoidance opportunities for multinational businesses might simplify the operation of the tax laws by encouraging multinational corporations to dismantle their complex organizational structures.

§ 20.02. Separate Basket Limitations

In 1986, Congress enacted a set of special limitations on the credit, popularly referred to as the separate basket limitations. The separate basket limitations are a major extension and rationalization of a patchwork of limitation rules adopted from 1962 to 1984. A category of taxable income subject to a separate basket limitation is segregated from other income; metaphorically, it is placed in its own basket. Foreign taxes imposed on taxable income in a particular basket can only offset U.S. taxes otherwise imposed on that category of income. Taxable income not included in a separate basket is subject to the general limitation, described in section 20.01. Income subject to the general limitation is said to be in the general limitation basket.

The separate basket rules contained in the 1986 tax act were modified in 1997 and totally revamped in 2004. The main features of these changes are described below.

The chief objective of the separate basket limitations is to reduce or eliminate the tax incentive that U.S. persons with excess credits otherwise would have for generating foreign source income rather than U.S. source income.[204] In keeping with that objective, the separate basket limitations generally apply to income that is easily moved from the United States to a foreign country. A secondary objective of the separate limitations is to generate some tax revenue for the United States from the foreign source taxable income earned by its citizens, residents, and domestic corporations. This objective is achieved, to a limited degree,

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[203] See Treasury I at 339-341; Treasury II at 391-393.

[204] One reason that Congress gave for tightening the limitations on the credit in 1986 was that more taxpayers would have excess foreign tax credits after the 1986 tax act went into effect, due to the lowering of the U.S. tax rate. See General Explanation of the Tax Reform Act of 1986 at 862.

by preventing high foreign taxes on certain types of income, such as income from oil extraction, from offsetting the residual U.S. tax on other types of foreign business income.

Section 20.02.1 explains how a separate basket limitation is computed. Section 20.02.2 describes the separate basket limitation for passive income. A second separate basket limitation applies to certain oil-related income. That basket is not addressed in this book.

The separate basket rules have been coordinated, to a substantial degree, with the rules under subpart F for limiting tax haven abuses. In addition, the separate basket rules are applicable in determining the limitation on the credit for taxes paid with respect to deemed distributions of subpart F income.

To reduce the compliance burden on individuals claiming modest foreign tax credits, Congress adopted a *de minimis* rule in 1997. Under that rule, individuals receiving certain passive foreign income are not subject to the limitation rules of Code section 904 in computing their allowable credit.[205] The amount of the credit that can be claimed under this rule cannot exceed $300 ($600 in case of two taxpayers filing jointly).[206] A person claiming a credit for taxes imposed on personal services income is not entitled to this relief. To be eligible under this rule, the individual must have received an information return ("payee statement") from the foreign government or its withholding agent showing the amount of the foreign taxes paid.[207] No carrybacks or carryforwards of credits are allowed.[208]

§ 20.02.1. Computation of a Separate Basket Limitation

A separate basket limitation can have two important consequences, depending on whether the income in a particular basket has been subject to low or high foreign taxes. First, it can prevent foreign taxes paid with respect to income outside the basket from offsetting the U.S. tax otherwise due on foreign source taxable income within the basket. Second, it can prevent U.S. taxpayers from using credits for foreign taxes imposed on income within the basket to reduce or eliminate U.S. taxes imposed on foreign source taxable income outside the basket. The first consequence is important if the income within the basket has been subjected to low foreign taxes. If the income within the basket has been subjected to high foreign taxes, then the second consequence is the important one.

The foreign tax credit allowable against U.S. taxes otherwise imposed on income within a separate basket is computed according to the following formula:

$$\textbf{Separate Basket Limitation} = \textbf{Tentative U.S. Tax} \times \frac{\textbf{Separate Basket Taxable Income}}{\textbf{Worldwide Taxable Income}}$$

This formula is identical to the general limitation formula except for the numerator of the limitation fraction. The numerator is foreign source taxable income subject to the separate basket limitation. The numerator is computed by determining the items of gross income in the separate basket and subtracting

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205 IRC §§ 904(k)(1)(A) and 904(k)(3)(A)(i).

206 IRC § 904(k)(2)(B).

207 IRC § 904(k)(3)(B).

208 IRC § 904(k)(1)(B) and (C).

from that gross income the deductions properly attributed to it under the source of deduction rules.[209] The operation of the separate basket limitation formula is illustrated by the example below.

Example 20.3: Operation of Separate Basket Limitation

PCo, a U.S. parent corporation, has separate basket taxable income of $100, on which it paid a foreign income tax of $10 (10% rate). It has other foreign source taxable income of $400, with respect to which it has paid a foreign income tax of $150 (37.5% rate). It has U.S. source taxable income of $600. Under these conditions, PCo would lose $10 of credit because of the separate basket limitation rules. The amount of credit allowable under a separate basket limitation is computed as follows:

(1)	*Separate basket taxable income*	*$100*
(2)	*Other foreign source taxable income*	*400*
(3)	*U.S. source taxable income*	*600*
(4)	*Worldwide taxable income (line (1) + line (2) + line (3))*	*1,100*
(5)	*Tentative U.S. tax (U.S. tax rate × line (4))*	*385*
(6)	*Foreign income taxes paid with respect to separate basket taxable income*	*10*
(7)	*Other foreign income taxes paid*	*150*
(8)	*Total foreign income taxes paid (line (6) + line (7))*	*160*
	Tax Due Without Special Basket Limitation	
(9)	*Total foreign source taxable income (line (1) + line (2))*	*$500*
(10)	*General limitation (line (5) × line (9)/line (4))*	*175*
(11)	*Amount allowed as credit (lesser of line (8) and line (10))*	*160*
(12)	*Tax due (line (5) – line (11))*	*225*
(13)	*Excess credit (excess of line (11) over line (10)*	*0*
	Tax Due Under Separate Basket Limitation	
(14)	*Separate basket limitation (line (5) × line (1)/line (4))*	*$35*
(15)	*Credit allowable with respect to separate basket taxable income (lesser of line (6) and line (14))*	*10*
(16)	*General limitation (line (5) × line (2)/line (4))*	*140*
(17)	*Credit allowable with respect to other foreign source taxable income (lesser of line (7) and line (16))*	*140*
(18)	*Total amount allowed as credit (line (15) + line (17))*	*150*
(19)	*Tax due (line (5) – line (18))*	*235*

[209] As with the general limitation, the taxable income of individuals, estates, and trusts is computed without any deduction for personal exemptions. IRC § 904(b)(1).

(20) Excess credit (line (8) – line (18)) 10

In the example above, the separate basket taxable income was subject to an effective foreign tax rate below the U.S. effective tax rate, and the residual foreign source taxable income subject to the general limitation was subject to an effective foreign tax rate above the U.S. effective tax rate. In these circumstances, the separate basket limitation prevented the U.S. taxpayer from cross crediting the excess foreign taxes imposed on the general limitation income against the U.S. tax imposed on the separate basket taxable income. The important consequence of the separate basket limitation rule was its impact on the numerator of the general limitation fraction. The separate basket limitation itself had no operative effect.

When separate basket taxable income has been subject to a high foreign tax and general limitation income has been subject to a low foreign tax, then the separate basket limitation operates to reduce the amount of the allowable credit for foreign income taxes paid with respect to the taxable income in the separate basket. The fact that the separate basket taxable income is removed from the numerator of the general limitation fraction has no operative consequence.

Consider, for example, PCo, a U.S. corporation, that has separate basket taxable income of $200, on which a foreign income tax of $75 was paid. PCo also has general basket foreign source taxable income of $50, on which a foreign tax of $5 was paid. Under these conditions, PCo would be able to credit the entire $5 of foreign taxes paid on the general basket foreign source taxable income, but it could credit only $70 (35% of $200) of the foreign taxes paid with respect to the separate basket taxable income. The separate basket limitation would prevent the cross crediting of excess foreign taxes imposed on the separate basket taxable income against the U.S. tax imposed on the residual foreign source taxation income.

§ 20.02.2. Passive Income Basket

The 1986 tax act established eight categories of income are subject to separate basket limitations under Code section 904(d)(1): (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) dividends from a noncontrolled section 902 corporation, (6) dividends from a DISC or former DISC, (7) taxable income attributable to foreign trade income, and (8) distributions from a FSC or former FSC. A separate basket for oil-related income that had been established earlier was retained.[210] These separate basket limitations were revised in 2004, for taxable years beginning in 2007 or thereafter, to eliminate all of these baskets except for the passive basket and the oil-related income basket. The 2004 tax act did not eliminate the special treatment of oil income, which, in effect, is given a separate basket under Code section 907.

In general, the passive income basket segregates investment income and certain other types of income taxed at an effective foreign tax rate at or below the U.S. rate from other types of foreign source taxable income. As a result, the U.S. tentative tax on passive income earned in a low-tax jurisdiction cannot be offset by the excess credits resulting from high foreign taxes imposed on other income. By preventing the cross crediting of such excess credits against the U.S. tax due on foreign source passive income, the separate basket limitation typically removes the tax incentive that U.S. persons holding moveable capital otherwise would have for earning their investment income outside the United States.

Section 20.02.2.1., below, describes the general category of income included in the passive income basket. The mechanical rule that removes highly taxed passive income from the passive income basket is

[210] IRC § 907.

called the high-tax kick-out rule.[211] Its operation is explained in section 20.02.2.2. An exclusion for financial services income is described in section 20.02.2.3. The exclusion for export finance interest is described in section 20.02.2.4.

§ 20.02.2.1. General

Subject to exceptions explained in the sections below, passive income, for purposes of the separate basket limitation, is comprised of interest, dividends, rents, royalties, and other income items of a type that would constitute foreign personal holding company income under the subpart F rules if received by a controlled foreign corporation (CFC).[212] The definition of foreign personal holding company income, for subpart F purposes, is described in the chapter dealing with CFCs. Also generally included in passive income are items of income subject to tax under the passive foreign investment company (PFIC) rules of section 1293.[213]

In addition to the above items, income classified as "specified passive category income" is included in the passive basket. In effect, certain income items relating to preferential foreign trade income that were formerly given their own basket are included in the passive basket, although they do not have the typical characteristics of passive income. The following items of income are classified as specified passive category income: (1) dividends from a DISC or former DISC out of foreign-source income, (2) distributions from a FSC or former FSC.[214]

The subpart F rules defining foreign personal holding company income provide that rents and royalties that are derived from the active conduct of a trade or business and that are received from an unrelated person are not subpart F income.[215] These rules apply, with some modifications, in determining whether rents and royalties are to be included in the passive income basket.[216]

Interest, rents, royalties, and dividends received by a U.S. shareholder from a CFC are not necessarily included in the passive income basket. The classification of such receipts depends upon the operation of certain look-through rules. The look-through rules are explained in section 20.03, below. In most circumstances, the look-through rules would treat interest, rents, royalties, and dividends received by a U.S. shareholder of a CFC as passive income only if those payments were made out of the passive income of the CFC.

§ 20.02.2.2. High-Tax Kick-Out Rule

Foreign source passive taxable income is removed from the passive income basket of a taxpayer if that income has been subject to an average effective tax rate above the top U.S. marginal rate applicable to that taxpayer.[217] This rule is called the high-tax-kick-out rule. Under current U.S. tax rates, the maximum rate

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[211] See General Explanation of the Tax Reform Act of 1986 (1987) at 880.

[212] IRC §§ 904(d)(1)(A) (imposing the separate basket limitation on passive income) and 904(d)(2)(B)(i) (defining passive income by incorporating by reference the definition of IRC 954(c)). Reg. § 1.904-4(b)(2)(i)(A) (2011).

[213] IRC § 904(d)(2)(B)(ii). See Reg. § 1.904-4(b)(2)(i) (B) (2011).

[214] IRC § 904(d)(2)(B)(v).

[215] See Reg. § 1.954-2(c) and (d) (2011) (providing criteria for distinguishing active from passive rents and royalties).

[216] See Reg. § 1.904-4(b)(2)(iii)(B) (2011). See also General Explanation of the Tax Reform Act of 1986 (1987) at 877.

[217] IRC §§ 904(d)(2)(B)(iii)(II) (excluding high-taxed income from the definition of passive income) and 904(d)(2)(F) (defining high-taxed income). See Reg. § 1.904-4(c)(1) (2011).

for corporations under Code section 11 is 35 percent. Thus a corporation paying foreign tax on passive income at an effective rate above 35 percent would be subject to the high-tax kick-out rule.

Passive income subject to the high-tax kick-out rule is included in the general limitation basket.[218] The rule advances the general policy of the passive income basket by removing the tax incentive that taxpayers paying high foreign taxes on their passive income otherwise would have for investing additional passive investment assets abroad rather than in the United States.[219] The following example illustrates the operation of the high-tax kick-out rule.

Consider PCo, a U.S. corporation, that holds a foreign patent. It is paid an annual royalty of $100 on the patent by a foreign person and is subject to a foreign income tax on that royalty of $40. PCo also has moveable capital, in the form of $100 of U.S. currency, that it could invest either in the United States or abroad for an annual return of $10. The average effective foreign tax rate on the $100 of royalty income is 40 percent. That rate is above the top U.S. corporate rate of 35 percent. Under the high-tax kick-out rule, the royalty income would be "kicked out" of the passive income basket into the general limitation basket. PCo would have no tax incentive, therefore, to invest its $100 abroad because the income from that investment would fall into the passive basket. The tentative U.S. tax on the $10 of income generated by that investment would not be offset by PCo's excess foreign tax credits attributable to the royalty income.

The average effective foreign tax rate on passive income is determined by dividing the amount of passive income by the foreign taxes attributable to that income. The amount of passive income is calculated by subtracting from gross passive income the deductible expenses properly allocable to that income.

In the case of a dividend received by a U.S. corporation from a foreign affiliate, the amount of foreign taxes attributable to the dividend would include the foreign taxes that were paid by the foreign affiliate and deemed paid by the U.S. corporation under Code section 902.[220] The amount of the dividend would be grossed-up by the amount of the deemed-paid foreign taxes.[221]

A similar rule applies to distributions of rents, royalties, and interest from a CFC. The high-tax kick-out rule is applied at the U.S. shareholder level if the total taxes paid and deemed paid by the U.S. shareholder exceeds the maximum marginal tax rate applicable to that shareholder. The high-tax kick-out rule is not used in classifying the income of a CFC for purposes of the look-through rules.[222]

The application of the high-tax kick-out rule to an item of passive income taxable under subpart F is determined by reference to taxes paid or accrued in the year in which the passive income is subject to U.S. tax.[223] Thus withholding taxes imposed on actual distributions of previously taxed subpart F income are not considered in determining the application of that rule.

Corporate taxes that are rebated upon a distribution of corporate profits are not taken into account in applying the high-tax kick-out rule. Assume, for example, that a wholly owned foreign subsidiary of a U.S. parent corporation is subject to a corporate tax on its income by Country A at an effective tax rate of 55

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[218] Income in the general limitation basket is called "general category income" and is defined as income other than passive category income. Thus income kicked out of the passive limitation basket ends up in the general limitation basket. See IRC § 904(d)(2)(A)(ii).

[219] See General Explanation of the Tax Reform Act of 1986 (1987) at 880.

[220] IRC § 904(d)(2)(F).

[221] Id.

[222] See IRC § 904(d)(3)(F)(ii).

[223] Reg. § 1.904-4(c)(6) (2011).

percent and then receives a rebate of 25 percentage points of that tax upon the distribution of that income as a dividend. The U.S. corporate parent receiving the dividend would not be subject to the high-tax kick-out rule because the effective tax rate on the dividend income was only 30 percent (55% – 25%).[224]

§ 20.02.2.3. Financial Services Income

The financial services income of a member of a financial services group or a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business is excluded from the passive basket and included in the general basket.[225] Prior to the changes made by the 2004 tax act, such income was included in its own separate basket.

In general, a financial services group is an affiliated group predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.[226] In general, the members of the group must be U.S. corporations or CFCs that meet an 80-percent voting and ownership test.[227] The definition of financial services income is very broad. The term would encompass most passive income derived by a person predominantly engaged in the active conduct of a banking, insurance, financing, or similar business.[228] For a person so engaged in such a business, it also would include any other income derived from the active conduct of that business.[229] In also includes insurance income of the type subject to tax under subpart F[230] and income derived by an insurance company from the investment of its reserves.[231] In brief, just about all of the income of a financial services group is included in the general basket.

§ 20.02.2.4. Exclusion for Export Finance Interest

Export finance interest[232] is excluded from the passive income basket. This exception is intended as an incentive for the export of property grown, produced, or manufactured in the United States.

§ 20.03. Look-Through Rules

As adopted in 1986, the credit limitation rules provided that U.S. taxpayers receiving income as a dividend, interest, or royalty from a controlled foreign corporation (CFC) would be treated under the separate basket rules as if that income had been earned by them directly. This conduit treatment of CFCs is achieved by the look-through rules, contained in Code section 904(d)(3). These look-through rules did not apply to foreign corporations that met the 10 percent ownership requirement for the indirect credit but did not qualify as a CFC. These corporations are referred to in Section 904(d) as “noncontrolled section 902 corporations” and are often referred to by tax specialists as 10-50 companies. The 1997 tax act generally extended look-through treatment to 10-50 corporations. The 2004 tax act modified the rules applicable to income derived through such corporations.

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[224] Reg. § 1.904-4(c)(7) and (8)(Ex. 9) (2011).

[225] IRC §§ 904(d)(2)(C). See Reg. § 1.904-4(e)(1) (2011) (defining financial services income).

[226] IRC § 904(d)(2)(C)(ii).

[227] Id.

[228] IRC § 904(d)(2)(D)(i)(II).

[229] IRC § 904(d)(2)(D)(ii)(I).

[230] IRC § 904(d)(2)(D)(ii)(III).

[231] IRC § 904(d)(2)(D)(ii)(II). See Reg. § 1-904-4(e)(2)(i)(A) and (B) (2011).

[232] IRC § 904(d)(2)(B)(iii)(I).

The look-through rules apply to dividends, interest, rents, and royalties paid by a CFC or a 10-50 company to its U.S. shareholders or other related persons.[233] Those rules also apply to deemed distributions under subpart F. Distributions subject to the look-through rules generally are classified, for purposes of the credit limitation rules, by reference to the character of the income of the foreign corporation out of which the distributions were paid. But for the look-through rules, distributions and deemed distributions from a CFC generally would be included in a U.S. shareholder's passive income basket.

§ 20.04. Allocation of Taxes

A U S. person claiming a foreign tax. credit with respect to income in a particular limitation basket must determine the amount of the foreign income taxes attributable to the income in that basket. Rules for attributing taxes to separate basket income are provided in Treasury regulation 1.904-6.

In general, taxes are related to income in a separate category of income only if the taxes were paid with respect to that income.[234] No taxes paid to a foreign country are attributed to income that is exempt from tax under the laws of that country.[235] A withholding tax on gross income is related to the gross income from which it is withheld.[236]

Taxes that are imposed ratably on more than one separate category of income are apportioned ratable to the net income in each separate category.[237] In making this apportionment, gross income is computed according to the laws of the government imposing the tax.[238] Ordering rules are provided in the regulations for reducing gross income, as defined under foreign law, to net income.[239] Taxes imposed on amounts that would not be income under U.S. law are attributed to income in the general basket.[240] If a tax is imposed on an item of income that has not yet been recognized under U.S. tax principles, the tax is allocated among the separate baskets as if the income had been recognized.[241]

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[233] In general, a U.S. shareholder of a CFC is a U.S. person owning 10 percent or more of the voting stock of the CFC.

[234] Reg. § 1.904-6(a)(1)(i) (2011).

[235] Id.

[236] Id. This rule does not apply to withholding taxes that are simply an advance payment of a general income tax imposed on net income. Id.

[237] Reg. § 1.904-6(a)(1)(i) and (ii) (2011).

[238] Reg. § 1.904-6(a)(1)(ii) (2011).

[239] Id.

[240] Reg. § 1.904-6(a)(1)(iv) (2011).

[241] Id.

The ordering rules for allocating taxes generally provide that deductions are allocated among separate categories of gross income according to the principles of foreign law.[242] Interest paid to a related party, however, is deducted from gross passive income, notwithstanding the provisions of foreign law.[243] This rule is particularly important for purposes of determining the application of the high-tax kick-out rule. The principles of Treasury regulation section 1.861-8 are applicable if the laws of the foreign taxing authority do not provide for the direct allocation or apportionment of deductions.[244]

§ 20.05. Review Problems

1. XCo, a U.S. corporation is in the oil business and the electric motor business. It has established a branch operation in France for the manufacture of the electric motors. The electric motors manufactured by that branch are sold in Europe and in the United States. The European sales are made by the French branch, and the U.S. sales are made through a U.S. branch of XCo.

Gross Income and Gross Receipts. For the current taxable year, XCo has gross receipts from the electric motor sales of $20,000. The U.S. gross receipts total $10,000 and the European gross receipts total $10,000. XCo's gross income from the electric motor sales is $6,000. Of that amount, $3,000 is attributable to the United States sales and $3,000 is attributable to the European sales. XCo also had gross receipts and gross income of $4,000 derived from oil extraction in Colorado. The following table summaries the information in this paragraph.

Summary of Gross Income and Gross Receipts						
Divisions of XCo	**U.S.**		**Europe**		**Total**	
	Gross Receipts	**Gross Income**	**Gross Receipts**	**Gross Income**	**Gross Receipts**	**Gross Income**
Electric Motors	$10,000	$3,000	$10,000	$3,000	$20,000	$6,000
Oil Extraction	$4,000	$4,000	$0	$0	$4,000	$4,000
Totals	$14,000	$7,000	$10,000	$3,000	$24,000	$10,000

[242] Reg- § 1.904-6(a)(1)(ii) (2011).

[243] Id.

[244] Id..

Deductions. XCo has paid $1,000 of interest to a New York bank on unsecured loans during the year, the proceeds of which were used in the oil business. It had general overhead expenses relating to the electric motor business of $2,000. It had $1,500 of general overhead expenses related to the oil extraction business. It has a deduction for research of $1,000. The research was conducted in the United States on improvements in its electrical motors. XCo has no other expenses for the year.

Summary of Deductions	
Interest	$1,000
Electric Motor Overhead	$2,000

The assets of XCo have a tax book value of $10,000. Their fair market value is unknown. The tax book value of the oil extraction assets is $4,000 and relate exclusively to the production of U.S. source gross income. The remaining assets (tax book value of $6,000) relate to the earning of foreign source gross income and U.S. source income from the electrical motors. An analysis shows that 50 percent of the gross income generated by those assets is U.S. source income and the remaining 50 percent of the gross income generated by those assets is foreign source income.

XCo pays an income tax to France of $1,200.

1a. How much of the deduction for interest should be apportioned to foreign source income? **Note:** Use the assets method *only* for apportioning the interest expense.

1b. How much of the deduction for electric moto r overhead should be apportioned to foreign source income?

1c. How much of the deduction for oil extraction overhead should be apportioned to foreign source income?

1d. How much of the deduction for electric motor R&D should be apportioned to foreign source income? **Note:** Use sales method *only* for apportioning the R&D deduction.

1e Compute the foreign source taxable income of XCo.

1f. How much of the French income tax of $1,200 is allowable as a credit against U.S. taxes after application of the limitation provisions?

2. VCo is a U.S. corporation engaged in the soft drink business, producing a fruit-based carbonated drink for the North American market. It has a bottling plant in the United States, which produces drinks solely for the U.S. market, and a bottling plant in Canada, which produces drinks solely for the Canadian

market. All of VCo's assets are associated with these bottling plants, other than a $4 million deposit in a Cayman Islands bank.

The assets held by VCo, their fair market value (when known), and their tax book value are shown in the following table:

Assets	Fair Market Value	Tax Book Value
U.S. plant	unknown	$3,000,000
Canadian plant	unknown	$3,000,000
Cayman deposit	$4,000,000	$4,000,000
Total		**$10,000,000**

During the taxable year, the U.S. bottling operation has gross receipts of $4 million, cost of goods sold of $2 million, and gross income of $2 million, all from U.S. sales. The Canadian branch has gross receipts of $2 million, cost of goods sold of $1 million, and gross income of $1 million, all from Canadian sales. The $4 million deposit in the Cayman account produced interest income of $400,000 (10 percent interest rate). VCo paid deductible expenses of $400,000, as follows:

(a) Interest payments of $200,000 on a recourse loan secured by its Canada and U.S. inventory of unsold soft drinks;

(b) Property taxes of $50,000 paid to the State of Michigan with respect to VCo's U.S. bottling plant;

(c) Office expenses related to U.S. sales of $100,000;

(d) Office expenses related to Canadian sales of $50,000.

VCo paid Canadian income taxes of $360,000 and no other foreign taxes.

2a. Compute the amount of the deduction for intere st expense that is associated with the Cayman deposit. How much foreign source taxable in come does VCo have in the passive basket?

2b. How much foreign source gross income does VCo have inthe general basket?

2c. How much foreign source taxable income does VCo have in the general basket?

2d. Compute the amount allowable as a foreign tax credit after application of the credit limitations.

3. PCo is a U.S. corporation. During the year, it has the following sources of income:

(a) PCo earns foreign source taxable income of $100 through a branch located in Country B. It pays normal corporate income taxes to Country B of $25 and a branch-profits tax of $5. The Country B branch of PCo manufactures widgets for sale outside the United States.

(b) PCo owns all of the stock of CCo, a CFC organized under the laws of Country C. CCo has income of $200, all of which is derived from the manufacture of flanges and none of which is subpart F income. CCo pays income taxes to Country C of $100 and distributes its after-tax income of $100 to PCo as a dividend.

(c) PCo also owns a bond issued by ACo, a foreign corporation organized in Country A. The bond pays interest annually of $60. A withholding tax of $6 is collected by Country A on the interest income.

(d) Finally, PCo owns 20 percent of the stock of TCo, a foreign corporation organized under the laws of Country T. TCo has manufacturing profits of $100 on which it pays income taxes to Country T of $50. It distributes all of its after-tax profits to its shareholders, with PCo receiving a dividend from TCo of $10.

All of the taxes mentioned above qualify under the regulations as income taxes or as in-lieu taxes.

3a. Which basket limitation (general or passive) appl ies to item 3(a)? What is the amount of income included in that basket on account of item 3(a), and what is that amount of the creditable tax?

3b. Which basket limitation (general or passive) applies to item 3(b)? What is the amount of income included in that basket on account of item 3(b), and what is that amount of the creditable tax?

3c. Which basket limitation (general or passive) appl ies to item 3(c)? What is the amount of income included in that basket on account of item 3(c), and what is that amount of the creditable tax?

3d. Which basket limitation (general or passive) appl ies to item 3(d)? What is the amount of income included in that basket on account of item 3(d), and what is that amount of the creditable tax?

3e. What is the amount of foreign tax credit allowable to PCo under the facts above?

4. PCo, a U.S. company, owns all of the stoc k of MCo, a Mexican company. MCo manufactures auto parts in Mexico for sale in the United States. All sales take place at MCo's factory in Mexico, with title passing at the factory. during the year , MCo earns the following amounts of taxable income:

(a) $2 million from sale of auto parts;

(b) $1 million from dividends from a 5% interest in a corporation engaged in tuna fishing on the high seas and the sale of the tuna in Japan;

(c) $1 million from interest on a German government bond.

MCo pays an income tax to Mexico of $1 million on its taxable income of $4 million (25% rate). It then distributes the remaining $3 million to PCo as a dividend. PCo has no other income.

Question. Compute the amount of PCo's taxable income, its tentative (pre-credit) U.S. tax (35% rate), and the amount of the allowable cred it after application of the credit limitations.