The Reformed Foreign Tax Credit: A Path Through the Maze

HARVEY P. DALE *

Introduction

The foreign tax credit has long been the United States' principal provision for mitigating multiple taxation of international income. In recent years, the credit mechanism itself has been questioned and voices have been raised asking for its repeal. The Tax Reform Act of 1976[1] did not remove the credit provisions; rather, it contented itself with more minor surgical revisions. Taken together, the changes substantially changed the visage of the credit, but not beyond recognition.

As usual, the operation also created new uncertainties and complexities which this article will explore. As the title hints, some suggestions will be made in the hope of helping to light a path through the new labyrinth.

The 1976 legislation made six principal changes in the operation of the foreign tax credit rules. One of these—the effect of boycott participation upon the foreign tax credit—will not be considered here.[2] The

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* HARVEY P. DALE is an Associate Professor of Law at New York University School of Law and of counsel, Conboy, Hewitt, O'Brien and Boardman, New York, New York. Authorities cited herein are believed to be current through December 31, 1977. The author wishes to express thanks to Richard Klein, Esq., for his valuable assistance in the preparation of this article.

[1] H.R. 10612, 94th Cong., 2d Sess., Pub. L. No. 94-455, 90 Stat. 1520 (herein cited as T.R.A. 1976).

[2] T.R.A. 1976 § 1061, adding I.R.C. § 908. *See generally* Rubenfeld, *Legal and Tax Implications of Participation in International Boycotts,* 32 TAX L. REV. 613, 640-41 (1977). Also beyond the scope of this article is a discussion of the relation of the foreign tax credit to the section 936 possessions corporation credit. The section 936 credit is available, by election in lieu of the foreign tax credit, to a domestic corporation that (1) received at least 80 percent of its gross income for the three-year period preceding the close of the taxable year from sources within a U.S. possession, and (2) derived at least 50 percent of its gross income from active conduct of a trade or business within a possession. The interplay between the foreign tax credit and the section 936 credit may result in imposition of a double tax. For example, an individual shareholder of an electing possessions corporation who incurs liability for Puerto Rico's tax on dividends will be deprived of the foreign tax credit otherwise available to him under section 901(b)(2). I.R.C. §§ 901(g), 904(b)(4). *See* Griggs, *Operating in Puerto Rico in the Section 936 Era,* 32 TAX L. REV. 239, 259-60 (1977). This result would be changed by section 2(t)(1)(A) of the Technical Corrections Bill of 1977, H.R. 6715, 95th Cong., 1st Sess. (1977), as passed by the House of Representatives on October 17, 1977 (herein cited as the Technical Corrections Bill of 1977).

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