

Dale, Creditability of Foreign Taxes,
U.S. Taxation in Developing Countries 121
(Matthew Bender 1980)

Chapter 4

Creditability of Foreign Taxes

Harvey P. Dale

A corporation formed in the United States is subject to U.S. income tax on its worldwide income.¹ It is also usually subject to tax by foreign jurisdictions in which it does business or from which it derives income. The foreign tax credit is the primary tool used by the United States to accommodate the overlap of taxing jurisdictions.²

The credit mechanism gives taxing priority to the source jurisdiction.³ It allows the foreign country to take the "first bite of the apple" and allows that "bite" directly to offset the amount of revenue raised by the United States with respect to the same income.⁴ In general, then, the foreign tax credit mechanism provides an accommodation between sovereign taxing jurisdictions; the taxpayer is merely a middleman or stakeholder. (We will have cause, below, to question and elaborate on this model.)

It is accordingly of central importance to the credit mechanism to determine what sorts of things will be creditable. Recently, there has been an explosion of activity in this area. In 1978 alone, the Internal Revenue Service published at least ten rulings on the question,⁵ and a regulations project was also initiated.⁶

Although it will be necessary to discuss these rulings briefly, it is not

121

121

the purpose of this paper to attempt a critical analysis of them.⁷ Rather, this paper will consider the ramifications of the procedures currently used to determine creditability. In particular, it will be suggested that further elaboration of detailed criteria for determining creditability is undesirable. Several possible alternative procedures will be discussed. Finally, a few suggestions for improving the current procedures will be made.

Preliminary Considerations

Ever since 1918—when a credit for foreign taxes was first granted by the United States⁸—creditability has been allowed for foreign “income, war profits, and excess profits taxes.”⁹ For convenience, this article will refer merely to foreign “income taxes.” It is surprisingly unclear why foreign income taxes—as opposed to other types of foreign imposts—were selected for creditability.¹⁰ There appears to be no a priori reason for selecting income taxes (and thus excluding other taxes or imposts) for creditability.

Economists have urged that credits should be granted for all taxes which cannot be “passed on.”¹¹ The notion is: if a particular payment may be passed on by the taxpayer, there is no need for a credit mechanism, since a deduction is sufficient. For example, consider a retailer required to collect a point-of-sale sales tax. His cost of goods is \$100, and he wishes to resell the goods for \$150. The goods are so marked, but a 3 percent sales tax is also charged at the cash register. The total amount received by the retailer is accordingly \$154.50. The \$4.50 of tax is remitted by the retailer to the taxing authority, leaving him with a net \$150 as he originally intended. Assuming that the full \$154.50 is treated as his receipts, he will compute his net income by deducting the cost of goods sold (\$100) and also by deducting the \$4.50 of sales taxes. His \$50 of net income is the correct figure, and is the same amount he would have calculated if the sales tax had been eliminated. The true incidence of the sales tax falls on the purchaser.

If, however, the particular tax cannot be passed on to the purchaser, a deduction mechanism is not adequate to produce an identical result. For example, suppose that for some reason the retailer was not able to charge the customer more than \$150, but nevertheless had to pay a \$4.50 tax. Absent that tax, his net income would have been \$50. If no credit, but

only a deduction, is allowed for the tax, his net income would be \$45.50. Assuming (for convenience) a flat 50 percent income tax rate applicable to the retailer, he would have paid—without the \$4.50 tax—one-half of \$50 or \$25 in income taxes, and would have had a net after-tax economic gain of \$25. Given the imposition of the tax, but granting no credit (and only a deduction) for it, his 50 percent tax rate will be applied to the \$45.50 remaining, and will produce a tax of \$22.75. His net after-tax economic gain will be only \$22.75. If, instead, a credit were granted for that tax, instead of a deduction, the tentative tax (before credit) would still be 50 percent of \$50, or \$25.¹² However, instead of paying the full \$25, the \$4.50 tax could be credited against it, thus reducing the net payment to only \$20.50. The credit mechanism leaves the retailer with a net after-tax economic gain of \$25, which is the desired result if the tax is not passed on, i.e., if the true incidence of the tax is on the retailer.

This economic analysis seems persuasive. It suffers, however, from two fundamental defects. The first is that it is extremely hard to apply to certain kinds of taxes. In particular, there is a long-standing and continuing inconclusive debate in the economic literature about whether corporate income taxes are passed on. And it may be that some other taxes—not denominated income taxes—are not passed on.¹³

The second major defect is history. If the life of the law has been experience, then perhaps as the law ages, the rules of law harden—like arteries. If so, we have reached the point of total senility with respect to the statutory category for creditability: it has been, and almost certainly will continue to be, limited to income taxes.

Nevertheless, policy considerations are important to the current argument. It is uncertain whether the "income tax" category is fully responsive to the policies of the foreign tax credit. Thus, we should be at least equally uncertain whether those policies are best served by elaborating detailed criteria for testing whether a foreign impost is or is not an income tax. Accordingly, we might be more attentive to the relevant policies, rather than focusing exclusively upon scholastic elaboration of arid statutory language.

Of course, everyone concedes that a foreign impost may be an income tax even though it does not conform in every detail to the Internal Revenue Code of 1954, as amended. The question is really one of emphasis. Dry elaboration of the statutory language draws one irresistibly to a closer

and closer mirroring of the concepts and rules of the Internal Revenue Code. A policy approach might afford greater flexibility in selecting creditable taxes. It is believed that this would be a desirable goal.¹⁴

Developing Criteria

There is little doubt that recent published rulings of the IRS represent at least a new focus on detailed criteria for testing creditability. It is also clear that these rulings are founded upon prior precedents. The intent here is not to debate the extent to which the rulings represent a departure from previous understandings. However, a brief description of current IRS views may be of some value. There are two connected, but different, inquiries mandated by the rulings. First, it must be determined whether the foreign impost is a tax (as opposed, for example, to a rental or royalty payment). Second, if it is a tax, it must be determined whether it is an income tax.¹⁵

The first inquiry seems to be directed to the "second model" of the operation of the foreign tax credit, discussed below: it appears to be designed to frustrate a taxpayer effort to persuade a foreign government—owning, for example, natural resources in place—to impose a "tax" instead of charging a royalty, thus producing a credit instead of a mere deduction, but without increasing the amount paid to the foreign sovereign. Thus, the IRS says that foreign impost is not a tax, when it is imposed by a foreign government which owns minerals in place,¹⁶ unless (1) that government also charges "an appropriate royalty or other consideration for the property that is commensurate with the value of the concession," (2) such royalty is "calculated separately and independently of the foreign tax," and (3) payment of such royalty is also "independent of the discharge of any foreign tax liability."¹⁷

The second inquiry assumes that a foreign tax has been paid and focuses on whether it is an income tax.¹⁸ The rulings¹⁹ invoke a three-part test for this purpose. First, an income tax must be imposed upon gain which is "realized in the United States sense."²⁰ Second, the tax must be designed to reach net income, and it must be "so structured as to be almost certain of doing so."²¹ Third, the tax must be imposed "on the receipt of income by the taxpayer" rather than on transactions.²²

The framework for applying these criteria is at least as important as the

criteria themselves. Each tax must be scrutinized to see whether it is indivisible and singular, or divisible. Little guidance is given on how to make this determination, except to indicate that a tax is generally divisible "if it is levied on more than one separate tax base and the tax on each base is separately computed."²³ Then, each separate tax is separately scrutinized *in its entirety*. The search is for the overall pattern, i.e., the three relevant criteria are to be applied "by reference to the entire class of taxpayers subject to the foreign tax and not on a taxpayer-by-taxpayer or transaction-by-transaction basis."²⁴ The tax will qualify if it meets the three tests in most cases. It is clear that occasional aberrational elements will not disqualify the tax. However, in a very significant sentence, the IRS states that

When a tax is imposed on a limited tax base or on a limited class of taxpayers and the tax includes a provision that violates one of these requirements, then the importance of that aberrational provision is necessarily increased by the limited scope of the tax base or class of taxpayers.²⁵

It thus is apparent that the "divisibility" question may often be of profound importance, for if a tax is found to be divisible, that may substantially decrease its chances of being creditable since each "aberrational provision" will be deemed to have an increased (and *disqualifying*) significance.²⁶

Competing Policies

Many legal rules represent a compromise among competing policies. If the policies are strong and opposed, the resulting compromise is usually in tension and accordingly less stable. In any event, anyone hoping to design a better garment must first consider the strains to which it is subject. At least some of the many policy considerations affecting the foreign tax credit mechanism—and the determination of what is a creditable tax—will be mentioned below.

The most fundamental policy behind the foreign tax credit is what might be called "international neutrality." It represents a desire not to impede international transactions, i.e., to make taxation neutral with respect to domestic and foreign business and investment decisions.

A second significant policy, here as elsewhere in the Code, is so-called "domestic neutrality," i.e., equal treatment of all U.S. taxpayers.

A third critical policy is protection of the revenue. Because the foreign tax credit cedes primary taxing jurisdiction to the foreign country, and abates the U.S. revenue in direct proportion to creditable foreign taxes, it creates the possibility of a rape of the U.S. Treasury. It is believed that this problem, and the felt need to counter it, were particularly significant in shaping several recent published rulings.

In this context, a reexamination of the foreign tax credit system model mentioned above is useful. The first model posits two conflicting sovereigns tugging at the income of a single taxpayer who is, accordingly, a mere stakeholder. That model is probably accurate in most cases. In some cases, however—including some involving significant amounts of revenue—it may be erroneous.²⁷ One variation views the taxpayer not as a helpless stakeholder, but rather as an active participant in the design of the foreign revenue system. This second model is perhaps most persuasive when the foreign government also owns the property (for example, the oil or gas resources) which is the subject of the taxpayer's operations. If the taxpayer can persuade the foreign government to take its cut by way of "taxes" instead of by way of "royalties," he may be successful in increasing his overall economic gain. The effect of this is to leave the foreign sovereign in approximately the same position, economically, as it was when it charged a royalty. The revenue transfer is then from the U.S. Treasury to the taxpayer, by virtue of the greater advantage of creditability (as opposed to deductibility) of the payments to the foreign sovereign.

A third model is also suggested. In that model, the foreign government merely increases its revenues up to (but not in excess of) the U.S. credit. This could be done by a so-called "soak-up" tax. Alternatively, it could be done by imposing a tax so fashioned as to select for higher taxation those foreign companies investing in the foreign jurisdiction for whom a foreign tax credit would be available as an offset. In this case, the apparent rape of the Treasury is conducted by the foreign sovereign.²⁸

Because the United States grants foreign tax credits unilaterally, it cannot now avoid rape merely by withholding consent. Instead, it must find methods of preventing rape by denying creditability. The most direct way of doing this would be to investigate the intent and motive of the taxpayer, and of the foreign sovereign. For a variety of reasons—including customary notions of international law (with respect to the foreign sover-

eign) and administrative convenience—it does not appear feasible to deal with creditability, generally, by investigating intent. Instead, elaboration of the criteria for creditability has been selected.

This creates at least two problems. The first is that it may not be effective. Even assuming that the criteria, as elaborated in published rulings and otherwise, are sustained by the courts, it is possible that well-advised foreign countries will revise their internal laws to comply with the new criteria. From this point of view, the elaborated criteria may amount to no more than drafting instructions to the foreign lawmakers.²⁹

A second problem with elaboration of criteria is the problem of complexity in general. Here, as elsewhere in the Code, complex rules affect those at whom they are directed, and others as well.³⁰ Criteria set forth in recent rulings will almost certainly affect many taxpayers whose positions are, in fact, properly described by our first model, rather than by either of the latter two models. Furthermore, the criteria purport to be an explication of what is, and presumably always has been, the law (even if the published rulings themselves are, with respect to the particular taxes they discuss, prospective).³¹ Thus, they will have retroactive impact on this same class of true-stakeholder taxpayers. Because the criteria are neither easy to understand nor to apply, additional costs will be involved in selecting tax advisers, and higher stakes will be involved in the so-called tax lottery.

Furthermore, this sort of complexity is automatically exported by the United States. Unlike most other complex areas of the Code, the foreign tax credit is critical to foreign jurisdictions. If creditability is denied for their imposts, international trade and investment from the United States into their jurisdictions may be seriously and adversely affected. Accordingly, there are often significant pressures to conform their internal laws to the elaborated criteria for creditability. Thus, we export complexity as we elaborate complex criteria for creditability.

Several recent published rulings tend to require foreign jurisdictions to increase the complexity of their internal tax systems. For example: withholding taxes on investment income have been held not to be creditable if the same sort of tax—that is, a flat-rate tax on gross income—is also applied to taxpayers who are doing business in the foreign country.³² The converse also seems true: withholding taxes will be creditable for U.S. purposes if, in general, they are imposed only upon taxpayers who do not

do business in the foreign jurisdiction. Thus, foreign jurisdictions may be under some pressure to adopt a system for taxing foreign persons who engage in business there on a necessarily more elaborate net-income basis, not only to preserve creditability for such business entities, but also to preserve creditability for passive investors!³³

There is no bright line between taxing gross income and taxing net income. Rather, the issue is better perceived as a spectrum. Businessmen are familiar with this notion, for example in negotiating "earn outs" or variable lease payments. The recipient of the payment will often attempt to negotiate a payment calculated by reference to the payer's gross income. This avoids the complexities and administrative difficulties of verifying and calculating deductions. Of course, it is a corollary that the percentage to be applied will be much lower if applied to gross items than net items. Many negotiations are concerned with the exact extent to which the parties will move from a pure gross basis to a net basis. There are an infinite number of possibilities along that route. In general, the further one moves from gross toward net, the greater the complexity and administrative difficulty, and the higher the percentage to be applied to the reduced figure. Rates and complexity tend to vary directly in this area.

To what extent should we pressure foreign jurisdictions to adopt complexity in order to ensure creditability? What good policy is served by denying creditability to low-rate taxes imposed on amounts falling close to the "gross" end of the spectrum? Why can we not fashion a rule that would presumptively permit creditability if the rate in question is sufficiently low to make it likely that it represents an administrative decision to achieve simplicity?

Other similar situations may be posed by the increasingly strict elaborated criteria for creditability. It is believed that many simplifying assumptions of foreign tax systems would not, in general, cause alarm within our foreign tax credit system, at least if the first model (discussed above) is operative. It is believed that the overwhelming concern of those responsible for the recent rulings was rape, either by taxpayers (under the second model) or by foreign governments (under the third model). The main thrust of the balance of this paper is to consider methods of protecting U.S. revenues without necessarily incurring the cost of proliferating complexity.

Alternate Procedures

Improvements are needed in the procedures by which we determine creditability. Two different sorts of suggestions will be made below. First, a statutory amendment to the Internal Revenue Code will be suggested.³⁴ Second, various other changes to existing procedures will be discussed.

Statutory Amendments

The major thesis of this paper is that negotiation is better than elaboration. At present, however, there is no legal mechanism by which the Treasury can precipitate negotiation, except occasionally in the context of overall treaty negotiations. It may be desirable to enable narrower negotiation, limited to the question of creditability.

A provision could be added to the Internal Revenue Code, with the following aspects. First, a presumption should be created that the imposts of a foreign jurisdiction will be creditable if they are imposed by the principal and broad-based, revenue-raising measure of that jurisdiction; if they are calculated generally on realized gains and income; if they generally permit appropriate deductions; and if they are imposed under a statute which is labeled an income tax. This presumption would be rebuttable, but the burden of proof would be on the IRS.

Second, the Secretary of the Treasury would be given authority, by notice, to declare any particular foreign government impost noncreditable. Any such declaration would have effect only after some period of time following publication of the notice in the Federal Register, e.g., nine months later. During that period of time, negotiations might well be precipitated. If satisfactory, the notification could be withdrawn prior to its effective date. If no successful resolution of the question was reached, the foreign tax would *conclusively* become noncreditable from and after nine months from the date of publication of the original notice.

Third, criteria would be broadly phrased in the statute to guide the Secretary of the Treasury in making the preceding determination. Most important, an explicit and brief statement of the policy of the foreign tax credit should be made, and then (in addition) various criteria could be listed, much as in current Code Section 385 with respect to the debt/equity conundrum. Regulations to elaborate the criteria should be

specifically authorized.³⁵ On the one hand, the reference to policy and the broad (but flexible) statement of criteria might be expected to reduce the pressure to grant creditability only to mirror-image foreign tax systems.³⁶ On the other hand, establishment of criteria would be useful in preventing development of pressures on the Secretary of the Treasury to make a determination of noncreditability for reasons other than fiscal ones—for example, for considerations of civil rights.

Finally, it might be desirable to add a provision permitting any affected taxpayer to test the legal validity of the noncreditability determination for a very limited period of time (e.g., six months) by a declaratory judgment procedure or the like.³⁷ Grounds for testing the determination would only be conformity to the general policy and the flexible criteria for creditability enunciated in the statute.

If adopted, such a statute might help to relieve the pressure for increasing elaboration, without sacrificing the power of the United States to protect its revenues. Furthermore, because determinations of noncreditability would be conclusive (subject perhaps to the declaratory judgment procedure), a substantial saving of expense in audit and litigation would result. By contrast, under the current system, each taxpayer is free to litigate the validity of any of the published rulings of the IRS; it seems quite likely that we shall see increased litigation on this question in the future.

In addition, since the determinations would always be prospective, taxpayers would have an opportunity to reorganize their affairs in light of impending noncreditability. By contrast, current procedures are generally retroactive, with only limited exceptions. Thus, taxpayers falling into the first model—the innocent stakeholder—are sometimes retroactively stripped of expected creditability.

It is important to note what this proposal does *not* do. It does not replace currently available procedures for determining noncreditability. Thus, the IRS would continue to be free to litigate creditability in all cases.³⁸ It is hoped, of course, that the availability of a conclusive and prospective determination of noncreditability would substantially reduce the pressure to deal with noncreditability on a retroactive, taxpayer-by-taxpayer basis.

Is there any precedent for this sort of idea? There is some slight precedent, although the available legal analogies have rarely if ever been used. Currently, Section 896 of the Code provides the president with authority

to deal with certain types of discriminatory foreign taxes. In addition, the Code excludes certain shipping and aircraft income of foreign persons from taxation on condition that their foreign jurisdiction grant "an equivalent exemption."³⁹ Presumably, the determination of exemption equivalency is made by the Treasury and perhaps the IRS. This could be invoked on a case-by-case basis.

Is it realistic to think such a statute might now be adopted? Congress has only recently amended the foreign tax credit provisions in fairly substantial ways.⁴⁰ There has been too little experience with the revised credit to make any further substantial revisions desirable at this time. Although the proposed statute would not make any substantial changes, it might indirectly become the pretext for a broad congressional reconsideration of the area. If so, this might be undesirable. Furthermore, it is very uncertain whether even a limited statutory amendment could be guided successfully through the tortuous path to adoption. Accordingly, other suggestions for improvement must be considered.

Nonstatutory Changes

Rulings. The policy of the Internal Revenue Service in issuing creditability rulings is in need of reexamination. In the foreign tax credit area, as elsewhere, published rulings are usually issued after the request of individual taxpayers. Unlike some other areas, however, the foreign tax credit rulings have a significant impact on many other taxpayers, and also on foreign governments. Published rulings on creditability might be improved if more complete information and fuller discussion of the issues preceded their publication. It would be useful to develop a way to permit participation in the ruling process by all interested taxpayers, and by representatives of the foreign governments in question.

This can now be done if the party requesting the ruling is prepared to waive the privacy provisions of Code Section 6103. In some cases, it is understood that this has happened. In addition, representatives of foreign governments have indirectly been allowed to participate. On an informal basis, there have been true three-way discussions among representatives of the Treasury, representatives of the foreign government, and taxpayer representatives. It is understood that the IRS is actively considering the possibility of opening up more creditability issues for public comment and participation prior to ruling.⁴¹ With appropriate safeguards, this

would seem desirable. The IRS should, however, preserve enough discretion so that it will not always be compelled to have such public hearings prior to issuing a published ruling. Of course, no such hearings would be required in the case of exclusively private rulings or technical advice. Accordingly, it is suggested that the IRS adopt policies which, in general, permit full participation by interested parties prior to the issuance of any published ruling dealing with creditability of foreign taxes.

Regulations. A regulations project has been initiated in the wake of recent published rulings.⁴² This is desirable for a number of reasons: it will give interested parties an opportunity to participate in the formulation of the final regulations, and the final regulations will have greater legal dignity than published rulings. Even so, there will be the need to balance the extent of elaboration of details for creditability against the desire for preservation of both some simplicity and some discretion.

Explicit reservation of some discretion to determine creditability on a case-by-case basis appears to be desirable. The creditability decision is complicated, and one might feel better if free to refer to all relevant facts and circumstances. However, the suggestion poses problems. The impulse to elaborate details is strong in a system, like ours, founded on principles of *stare decisis* and notions of equity. This fundamental policy problem is linked with retroactivity: because decisions involving discretionary application of creditability criteria might have to be retroactive, it might be harder to sustain the exercise of discretion if granted by regulations (rather than by statute, as suggested above). If, however, it was possible to preserve discretion but to exercise it generally on a prospective basis only, many of the objections to broader case-by-case discretion might fall. Thus, it is suggested that the regulations reserve some discretion in this area by incorporating an all-facts-and-circumstances approach, but that an explicit cross-reference to Section 7805(b) also be included to indicate a readiness to limit retroactivity in appropriate cases. This may strike a balance among avoiding the exporting of too rigid and complex criteria for creditability, erecting workable defenses against a rape of the fisc, and providing reasonably predictable guidance to concerned taxpayers.

The regulations might also contain at least one safe harbor for withholding taxes at low rates imposed on passive individual investors. It has been shown above that relatively lower rates may be an indication of a

bona fide attempt to tax net income but to calculate the tax—for reasons of administrative simplicity—against gross income. Two special concerns combine to argue for such a safe harbor. First, an overwhelming proportion of all tax returns claiming foreign tax credits involves just such withholding taxes on foreign investment income of individuals. In 1975, for example, about 234,000 individuals claimed foreign tax credits on their returns, in an aggregate amount of about \$382 million. Between 100,000 and 125,000 returns involved foreign-source dividends, interest, rents, or royalties, with respect to which foreign taxes were claimed paid in the aggregate amounting to approximately \$49 million (before application of the limitation, which could only operate to reduce the actual amount of available credits). By contrast, only approximately 6,000 corporate returns were filed claiming foreign tax credits, but the amounts in question aggregated approximately \$20 billion. In other words, individual returns involving foreign taxes withheld on passive investment income represented perhaps one-half of all returns filed claiming foreign tax credits, but the amount of credits involved represented less than one-quarter of 1 percent of the aggregate amount of such credits claimed.⁴³ A simplifying safe harbor rule would thus help many taxpayers while “risking” relatively little revenue.

The second concern arises from the unexpected effect here of the rules affecting tax return preparers.⁴⁴ Many individuals falling within the suggested safe harbor must get assistance—from accountants, lawyers, or others—in completing their returns. The IRS has ruled that such foreign withholding taxes are *not* creditable if the foreign tax system imposes the same tax on persons (other than the taxpayer in question) engaged in business there. Accordingly, the preparer must investigate the foreign tax system in some detail before filling out the taxpayer's return, in order to avoid penalties imposed on the preparer for negligence. The IRS has ruled that the preparer may not rely on the taxpayer's views or instructions as to the foreign law,⁴⁵ and may not even rely upon an attorney's opinion if the preparer doubts its accuracy.⁴⁶ Thus, the preparer may well be put to the task of researching an entire foreign taxing system in order to prepare an individual's tax return, unless the preparer is willing to risk a penalty for not doing so. Who is to bear the cost of this effort? Recall that the average credit claimed here is about \$400 per return.

A serious effort should be made to avoid the above result. Perhaps the

regulations could provide a presumption of creditability for withholding taxes imposed by foreign jurisdictions if: (1) the foreign rate was at or below a certain percentage, e.g., 30 percent; (2) the income in question was similar to that class of income generally described in the Internal Revenue Code as "fixed or determinable annual or periodical" income,⁴⁷ and (3) the taxpayer was an individual not engaged in trade or business within the foreign jurisdiction.

This safe harbor would probably cover virtually all foreign taxes imposed upon passive U.S. investors. It thus would affect a large number of taxpayers, but probably a relatively small amount of creditable foreign taxes would be involved. Such a provision would minimize the need for U.S. investors to become involved in more complex analysis of the more detailed criteria for creditability. The safe harbor provision might also contain language allowing the IRS to contest the creditability of an apparently qualifying foreign tax, if, under all of the circumstances, there was substantial evidence of tax avoidance abuse. This final provision could be invoked to prevent a rape, but if properly administered, it would not weaken the simplifying impact of the safe harbor.

Conclusion

The preceding suggestions are not intended to be exclusive. For example, most income tax treaties to which the United States is a party contain provisions dealing with creditability of foreign taxes. Such provisions are very helpful in deciding issues of creditability.⁴⁸

This paper is not intended to express a view—laudatory or critical—about the propriety of positions taken in recent published rulings. In general, the rulings do not adopt wholly new criteria. Rather, they reorganize and explicate previously used criteria. They may not represent "too much" detail. Nevertheless, a trend toward increased elaboration of ever-more-rigid criteria can be detected. Such a trend is believed to be undesirable. It is hoped that the Treasury and the IRS will continue to search for improved procedures for determining creditability.

Notes

1. Reg. §1.11-1(a). The same rule applies to U.S. citizens. Reg. §1.1-1(b).
2. The foreign tax credit is generally governed by Internal Revenue Code

(I.R.C.) Sections 901-8, which constitute Subpart A of part III of subchapter N of Chapter I of the Code. There are, however, various additional statutory provisions affecting the credit elsewhere in the Code, e.g., I.R.C. Sections 78, 275, 960.

3. Although it is possible to quibble with this statement technically—because in extremely unusual circumstances, the foreign tax credit may be available even though the taxing jurisdiction is not the source jurisdiction, e.g., Rev. Rul. 55-414, 1955-1 C.B. 385—there is no doubt that it accurately reflects the normal state of affairs.

4. It is the function of the foreign tax credit limitation, now in I.R.C. Section 904, to prevent high foreign taxes from offsetting U.S. taxes on *domestic* income. (The legislative history states that the limitation was first imposed, in 1921, to avoid having foreign tax credits “wipe out” the U.S. tax. House of Representatives (H.R.) Rep. No. 350, 67th Cong., 1st Sess., 1921, p. 13.) But the limitation does not really operate, precisely, to identify “the same income” which was subject to foreign tax. First, the limitation fraction, as amended in 1976, pools all foreign source income in the numerator of the fraction, whether or not such income was subject to foreign tax. Second, there is no necessary correlation between the limitation fraction’s numerator, which is calculated according to U.S. concepts and in U.S. dollars, and the actual number which represents the foreign jurisdiction’s tax base. Indeed, it appears impossible to assign any precise meaning to the concept of “the same income” in this context. This, in turn, deprives the notion of “double taxation” of conceptual rigor.

5. Rev. Rul. 78-61, 1978-1 C.B. 221; Rev. Rul. 78-62, 1978-1 C.B. 226; Rev. Rul. 78-63, 1978-1 C.B. 228; Rev. Rul. 78-222, 1978-1 C.B. 232; Rev. Rul. 78-233, 1978-1 C.B. 236; Rev. Rul. 78-234, 1978-1 C.B. 237; Rev. Rul. 78-235, 1978-1 C.B. 238; Rev. Rul. 78-258, 1978-1 C.B. 239; Rev. Rul. 78-410, 1978-2 C.B. 347; Rev. Rul. 78-424, 1978-2 C.B. 197. See also the very interesting Rev. Rul. 78-355, 1978-2 C.B. 195, dealing with similar questions but in a different context, and reaching an apparently more relaxed and policy-oriented position.

6. Announcement 78-144, 1978-39 I.R.B. 24, 43 Fed. Reg. 38429 (Aug. 28, 1978). See also Announcement 78-165, 1978-46 I.R.B. 24, 43 Fed. Reg. 46859 (Oct. 11, 1978), extending the comment period to November 27, 1978. A summary of some of the comments received by the IRS, by early December 1978, appears in *Tax Notes* (Dec. 18, 1978) 25:699. Additional comments were filed later. [Proposed Regulations were issued in June 1979, after this paper was completed; they are not discussed herein.]

7. For one extremely critical view, see Report of the Foreign Tax Credit Subcommittee, Committee on Foreign Activities of United States Taxpayers, Section of Taxation, American Bar Association, “The Creditability of Foreign Income Taxes: A Critical Analysis of Revenue Rulings 78-61, 78-62 and 78-63,” *Tax Lawyer* (1978) 32:33.

8. Revenue Act of 1918, chap. 18, §240(c), 40 Stat. 1082.

9. This triumverate marches inseparably together throughout the Code. E.g.,

I.R.C. Sections 164(a)(3), 275(a)(4), 901(b), 901(c), 901(e)(1), 901(f) [query typographical error], 901(g), 902(a), 902(b), 902(c), 903, 906(a), 907(c)(5), 906(a), 906(b).

10. I.R.C. Section 164(a) clearly allows a deduction for other types of foreign taxes.

11. An analysis of the economic literature is beyond the scope of this article, as well as the competence of its author. A useful introduction to the concept appears in Elizabeth A. Owens, *The Foreign Tax Credit* (Cambridge, Mass.: Harvard Law School, 1961), pp. 83-88. See also Peggy B. Musgrave, *United States Taxation of Foreign Investment Income* (Cambridge, Mass.: Harvard Law School, 1969), pp. 109-15; Douglas A. Kahn and Pamela B. Gann, *Corporate Taxation and Taxation of Partnerships and Partners* (St. Paul, Minn.: West Publishing Co., 1979), pp. 26-36.

12. It is fundamental to the credit mechanism that either a deduction or a credit—but never *both*—is granted for a creditable amount. Thus, an election to claim a credit operates as a denial of a deduction for the amount in question. I.R.C. Section 275(a)(4). In the text example, then, the taxable income is \$50, not \$45.50, if a credit is granted for the \$4.50 sales tax.

13. There appears to be no doubt, however, that taxes imposed on nonbusiness income of individuals are not passed on. This argues for allowing foreign tax credits for foreign taxes imposed (typically by withholding at the source) on investment income—dividends and interest, typically—of individuals. See notes 43 to 47.

14. Elsewhere in this volume, John McNulty has made some extremely thoughtful and cogent comments on this line of reasoning.

15. See Rev. Rul. 76-215, 1976-1 C.B. 194. If the foreign impost is a tax, but not an income tax, it may still be creditable if it qualifies under I.R.C. Section 903 as a tax "in lieu of" an income tax.

16. Although the relevant authorities discuss only natural resources in place, the reasoning seems equally applicable to any situation in which the foreign government—through ownership of any assets, or for other reasons—appears to be entitled to a form of compensation typically paid in private business transactions. (Of course, one should exclude the providing of customary public services and facilities, such as police, public transport, and public road maintenance.) This said, ownership of natural resources in place is nevertheless of overwhelming current significance, because such a large proportion of claimed foreign tax credits arises in mineral-extraction industries.

17. Information Release 1638 (July 14, 1976). In earlier rulings, the IRS has also ruled that foreign imposts are not taxes (a) when paid under a labor code with proceeds going to the "works council," I.T. 3768, 1945 C.B. 204, declared obsolete, Rev. Rul. 70-293, 1970-1 C.B. 282; (b) when paid as compulsory loans, but repayable with interest, Rev. Rul. 59-70, 1959-1 C.B. 186; Rev. Rul. 60-56, 1960-1 C.B. 274; Rev. Rul. 67-187, 1967-1 C.B. 185; (c) when, instead of paying the tax, the taxpayer exercises an option, granted by foreign law, to purchase government securities, Rev. Rul. 63-49, 1963-1 C.B. 124 [query

whether a taxpayer choosing not to exercise such an option, but paying the tax instead, is entitled to a credit? [T. 4023, 1950-2 C.B. 49, as distinguished by Rev. Rul. 63-49, *ibid.*, held yes. The result may be doubted. Cf. Rev. Rul. 76-508, 1976-2 C.B. 225], or (d) when tax was paid as a compromise of claims for royalties, etc., by the foreign government, Rev. Rul. 68-149, 1968-1 C.B. 341. One recent ruling may also touch on this issue: Rev. Rul. 78-258, 1978-1 C.B. 239, disallows a credit for Brazilian withholding taxes on interest to the extent that such taxes are directly paid back by the foreign government to the foreign withholding-agent borrower. The ruling, however, is ambiguous and may turn, instead, on the question whether the tax has been properly paid or accrued by the creditor-taxpayer. Compare Rev. Rul. 69-433, 1969-2 C.B. 153, and *HMW Industries, Inc. v. Wheatley*, 504 F.2d 146 (3d Cir. 1974), where the "subsidy" was paid back directly to the taxpayer, with both the IRS and the court finding the repayment to be a reduction in taxes paid.

18. Alternatively, the tax might be creditable if it were a tax imposed "in lieu of" an income tax. The I.R.C. Section 903 regulations are quite restrictive, however. They deny "in lieu of" status to any tax unless (a) the foreign country has a general income tax in force (as opposed, for example, to a so-called "schedular tax" which taxes separately differently situated taxpayers or industries), (b) the general income tax would normally apply to the taxpayer, absent some special provision, and (c) the general income tax is totally supplanted by the tax in question. Reg. §1.903-1. Recent rulings enforce these requirements. Rev. Rul. 78-61, 1978-1 C.B. 221, denies "in lieu of" status to a tax when it supplants one but not all generally applicable income tax laws of the foreign jurisdiction. Rev. Rul. 78-63, 1978-1 C.B. 228, denies "in lieu of" status to a tax imposed by a jurisdiction which has no single generally applicable income tax. Rev. Rul. 78-424, 1978-2 C.B. 197, denies "in lieu of" status to the U.K. petroleum revenue tax, since it does not supplant the other generally applicable U.K. income taxes.

19. Particularly Rev. Rul. 78-61, 1978-1 C.B. 221, which is not only the first, but also the most detailed and analytical, of the 1978 rulings.

20. *Ibid.* It is unfortunately far from clear when gain is realized in the U.S. sense! The foreign-tax-credit rulings do not choose to look at the somewhat more clear question of recognition, perhaps to avoid exporting U.S. notions of non-recognition events. However, realization may be a problem criterion, not only because of its lack of precision, but because it seems appropriate primarily in connection with gain arising out of sales or exchanges, rather than to other forms of income.

21. *Ibid.* Latitude is allowed for taxes on certain classes of gross income, such as dividends, interest, and royalties, on the "presumption" that expenses related to these items will ordinarily be less than the income. If, however, circumstances demonstrate that this "presumption" is erroneous, e.g., because the interest in question is received by a bank actually doing business in the foreign jurisdiction (so that expenses attributable to the interest received could be quite substantial, and even result in a net loss), then the tax on such gross items will not be creditable. Rev. Rul. 78-233, 1978-1 C.B. 236; Rev. Rul. 78-235, 1978-1 C.B. 238.

22. Rev. Rul. 78-61, 1978-1 C.B. 221. This criterion is designed to distinguish income taxes from sales taxes, use taxes, privilege taxes, and the like.
23. *Ibid.* Is Chapter I of the U.S. Internal Revenue Code a "divisible" tax using this test?
24. *Ibid.*
25. *Ibid.*
26. Indeed, it may be that the scope of judgment concealed within the "divisibility" issue is sufficient to allow for the exercise of a substantial amount of administrative discretion about ultimate creditability. If so, this article's arguments should also be addressed to those IRS personnel charged with exercising such discretion.
27. It is, of course, possible that each of the "models" has at least some truth to it, and that more than one may be involved at any one time.
28. A possible fourth model is suggested by McNulty. He remarks that the foreign tax credit may be viewed as a form of foreign aid. This perspective would be most clearly valid if the United States were ever to agree to so-called "tax-sparing" credits. (Compare I.R.C. section 936.)
29. At least some concerned foreign jurisdictions have already retained U.S. counsel to assist in redrafting their local taxes to achieve creditability. Indonesia, whose production-sharing tax was held noncreditable in Rev. Rul. 76-215, 1976-1 C.B. 194, revised that tax substantially and was able to achieve creditability for its revised system in Rev. Rul. 78-222, 1978-1 C.B. 232. Under the revised Indonesian system, it seems clear that less creditable taxes will be paid. Thus, U.S. revenues will presumably increase. If so, this example illustrates that compliance with recent rulings may have a more substantial impact than indicated by the phrase "drafting instructions."
30. Not all, or even most, of those taxpayers affected are sophisticated and able to hire expensive advisers to assist them, as mentioned later in the text. Compare the observations of one of the leaders of the private tax bar: Sidney I. Roberts, "Simplification Symposium—Overview: The Viewpoint of the Tax Lawyer," *Tax Law Review* (1978) 34:7-9.
31. Several recent rulings have invoked I.R.C. Section 7805(b) to limit their retroactive impact. E.g., Rev. Rul. 78-62, 1978-1 C.B. 226; Rev. Rul. 78-63, 1978-1 C.B. 228. In the case of Indonesia's production sharing tax, not only the IRS but also Congress got into the act with respect to retroactivity. See Rev. Rul. 78-410, 1978-2 C.B. 347. See also Revenue Act of 1978, §701(u)(9), Pub. L. 95-600, 92 Stat. 2763. Notwithstanding these particular "prospective only" rules, the criteria themselves, as elaborated in the rulings, purport to be expressions of what the law has been.
32. Rev. Rul. 78-233, 1978-1 C.B. 236; Rev. Rul. 78-235, 1978-1 C.B. 238.
33. *Ibid.* This double impact is discussed further, and a suggestion concerning it is made later in the text.
34. Specific statutory authority for the following proposal seems desirable. This

article is not intended, however, to imply that the IRS and the Treasury lack power to promulgate regulations, under the existing law, which adopt the proposal.

35. The analogy to I.R.C. Section 385 is not intended to suggest that issuance of such regulations should be deferred for at least eight years after enactment of the statute.

36. The rulings do not require exact "mirror imaging" for creditability. The phrase indicates only that the rulings select, on a spectrum from total dissimilarity to total identity, a point relatively closer to the latter.

37. *Cf.* I.R.C. Section 7477. Since it is intended that the Secretary's determination would be final and binding on all taxpayers, such a remedy would allow interested taxpayers a day in court on the question.

38. Otherwise, a quick-stepping foreign jurisdiction could continuously amend its tax laws, every nine months, thus leaving the United States powerless to deny credits for those taxes.

39. I.R.C. Sections 872(b), 883(a). In a recent ruling, the IRS indicated that a broader, policy-oriented approach would be used for this purpose in testing whether the "equivalent exemption" was from a foreign "income tax" (as required by the regulations). Rev. Rul. 78-355, 1978-2 C.B. 195.

40. See generally, Harvey P. Dale, "The Reformed Tax Credit: A Path Through the Maze," *Tax Law Review* (Winter 1978) 33:175.

41. The IRS has a general procedure for issuing published rulings, and it already provides for conferences or solicitation of comments in appropriate cases. Rev. Proc. 78-24, 1978-2 C.B. 503, at §7.01(6).

42. See note 6.

43. Letter from the author to Marcia Field, Office of International Tax Affairs, Office of the Secretary of the Treasury (Sept. 12, 1978), and letter from Mrs. Field to the author (Oct. 5, 1978).

44. I.R.C. Section 6694 provides for penalties for negligent or intentional disregard of rules and regulations by tax-return preparers.

45. Rev. Rul. 78-344, 1978-2 C.B. 334. The text statement *may* be a trifle too broad: the ruling only addresses the ability of the tax-return preparer to rely upon taxpayer statements of law (or perhaps mixed fact and law). Perhaps the preparer could rely upon the taxpayer's description of the foreign tax system—but perhaps not! The regulations require the preparer to exercise "due diligence" in applying the rules and regulations, and this standard may well be thought to require at least some inquiry by the preparer into the foreign tax law. Reg. §1.6694-1(a)(1).

46. Letter ruling 7813019. The author hopes that the injunction of I.R.C. Section 6110(j)(3), which provides that such letter rulings "may not be used or cited as precedent," is not violated by *this* citation. Alternatively, he trusts that any resulting punishment will not be cruel or unusual.

47. Reference is made particularly to I.R.C. Section 871(a)(1)(A). It might be preferable, however, to pick and choose among the items enumerated there,

including (for example) interest, dividends, rents, and royalties (see Reg. §1.871-7(b)), but excluding compensation (because this almost invariably derives from the conduct of a business; see Rev. Rul. 78-234, 1978-1 C.B. 237). A case could be made for including other types of income, e.g., alimony. At the least, including dividends and interest would seem appropriate, and would contribute substantially to the cause of simplicity.

48. Of course, they are not perfect. Indeed, as soon as the foreign treaty jurisdiction amends its tax laws, the question arises whether they are, as thus amended, still creditable by virtue of the treaty or otherwise.