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## International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes

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## I. INTRODUCTION

The combination of expanding international trade and climbing corporate income tax rates in the early part of this century required nations to evolve methods for reducing the level of international double taxation. While most countries came to rely upon a variety of techniques,[1] two general approaches emerged to the taxation of the income of residents derived from foreign economic activity.[2] Some countries adopted a territorial based system in which foreign source income is normally exempted from domestic tax.[3] That system generally leaves the taxation of foreign income to the government within whose territory the activity occurs and thus avoids double taxation entirely. Other countries, including the United States, chose to impose their tax on the world-wide income of their individual citizens and residents and domestic corporations.[4] That approach necessitated the development of specific mechanisms to reduce double taxation when the country within whose borders the income had been derived also imposed a tax on that income.[5]

The prevailing solution to this source of double taxation is for the residence country to allow its taxpayers to credit taxes paid to foreign jurisdictions against their domestic income tax liability. The extent to which such a foreign tax credit effectively relieves double taxation, however, depends in part upon the adequacy of the description of the foreign taxes that may be credited against the domestic tax liability. If the description is over-inclusive, allowing too broad a range of foreign taxes to be credited, the foreign income will be taxed too lightly. Conversely, if the description is under-inclusive, double taxation will not be fully relieved and the foreign source income will be taxed more heavily than domestic income.

The United States foreign tax credit is both over- and under-inclusive and thus incorrectly taxes foreign source income in a wide range of circumstances. The most serious deficiency in the existing credit, however,

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1. The bilateral income tax treaty, the function of which is to reduce the level of taxation by the source country, is one common example. Sometimes source countries unilaterally exempt items of income from tax, see, e.g., IRC § 871(h) (interest), or a residence country that nominally taxes world-wide income may in fact exempt some foreign source income from tax, see, e.g., IRC § 911.

2. See Adrian Ogley, Principles of International Tax: A Multinational Perspective 22-25 (1993).

3. France, the Netherlands and some Latin American countries are notable among these. Some countries, Germany in particular, exempt foreign source income by treaty.

4. See Michael J. McIntyre, The International Income Tax Rules of the United States § 4/A1 (1989).

5. For the history of U.S. policy in this regard, see generally Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke L.J. 1021 (1997).

is the failure to allow the crediting of taxes collected by foreign governments pursuant to provisions that might fairly be described as integral to a general income tax but which do not conform to a conception of income taxation as developed by the United States. That flaw in the international income tax rules of the United States is harmful to both United States based multinational business and to foreign governments seeking to fashion innovative but nonconforming taxing statutes. The need to clarify and revise the scope of the credit is long overdue.[6]

A definitive description of the foreign taxes that ought to be eligible for the foreign tax credit has proven to be surprisingly elusive. During the first third of a century following the adoption of the credit in 1918, Congress twice sought to fine tune its coverage but neither effort was particularly successful.[7] Following the collapse of the second attempt, the undertaking was abandoned—more for lack of a solution than satisfaction with existing law.[8] In her highly respected study of the credit, Elisabeth Owens concluded that "the chief determinative factor in deciding whether a tax qualifies for the credit should be whether or not the tax is shifted or passed on by the person paying the tax"[9] but she was forced to admit that the practical application of that test would be difficult, at best. Professor Owens argued, however, that her shifting test required that a relatively narrow scope be extended to the credit, and she was highly critical of both the extension of the credit to taxes "in lieu of" income taxes and the further extension proposed in 1954 to the "principal tax" of a foreign country. That philosophy, if not the shifting test itself, proved influential.

While the impropriety of crediting taxes that have been shifted to others cannot be doubted, the fundamental flaw in the shifting test emerged in the succeeding decades. Since even the corporate income tax is likely shifted at least in material part, tax incidence analysis provides little basis for discriminating among foreign taxes and in fact suggests that no tax should be creditable.[10]

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6. For examples of previous workings calling for reform, see Joseph Isenbergh, The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes, 39 Tax. L. Rev. 227 (1984); Stanley L. Ruby, Note, Characterization of an Income Tax for the Purpose of the Foreign Tax Credit, 14 Vand. L. Rev. 1469 (1961).

7. See infra text accompanying notes 98-101.

8. The conceptual confusion of the times is marvelously summarized in an article by then Professor Stanley Surrey. Stanley S. Surrey, Current Issues in the Taxation of Corporate Foreign Investment, 56 Colum. L. Rev. 815, 819-22 (1956).

9. Elisabeth A. Owens, The Foreign Tax Credit: A Study of the Credit for Foreign Taxes Under United States Income Tax Law 83 (1961).

10. See, e.g., Karen N. Moore, The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal, 7 Am. J. Tax Pol'y 207, 224 (1988).

The absence of a generally accepted conception of creditable taxes is partly attributable to an unduly rigid approach to the concept of "double taxation." The point of the foreign tax credit is to mitigate the burden of international double taxation when a residence country insists on taxing the worldwide income of its residents in order to promote a version of capital export neutrality. That burden is broader than the mere imposition of two taxes upon a single tax base. What should be credited are foreign taxes incurred by the taxpayer by virtue of activities abroad that are in addition to, rather than in replacement of, the U.S. taxes that are imposed on the taxpayer's foreign source income. Given the numerous taxes that are and are not imposed by the United States and by the various foreign jurisdictions, it may well be impossible to reduce that elemental concept of additional tax burden to a workable definition of a creditable tax. Nevertheless, this perspective on the credit at the very least suggests that a relatively broad scope should be given to the concept of creditable taxes, broader, in fact, than existing U.S. law.

This article does not attempt to reduce that or any other conception of a creditable tax to administrable language. Rather, it seeks a far more modest but, hopefully, more attainable goal. Within the confines of the existing sections 901 and 903 credits, there exists a great range of possible interpretations of what constitutes a creditable tax. At many, seemingly unrelated, points, U.S. administrative rules and practices have over the years evolved towards the adoption of indefensibly narrow interpretations of what kinds of foreign taxes are eligible for the credit. Those interpretations have narrowed the scope of the foreign tax credit without statutory authority for doing so and perhaps in conflict with the congressional design for the credit. This article identifies several of those interpretations, seeks to establish their irrationality, and calls for their revision in a manner that will better execute the spirit and purpose of the foreign tax credit.

One of the more engrossing aspects of the excessive narrowness of the existing credit is the history of its evolution. Surprisingly, perhaps, in the formative years of the credit, the courts and, to a large extent, the tax collector did a fairly good job of defining the foreign taxes for which a credit might be claimed under U.S. law. After nearly a half-century of reasonably satisfactory experience, however, taxpayer abuses prodded the Internal Revenue Service into an overly restrictive reaction that evolved into current law. Thus, as is true elsewhere in the taxing system,[11] the deterioration in

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11. The massive complexity of the partnership rules of the Code resulted from the same phenomenon and developed during the same period of time.

Subject to numerous conditions, § 901 authorizes a credit for taxes of foreign countries and of possessions of the United States. Section 903 allows a credit for a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by a foreign country or United States possession.

the quality of the foreign tax credit is largely attributable to the inability of the tax collector to stem taxpayer abuse with measured and appropriate responses. This article examines the workings and derivation of four specific and related features of the foreign tax credit: (1) The rules defining "the tax" for which a credit may be claimed; (2) The rules governing the extent to which the use of proxies for computed income destroys the classification of a tax as an "income" tax; (3) The rules limiting the ability to credit alternative or minimum taxes imposed in connection with an income tax; and (4) The rules governing the extent to which such nonconforming provisions of foreign law may be treated as a creditable tax "in lieu" of an income tax. The conclusions suggested by this examination are that the United States foreign tax credit is in fact unduly narrow and that this scope is unnecessary to accomplish any legitimate objective of the credit. Accordingly, the scope of the credit should be expanded, largely by restoring the regulatory rules that prevailed prior to the aggressive reinterpretations that occurred in the 1970s.[12]

## II. A Note On the Significance of the Question

In the following pages, the attempt will be made to demonstrate that the scope of the existing foreign tax credit is simply wrong. The results produced in practice do not reflect the most rational construction of the credit and do not further the policies of the credit as well as would alternative constructions. However, the inadequacies of the foreign tax credit have the capacity to do harm beyond the mere miscalculation of the tax liabilities of a subset of taxpayers.

To the extent that an overly restrictive interpretation of the credit results in the inability to credit taxes that functionally duplicate in the international arena the effect of the Internal Revenue Code domestically, international double taxation is not relieved for the American businesses subject to the foreign tax. That means two things. All else being equal, the foreign business opportunity will be rendered less attractive than a domestic opportunity and international trade will be discouraged by the artificial barrier created by domestic tax law.[13] Second, relative to its competitors in other countries which more effectively eliminate international double taxation, the U.S. business will be disadvantaged. Thus, should it pursue the foreign

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12. A broader inquiry would be whether limiting the credit to income taxes is appropriate. While that question deserves consideration, the task is not undertaken here.

13. See generally Joint Comm. on Tax'n, Factors Affecting the International Competitiveness of the United States 232-64 (Comm. Print 1991); S. van Weeghel, The Improper Use of Tax Treaties 16 (Kluwer, 1998).

opportunity, it will not find itself competing on a level field and will be less likely to survive the foreign competition.[14]

A further, and perhaps more compelling, reason to rethink the scope of the foreign tax credit lies in its effect on foreign governments. Foreign governments clearly understand the discouraging effect of double taxation. If a significant tax that a foreign government proposes to levy will not be creditable in a second jurisdiction which pursues a policy of world-wide taxation of its domestic corporations, then that tax will quite reasonably be assumed to discourage inbound investment from that second country. If, in addition, the second country is an important source of investment for the foreign government, that government will find itself under substantial, probably overwhelming, pressure to revise its otherwise preferred approach to broad based taxation.

There are at least two undesirable consequences of this pressure on foreign governments to conform the boundaries of their income tax laws to the U.S. conception of income taxation. First is the potential damage to our relationships with our trading partners. Of course, not all foreign taxes will ever be, or should be, eligible for the credit. However, an excessive and unreasonable narrowness in the description of the taxes that are creditable in the United States works an unnecessary oppression on our neighboring countries without producing any countervailing benefit to the United States. There is no gain from such an approach to international relations.

Moreover, to the extent that other countries do conform their taxing systems to the admittedly creditable, innovation and experimentation in public finance will be discouraged. The current level of antagonism within the United States to our own income tax law has led to repeated calls for "major tax reform." Yet, one of the obstacles to truly major reform is the lack of international experience with other forms of taxation other than value added taxation. Just as the states may function as laboratories for public policy development within our federal system, the several countries of the world have and should be able to continue to serve as testing grounds for new approaches to taxation. The pressure to conform their system to our definition

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14. Despite the negative effect of an unduly narrow credit, the existing scope of the foreign tax credit has not in recent years been as controversial as might have been expected. There are perhaps two reasons for business' acquiescence. The failure of prior efforts to correct the scope of the credit has taught that the solution is elusive while attempts to achieve it can be counterproductive. Second, the combination of the relatively low rates of U.S. taxation of business and particular features of the computation of the overall limitation on the amount of foreign taxes that may be credited against U.S. income tax liabilities have left many U.S. businesses with more foreign tax credits than they can use. In the face of such excess credits, making the credit more inclusive naturally falls low on the list of tax reform priorities.

of income taxation may severely retard such experimentation, and that is our loss as well as theirs.

These concerns are not merely theoretical. Charles McLure and George Zodrow have reported that in 1994 Bolivia seriously considered adopting a flat tax which would have provided a working model for the consumption tax advocates in the United States. However, "the IRS's decision that the hybrid cash flow tax would not be creditable prevented Bolivia from introducing a tax that had clear economic and administrative benefits for that country."[15] While the experiences of other countries have not been documented like the Bolivian experience, the pressures that forced Bolivia to adopted a conventional income tax exist for all countries that are dependant upon investment from the United States.

## III. The Contours of the Foreign Tax Credit

In order to appreciate the importance of crediting foreign taxes and to understand how that result can be blocked under current law, it will be useful to rehearse the operation of the credit in broad outline.

For the sake of this discussion, assume that the U.S. tax rate is 35% while the foreign rate is only 25% and that the only income in question is $1000 of net income derived from a single foreign jurisdiction. As one basis for comparison, notice that if the United States, the residence jurisdiction in our example, applied a territorial based taxing system, the final tax paid by the taxpayer on this income would be $250, 25% of the net income, and there would be no need to coordinate the foreign and domestic taxes. The foreign tax would be, quite simply, the final tax. The United States, of course, does tax foreign source income and extends a remedial foreign tax credit. First, however, assume that the foreign tax is found to be noncreditable. Under this assumption, the foreign tax would at least be deductible for U.S. tax purposes so that U.S. taxable income would be less than foreign income by the amount of the tax. The final world-wide tax imposed upon this taxpayer would be computed as follows:

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|---|---|
| Net Income for foreign purposes | $1000 |
| Foreign tax at 25% | 250 |
| Net Income for U.S. purposes | 750 |
| U. S. tax at 35% | 262.50 |
| Total taxes paid | 512.50 |
| Overall effective tax rate | 51.25% |

15. Charles E. McLure, Jr. & George Zodrow, Creditability Concerns Doom Bolivian Flat Tax, 12 Tax Notes Int'l 825, 829 (Mar. 11, 1996).

The ability to deduct the foreign tax of course provided some benefit to the taxpayer. Had the tax not been even deductible, the United States tax would have been $350 and the overall effective rate of tax would have been a crushing 60%. Still, the deduction has not provided a great deal of benefit. The foreign source income will obviously be subject to a far higher rate of tax than the 35% that the taxpayer would incur on purely domestic income.

If the foreign tax is held to be creditable, the world-wide tax computation would be as follows:

| | |
|---|---|
| Net Income for foreign purposes | $1000 |
| Foreign tax at 25% | 250 |
| Net Income for U.S. purposes | 1000 |
| U. S. tentative tax at 35% | 350 |
| Foreign tax credit | (250) |
| Final U.S. tax | 100 |
| Total taxes paid | 350 |
| Overall effective tax rate | 35% |

This difference between the effect of crediting the foreign tax and the effect of a mere deduction is dramatic and amply explains the significance, not only to the taxpayer, but also to both the foreign and United States governments, of the characterization of the foreign tax as creditable or not.

Familiarity with one added aspect of the credit will prove useful. This time, assume instead that the foreign rate of tax is 45%, higher than the U.S. rate, and that the taxpayer derives income of $1000 from U.S. sources as well as $1,000 from foreign sources. The computation of the credit would be as follows:

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|---|---|
| Net Income for foreign purposes | $1000 |
| Foreign tax at 45% | 450 |
| Net Income for U.S. purposes | 2000 |
| U. S. tentative tax at 35% | 700 |
| Foreign tax credit | (450) |

At this point it can be seen that, if the entire foreign tax of $450 is credited against the U.S. tax of $700, the credit will not only offset the U.S. tax on the foreign income but will also offset a portion of the U.S. tax on the U.S. source income. That result, while consistent with the goal of eliminating international double taxation, is nonetheless unacceptable. Foreign governments could use high rates of tax to simply drain the U.S. Treasury. Accordingly, except for three innocent years following the introduction of the credit, the amount of foreign taxes that may be credited in any given year has been subject to some form of limitation that generally prevented a credit for more than the U.S. tax on the foreign income. Thus, under the present workings of section 904, the amount of the credit that could be claimed currently would be limited to $350. To continue:

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|---|---|
| Credit after limitation | (350) |
| Final U.S. tax | 350 |
| Total taxes paid | 800 |
| Overall effective tax rate | 40% |

In addition, the taxpayer has an unused credit of $100 which may be carried forward and applied in a future year, subject to the overall ceiling of section 904. The taxpayer, in the practitioner's jargon, is in an "excess credit position."

## IV. A HYPOTHETICAL CASE

The narrow scope of the foreign tax credit can better be understood through illustration. That illustration can be provided by applying the specific rules of the credit that are of interest here to the taxing statutes of a hypothetical foreign jurisdiction. The example is based upon provisions of various European and Latin American tax laws currently in force.

The hypothetical jurisdiction imposes a tax at the national level which is called an income tax. Unlike the U.S. Internal Revenue Code, however, the law does not purport to tax "all income from whatever source derived" but rather taxes income from specific sources. Nevertheless, most sources of income are subject to tax. Receipts from specified sources are reported on one of six "schedules" along with the deductions related to those receipts. All net receipts shown on the five schedules applicable to residents of the foreign jurisdiction are subject to the same flat rate of tax.[16]

Income from farming is reported on Schedule 2. However, farmers who own less than a specified acreage do not report their receipts from the sale of their production and expenditures associated therewith on that schedule. Rather, the taxable amount reported by such persons on Schedule 2 is the amount determined by multiplying a statutorily prescribed rate and the assessed value of the property. That assessment varies depending upon the precise use to which the property is placed and is revised at infrequent intervals.[17] The resulting taxable amount is quite small—almost undoubtedly

16. Compare, for example, the tax system of the United Kingdom. See William B. Barker, A Comparative Approach to Income Tax Law in the United Kingdom and the United States, 46 Cath. U. L. Rev. 7 (1966).

17. Compare the inclusion of cadastral income in the base of the income tax of many countries. Cadastral income may be described as a form of imputed income, typically from real property, based upon a valuation of the property that may or may not reflect actual market value. See, e.g., Vanja Mihajlova, Republic of Macedonia's Tax System Examined, 10 Tax Notes Int'l 287, 287 (Jan. 23, 1995).

less that the actual net income from the farm determined in accord with United States tax concepts.

Income from active business operations is reported on Schedule 3. Under Article 12 of the income tax law, all incorporated businesses must compute a nominal yield on their business assets. That yield is determined by multiplying 5% times the fair market value of the tangible and most of the intangible assets of the business, determined annually. If this so-called nominal yield is greater than the amount of net income otherwise reported on Schedule 3, then the nominal yield is to be reported instead of actual income.[18]

In addition, the jurisdiction has imposed an Emergency Recovery Tax at the rate of 2% on all agricultural and industrial businesses. The tax is quite simple in design, in imposed on net profits, and, standing alone, would constitute a creditable tax under section 901.

As will be developed in the following pages, there should not be any question but that the tax paid on the amounts reported on Schedule 2 as income from farming should, from the perspective of sound income tax policy, be creditable against the U.S. income tax liability of the farmer/taxpayer. Moreover, there should not be much question but that minimum tax liability reportable on Schedule 3 should also be creditable. In either case, a U.S. citizen or resident subject to both U.S. tax and the foreign country tax will be subject to exactly the kind of double taxation that the foreign tax credit was created to relieve. The fact that the foreign country uses a proxy for certain categories of income does not in the least alter the essential nature of the foreign tax as a tax on income nor does it in any respect eliminate the prospect of double taxation. Indeed, it would be overbearing and oppressive for the United States to force the foreign country to choose between abandoning a desired modification of its income tax and causing potential investors from the United States to be deterred by the prospect of uncreditable taxes. If we conclude that the tax cannot be credited under existing United States law, then something is wrong with the scope of the credit under U.S. law.

## V. THE NATURE OF AN INCOME TAX: THE SQUINTING EYE OF THE BEHOLDER

Before it can be said that a payment made pursuant to a provision of a foreign tax is creditable, many issues must be resolved favorably. First, the payment must be a "tax."[19] That obvious and seemingly innocuous requirement turns out to be one of the major, albeit unnecessary, reasons for the

18. Compare the business assets taxes used in Latin America. See infra note 104 and accompanying text.

19. See Regs. § 1.901-2(a)(1)(i).

narrow scope of the credit. Second, the "predominant character" of the tax must be that of an "income tax" in the "U.S. sense."[20] We will return to the required character and sense. The central issue is whether the foreign tax, standing alone, constitutes an income tax.

As the economies of the world shifted from basically agrarian to basically industrial, income taxation emerged as the most popular mechanism for funding governments.[21] The taxation of income, however, requires resolving large numbers of definitional and interpretative issues. That in turn requires the involvement of relatively large numbers of highly educated tax specialists both within and without government. In short, income taxation is expensive both for governments and taxpayers. In addition, relative to other tax bases, income is hard to identify and easy to conceal. As a result, the costs of collecting the tax due, once it has been defined, are high. Even without the desire to conceal, compliance with the relatively complex rules of income taxation can be difficult, particularly for a population of limited literacy and virtually no exposure to accounting conventions. All of these costs of income taxation become more pronounced for countries whose economies are relatively less developed. The administrative difficulties are magnified when the taxpayer is a multinational business whose financial dealings span national boundaries.

In response to these costs and obstacles, countries, particularly developing countries, that have determined to adopt income taxation have also determined to adopt features and provisions that compromise the theoretical rigor of their taxing system but provide more than adequate compensation in the form of simplified administration and easier, more reliable collection. Relative to taxation in the United States, the use of such proxies or approximating devices appear more significant than they are in fact. The United States' tax system is distinguished by the acceptance of numbing complexity in the pursuit of extremely refined and precise consequences. Much of the rest of the world is content to achieve the more balanced approach to taxation that characterized the U.S. system prior to 1969. In the hypothetical example, that compromise is contained in the treatment of the relatively low income farm population. Income from near sufficiency level farming is presumed or estimated pursuant to a formula that is not directly related to actual cash flow. The question is whether such an approximation of income can be viewed as a feature of income taxation.

In neither theory nor practice is there likely to be a clear and simple answer to that question. If a country were to rely exclusively upon proxies for

20. Regs. § 1.901-2(a)(1)(ii).

21. See Ken Messere, Tax Policy in OECD Countries 46-50 (IBFD Publications 1993).

income in the design of its taxing statute, the result would not be an income tax. If taxable income for all taxpayers were deemed to equal the number of windows in the taxpayer's principal residence or place of business multiplied by $10, the tax would be a tax on windows, not income. However, if some applications of a tax generally imposed on actual net income employed proxies for that computation in some contexts, the fundamental nature of the overall tax would not be altered. Indeed, such compromises would find strong parallels within the U.S. system. For example, one compromise within the U.S. system is that appreciation in the value of property is taxed only on a sale or other disposition; not when it occurs.[22] That doctrine of realization is a quite substantial compromise with an ideal system of income taxation which would tax such accretions to wealth as they occur.[23]

The proxy tax imposed on low income farmers in the illustrative example would not, standing alone, constitute an income tax for purposes of the credit. Under the regulations, an income tax is a tax that is "likely to reach net gain in the normal circumstances in which it applies."[24] Were that the sole content of the test for income taxation, it might well be possible to demonstrate that the tax on farming would meet the test. However, the regulations continue to preclude that result by specially defining the phrase "likely to reach net gain" as meaning the tax meets three specific tests.[25] The tax must be imposed upon realized income, it must be imposed upon gross receipts and it must allow the deduction of significant expenses. Thus, in order to be "likely to reach net gain," the tax must be imposed on a base consisting of realized gross receipts reduced by the significant items of deduction granted by U.S. tax law. While each of these three requirements is softened by elaboration and exception, the tax on farming would fail most, if not all, of the specific requirements. The harshness of that result is surprising and, as argued above, inappropriate. The reason that U.S. law has gravitated to this position is just as surprising and provides a basis for beginning to rethink the existing regulations.

### A. *The Formative Years*

The effect of the use of proxies or income-approximating devices appears to have been the first question raised in connection with the new foreign tax credit. In the post-World War I era, many Americans lived and

22. Eisner v. Macomber, 252 U.S. 189 (1920).

23. Ironically, one of the features of U.S. law against which foreign taxes are measured is the doctrine of realization. The foreign taxes that have failed that test are sometimes closer to an ideal system of income taxation than is the U.S. system. See, e.g., F.W. Woolworth Co. v. United States, 91 F.2d 973 (2d Cir. 1937), cert. denied 302 U.S. 768 (1938).

24. Regs. § 1.901-2(a)(3)(i).

25. Regs. § 1.901-2(b).

worked in France, and Herbert Ide Keen was one of them. Under French tax law, the taxable income of resident aliens was subject to a minimum tax computation: taxable income was the greater of actual income or seven times the rental value of the taxpayer's French residences. (It might be speculated that the French authorities expected that aliens typically would devote about 14% of their salary to rent.) Under this provision, Mr. Keen was determined to have taxable income for French purposes of $4,784. In fact, that amount was substantially less than his actual compensation for his services in France of $10,915, all of which was reported as income in the United States.[26]

The Commissioner had taken the position in prior published rulings that this French tax was not an income tax but rather was a property tax and that payments pursuant to the tax were not creditable.[27] The Board of Tax Appeals without hesitation rejected the Commissioner's characterization of the tax as a property tax and held instead that it was an income tax and creditable against the taxpayer's U.S. tax liability. The Board noted that the fact that the income was determined differently from the computation of income for U.S. purposes did not alter the nature of the tax which, the Board concluded was "a tax upon his income in 1923."[28] The Commissioner almost immediately acquiesced in the result.[29]

The broad and flexible view of income taxation held by the Board of Tax Appeals in *Keen* quickly became generally accepted by the tax collector. In particular, the narrow holding of that case, that the amount paid pursuant to a provision embedded in a general income tax law which estimates net income through the use of an approximating formula is a creditable tax, remained good law for nearly half a century. Thus, for example, in 1950 the Service ruled that a Dominican Republic tax,[30] which contained a rebuttable presumption that the net income of nonresident transportation companies was equal to 6% of gross receipts, was an income tax.[31]

Similarly, in 1967 the Service considered the application of the Guatemalan income tax to foreign insurance companies.[32] Article 15 of the law provided that in the case of reinsurance arrangements with foreign companies, in taxing the assignees of the insurance contracts it would be

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26. Keen v. Commissioner, 15 B.T.A. 1243 (1929). No issue was made of the fact that this larger amount might properly have been reportable in France. Possibly France in 1923 made no effort to identify income of Americans in excess of the computed minimum.

27. O.D. 1093, 5 C.B. 194 (1921); S.M. 3155, 4-1 C.B. 45 (1925).

28. Keen v. Commissioner, 15 B.T.A. at 1246.

29. 8-2 C.B. 27 (1929).

30. I.T. 3997, 1950-1 C.B. 63.

31. See also Rev. Rul. 272, 1953-2 C.B. 56 (treating a Haitian tax quite similar to the French tax involved in *Keen* as an income tax); Rev. Rul. 59-192, 1959-1 C.B. 191.

32. Rev. Rul. 67-329, 1967-2 C.B. 257.

"assumed by right the taxable income of these companies is equivalent to 10% (ten percent) of the amount of the premiums assigned." The Commissioner concluded that the tax imposed by the overall law was "essentially a tax on net income" and the fact that the law required that income of some taxpayers be computed "in a different manner from that used for taxpayers generally does not change the nature of the tax imposed." Thus, "the tax on income as determined by the formula described in Article 15 is an income tax within the meaning of section 901 of the Code." Although it was not evident from their highly abbreviated texts, this doctrine also underlies the rulings that the "taxes" imposed upon United States oil companies by various foreign countries were income taxes.[33] These rulings would prove to be the undoing of the doctrine.

This acceptance of nonconforming elements in foreign tax systems by the Board is also evident in the first cases to arise that involved the realization of income in a manner then unknown to U.S. law.[34] The Burk Brothers bought goat skins through an office in Calcutta and imported them to Philadelphia where they manufactured the skins into leather which they then sold. Under the United States rules governing the source of income, all of the income from the sales in the United States of goods purchased abroad would be attributed to the United States. However, under the source rules applied by the income tax laws of British India, a portion of the actual overall profits derived by Burk Brothers was allocable to the Calcutta office and subjected to (a relatively small) tax. While the issue was not made entirely clear, the income was apparently deemed to arise upon the export of the skins and prior to their actual sale in the United States. The Commissioner sought to deny a credit for the Indian tax on the ground that the tax was an excise tax, not an income tax. The Board, while recognizing that the United States did not treat the transfer of inventory between a branch and the home office as an income generating event, nevertheless founds that it was "perfectly clear" that the tax paid was a creditable income tax.[35]

### B. *The United States Conception*

While the decision in *Keen* established a flexible approach to the use of proxies for income, language in the opinion contained the seeds of a very

33. E.g., Rev. Rul. 55-296, 1955-1 C.B. 386; Rev. Rul. 68-552, 1968-2 C.B. 306.

34. E.g., Burk Brothers v. Commissioner, 20 B.T.A. 657 (1930).

35. The favorable decision unfortunately availed the Burks nothing. Since under U.S. law they did not have any foreign source income, under the recently enacted overall limitation on the credit, their credit ceiling was zero. Five years later, however, a second trader in Indian goatskins who did have foreign source income was able to credit the Indian tax under the authority of *Burk Brothers*. Briskey Co. v. Commissioner, 29 B.T.A. 987 (1934), aff'd, 78 F.2d 816 (3d Cir. 1935).

different rule. While it seems clear that the Board believed that the French approach to estimating the income of resident aliens was compatible with the fundamental notions of income taxation embodied in the tax laws of the United States, in arriving at that conclusion the Board remarked that this tax was upon "what the French Government determines to be income." It seems extremely unlikely that this was so. Rather, it seems rather obvious that an amount computed by multiplying apartment rental times seven would not be regarded as income by any government, French, American or otherwise. To the contrary, the computed amount was quite plainly intended as a proxy for income, as a "rough justice" but easy to administer method of estimating the net income of resident aliens, which the French chose to use but the United States did not. This issue in *Keen* was not whether the French were foolish enough to think that an expenditure was income, but rather whether the use of a proxy for certain limited categories of income was incompatible with the characterization of the broader tax as an income tax. Nevertheless, in the early cases construing the credit, there was some confusion on the point.

Shortly after its decision in *Keen* the Board heard a case involving the creditability of a Cuban municipal tax law. The only issue was whether a tax on the profits from the operation of the taxpayer's "gas and electric light" plants was an income tax or a tax on the privilege of doing business. The Commissioner relied upon an expert on Cuban law who was able to persuade the Board that the tax in question was a privilege tax that was merely measured by profits and which therefore was not creditable.[36] The taxpayer thereupon filed a motion for rehearing which was granted. At the new evidentiary hearing, nine experts on Cuban law, five on one side and four on the other, testified. These proceedings produced a different result. The earlier opinion was vacated and a decision rendered in favor the creditability of the tax.[37]

While the Board placed substantial stress on the Cuban understanding of the Cuban law, it does not appear that the Board thought that the Cuban characterization was controlling. The Board observed approvingly that:

> The respondent has also said that determination of whether a given foreign tax is thus 'a tax on income' is to be made from an examination of the foreign tax law itself, without regard to any title or classification given to it by the foreign government: I.T. 2620, . . . .

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36. Havana Electric Railway, Light & Power Co. v. Commissioner, 29 B.T.A. 1151 (1934), rev'd on rehearing, 34 B.T.A. 782 (1936).

37. Havana Electric Railway, Light & Power Co. v. Commissioner, 34 B.T.A. 782 (1936), rev'g, 29 B.T.A. 1151 (1934).

The Board undertook that examination and concluded that the tax in question was imposed upon net profits and thus constituted a creditable income tax. Without doubt, however, the proceedings and opinion of the Board devoted far more attention to that Cuban classification than to an examination of the law itself and that disproportionate emphasis might have been misleading.

Two years later the Supreme Court first addressed the foreign tax credit in *Biddle v. Helvering.*[38] *Biddle* involved the tax system of the United Kingdom in which the corporate and shareholder taxes were largely integrated in a way entirely alien to U.S. tax law. The issue presented was simply whether the corporation or the shareholders should be regarded at the payor of the tax.[39] Although there was no question but that the tax involved was an income tax within anyone's conception, in the course of its opinion the Court quite generally noted that United States law should govern the determination of whether a tax was an income tax within the meaning of the United States tax laws. That statement by the Court could not have been intended or regarded by others as a change in the application of the credit. The Commissioner had always regarded the definition an income tax to be determined by U.S. law. For example, in I.T. 2620,[40] issued five years before and relied upon by the Board in *Havana Electric,* the Commissioner stated that "it must be shown that the tax imposed by the foreign law is a tax on income, according to the United States concept . . . ." Nevertheless, subsequent authorities would treat the dicta in *Biddle* as establishing a new rule inconsistent with then existing caselaw.[41]

While there may have been some confusion on the point in the very early years of the income tax, there was never a very serious question but that the dicta in *Biddle* was a correct statement of how the foreign tax credit was to be applied. Labels and classification created by foreign governments cannot be allowed to control U.S. income tax consequences absent a clear congressional intention to that effect. The vastly more important question, however, was what exactly was meant by the reference to a United States conception of income. In its most provincial sense, that phrase could be intended to mean the financial receipts, and only the receipts, subject to tax in fact under the Internal Revenue Code. On the other hand, there is a

38. Biddle v. Helvering, 302 U.S. 573 (1938).

39. Mostly because of its discomfort with the British system, the Court held that the shareholder was not entitled to a credit for the tax withheld by the corporation on the distribution of dividends. That unsatisfactory result persisted for exactly eight years when it was overruled by the treaty with the United Kingdom.

40. I.T. 2620, 11-1 C.B. 44 (1932).

41. Commissioner v. American Metal Co., 221 F.2d 134, 140 (2d Cir. 1955). The unexplained remark to that effect in this opinion would be relied upon heavily by Chief Counsel in seeking to change prior law. See infra note 45.

generalized concept of income taxation which is shared by students of taxation in Germany and England—and in the United States. No single enacted national law embodies the fully developed concept of income shared by these scholars, nor could it, for the details of the concept are subject to continual debate. Nevertheless, each of these countries and countless others have a law that falls squarely within that general conception of an income tax. In this sense, the United States *conception* of an income tax is the same as the German *conception* of an income tax although the two countries have enacted very different versions of that conception.

During the period beginning with the enactment of the foreign tax credit and extending into the early 1970s, the Board of Tax Appeals and the Service personnel clearly viewed the concept of income referred to in *Biddle* and later authorities as a broad concept, not at all limited to enacted provisions of the Code.[42] Indeed, there is no indication that the Service personnel regarded *Biddle* as reflecting any material change in the law at all. Most rulings during this period refer to the requirement that a tax be an income tax with the U.S. conception. The only change in this recitation occasioned by the decision in *Biddle* was the citation to that case. As a result, in the post-*Biddle* era the Service continued to treat *Keen*-type taxes that employed proxies or presumption or estimates as income taxes and creditable. Thus, in 1953, for example, a full 16 years after the decision in *Biddle*, the Service ruled that a Haitian tax quite similar to the tax considered in *Keen* "falls within the United States concept of an income tax."[43] That was so although taxable income was computed in a manner entirely unknown to U.S. law.

*Biddle* was compatible with *Keen* because the conception of income referred to by the Supreme Court was not a narrow, provincial conception but rather was a broad, generalized conception of income. Thus, to be creditable, a foreign tax did not need to conform to U.S. law in all details. Rather, the tax need only be a tax "on income in its fundamental sense as meaning gain or profit."[44] Accordingly, a foreign tax might well be an income tax even though it was imposed on amounts that were not in fact subject to tax under U.S. law.

By the end of the 1960s, therefore, it was well established that the use of various devises to estimate net income, such as presumption, estimates and formulae, within the context of a broader income tax act did not detract from the creditability of the tax. The firmness of that position is underscored

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42. And see Philip R. West, Foreign Law in U.S. International Taxation: The Search for Standards, 3 Fla. Tax Rev. 147, 154-56 (1996).

43. Rev. Rul. 272, 1953-2 C.B. 56. See also Rev. Rul. 67-329, 1967-2 C.B. 257 (Guatemala).

44. I.T. 2620, 11-1 C.B. 44, 46 (1932).

by a memorandum issued by Chief Counsel[45] in 1971.[46] The taxpayer, which otherwise was subject to the general income tax imposed by Jamaica, had entered into an agreement with that government that its taxable income would be determined by assuming a profit from its mining operations that was geared to the selling price of processed ore. It then sought a ruling with respect to the creditability of the tax paid and the rulings division was prepared to rule that payments under the agreement were indeed creditable as a tax, but only as a tax in lieu of an income tax under section 903. Chief Counsel concluded that the tax was an income tax and creditable under section 901. The agreement merely provides for an alternative method of computing the net income that is subject to the general income tax and the use of that formula does not alter the nature of the tax.

### C. *Oil Royalties and the Reversal of Policy*

At the same time, however, Chief Counsel's office was becoming concerned that some foreign governments, presumably in collusion with U.S. taxpayers, were using formula-generated computations of net income to achieve improper results.[47] As a result of transfer pricing audits under section 482 of the international operations of major oil companies, the Service had developed an understanding of the pricing policies of those companies and of their financial relationships with the host governments. The Service apparently concluded that payments to the host governments that should have been characterized as royalties and thus deducted were being disguised as creditable taxes, thus producing a vastly greater reduction in U.S. tax liability. The problem arose when a U.S. business was engaged in extracting minerals, often oil, in a foreign country under whose laws the mineral belonged to the government. Under those conditions, the taxpayers might properly be required to pay an income tax based upon their net income from activities in the foreign jurisdiction and might properly be required to pay a royalty which traditionally would be based upon the quantity of minerals extracted or their gross selling price or value. By using a formula price geared to the value of the mineral extracted, such as the formula approved in General Counsel Memorandum 34567, colluding taxpayers and

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45. In the following pages, reference is made to Chief Counsel's office, as distinguished from the IRS in general. That office houses the legal advisor to the IRS and lies within the Service but the office is highly independent. In fact, Chief Counsel reports to the general counsel of the Treasury Department, not to the Commissioner. See George Guttman, Should IRS Chief Counsel Report to the Commissioner?, 79 Tax Notes 1542 (June 22, 1998). For that reason, memorandum issued by Chief Counsel are entitled General Counsel Memorandum.

46. Gen. Couns. Mem. 34,567 (July 28, 1971).

47. See Tech. Adv. Mem. 98-21-003 (Feb. 9, 1998) (observing that the final regulations under § 901 had resolved that issue).

foreign governments might combine both payments into a single payment that would be treated as a creditable tax. In the Middle East that formula price took the form of a "posted price." By agreement between the producer and the host government, all sales of crude oil must be made at the posted price which was not related to, and in fact was far greater than, the market value of the crude. As a result of this device, the governments using the technique would obtain revenue geared to the quantity of production rather than the profitability of the producer while the producer would pass the burden of the payment along to the United States Treasury through the mechanism of the foreign tax credit.

This problem of disguised royalties was indeed a real problem and one requiring redress by the Service. However, when the Service first studied the issue, it concluded that disallowing a credit for these payments would be "extremely difficult to maintain in court" in light of the existing precedents.[48] In particular, General Counsel Memorandum 33348 concluded that the line of cases and rulings following *Keen*, which the memorandum characterized as "comput[ing] net income by means of arbitrary percentages or other fixed factors in an apparent attempt to avoid uncertainty as to the amount of tax due" [emphasis in original], were indistinguishable. Over the next decade, however, the attitude of the Chief Counsel's office, if not of the Service generally, towards the crediting of these payments hardened and that office determined to aggressively reshape those precedents to its own liking in order to provide a firmer foundation for attacking the crediting of what appeared to be oil royalties. Accordingly, Chief Counsel initiated a wide ranging attack which included a frontal assault on *Keen* and its progeny.

That attack is developed in a series of General Counsel Memoranda prepared during the mid-1970s[49], the conclusions of which were embodied in several subsequently issued Revenue Rulings.[50] The scope of the attack emerges from General Counsel Memorandum 36540,[51] which involved Indonesia. The taxpayer had entered into an agreement with an agency of the government which, among other matters, required that the taxpayer's income for purposes of the corporate income tax be computed under a formula that was geared to the value of the oil produced. Under the operation of this

48. Gen. Couns. Mem. 33,348 (Oct. 7, 1966).

49. The differences in the tone of Gen. Couns. Mem. 33,348 issued in 1966 and the several GCMs issued in the 1970s is striking. The earlier document is a careful, impartial legal analysis with only a touch of strategic manipulation in the area of "in lieu of" taxes. See text at notes 94-95. The later documents are briefs–and aggressive briefs at that.

50. In particular, Rev. Ruls. 76-215, 1976-1 C.B. 194; 78-61, 1978-1 C.B. 221; 78-62, 1978-1 C.B. 226; 78-63, 1978-1 C.B. 228; each of which was declared obsolete following the adoption of the 1983 regulations. Rev. Rul. 84-172, 1984-2 C.B. 315.

51. Gen. Couns. Mem. 36,540 (Jan. 5, 1976). See Rev. Rul. 76-215, supra note 50.

highly complex agreement, an increase in the selling price of the oil produced a disproportionately large increase in the computed amount of taxable income and thus in the amount treated as a tax. In addition, the payment of this amount was to be discharged from the share of production allocated to the agency.

The Memorandum concludes, first, that the amounts paid under the agreement are royalties, not taxes, and thus are not creditable. That conclusion, which seemed generally correct, was sufficient to dispose of the ruling request before the Service. However, the Memorandum continued to conclude that even if a part of the allocation of production to the government agency did constitute the payment of a tax, that the tax would still not be creditable because the portion of the allocation of production that constitutes a tax cannot be severed from the portion that constitutes a royalty. Thirdly, if that were not enough, the Memorandum further asserted that even if the portion of the allocation that constitutes a royalty could be severed, it would still not be creditable because the tax did not constitute a tax on income. Referring to the base of the tax as "fictitious income," the Memorandum argues that if the tax base includes "substantial amounts of fictitious income," it does not fall "predominantly on net gain in the American sense" and thus is not a tax on income.

This third alternative basis for denying the credit represented an abrupt reversal of the position that the Service has held for nearly 50 years.[52] The reason for that reversal of policy apparently is to be found in the conclusion reached 10 years before that the denial of the credit for the payments by the oil producers would be inconsistent with the line of authority flowing from *Keen*. If that were so, the oil royalties could not be attacked without first undermining the precedential value of that line of authority. That undermining was developed in General Counsel Memorandum 36552[53] which nominally addressed the issue of whether the Ontario Mining Tax Act constituted an income tax.

The Ontario tax was imposed on the net profit from mining and generally resembled an income tax. However, to deal with the problem of an

52. It is evident from Gen. Couns. Mem. 37,263 (Sept. 21, 1977), that the Service believed that its reversal of position received support from the decision of the Court of Claims in the *Bank of America* case. That case involved a gross income tax which the trial commissioner had held to fall within the U.S. conception of an income tax because at the time it was commonly believed that the Sixteenth Amendment allowed a tax on gross income and that deductions were a matter of legislative grace. While this decision was reversed by the full court, the court made clear that its decision was not intended to bar a credit for a gross income tax used as a proxy for a net income tax, such as was involved in Santa Eulalia Mining Co. v. Commissioner, 2 T.C. 241 (1943).

53. Gen. Couns. Mem. 36,552 (Jan. 19, 1976).

integrated miner-manufacturer that sold processed minerals rather than ore, the tax provided that profit included the market value of the output at the mine head. The Ontario tax thus presented a second type of nonconformity which had troubled the administration of the foreign tax credit from the very beginning: whether a tax that employed notions of deemed dispositions resulting in taxable gain at an earlier stage of the manufacturing process than in the United States was nevertheless an income tax.[54] The Ontario tax did not raise the issue, first presented in *Keen*, of the creditability of a tax that relied upon the use of a proxy for computed income. However, for no reason relevant to the issue before it, General Counsel Memorandum 36552 brought the early case within the scope of its analysis. *Keen* was said to have imposed a tax on "unrealized rental income" which, of course, did not conform to the United States standard of an income tax. Thus, the Service concluded, the case was inconsistent with the later decision of the Supreme Court in *Biddle* which required such conformity. Chief Counsel's office thus suggested to their colleagues in the rulings division that the long-outstanding acquiescence in *Keen* be withdrawn and that the series of rulings relying on the doctrine of that case be revoked.[55]

### D. *Evaluating the Attack on Abuses*

These 1970' era GCMs make it clear that the Service disowned the more flexible approach to the concept of income taxation begun, in the 1920s with the decisions in *Keen* and *Burk* and extending into the decade of the 1970s, solely in order to strengthen its litigating position with respect to the oil royalties. Two observations can be drawn from that conclusion. First, the broad revision of prior law sought by Chief Counsel and embodied in the new ruling policy was entirely unnecessary. The fundamental defect in the oil payments was that the payments, at least in substantial measure, were not taxes, and that defect was recognized at the time. That issue, of course, was

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54. See Burk Brothers v. Commissioner, supra note 34.

55. Including Rev. Rul. 272, 1953-2 C.B. 56 (Haitian tax similar to the French); Rev.Rul, 59-192, 1959-1 C.B. 191, and Rev.Rul. 56-658, 1956-2 C.B. 501 (Cuban tax using deemed disposition); and I.T. 3997, 1950-1 C.B. 63, (Dominican Republic tax on estimated income). A similar approach was taken to the decision in *Burk Brothers* and the line of authority that it represents. In *Burk Brothers* the taxpayers had been subject to taxation in India on the appreciation in the value of exported goatskins, a tax that may have been due at the time of export rather than the later time of the sale of the skins in the United States. Characterizing the tax as "triggered by a purchase" and "without reference to the amount of income, if any, actually realized during the year," General Counsel Memorandum 36,552 argued that the tax could not be credited and that position was subsequently published in Rev. Rul. 78-62, supra note 50.

completely unrelated to the issue presented in such cases as *Keen* and *Burk* of whether an admitted tax was an income tax.

It does not appear from the written record exactly why the personnel in the office of Chief Counsel went from the assertion in 1971 that formula computations of income constituted a form of income taxation to the scattergun attack on the crediting of such taxes five years later. However, it is clear that the American oil companies, working in conjunction with the governments of friendly nations, had devised a scheme for passing more of the burden of the payments to the foreign governments on to the U.S. Treasury than was permissible, and it is also clear Chief Counsel was determined to stop that abuse. In that light, the revision of the scope of the foreign tax credit was a simple casualty of the seemingly endless warfare between aggressive taxpayers and a beleaguered Internal Revenue Service.

Second, it also appears that these revisions of the credit were misguided as well as unnecessary. During the long history of the foreign tax credit a variety of approaches to the definition of the base of an income tax had been discovered throughout the world. In numerous rulings and court decisions, these various provisions had been treated as constituent elements of general income taxes. Those decisions achieved a reasonable and appropriate accommodation with our neighboring countries by accepting differences in the rigor with which the tax base may be defined in an income tax. This tolerance for atypical and nonconforming features of a broad based tax allowed countries to fashion the system of taxation that worked best for them without preventing the creditability of their taxes and thereby jeopardizing needed investment from the United States. Moreover, that flexible approach to the definition of an income tax furthered the purposes of the foreign tax credit by reducing instances of international double taxation. Laying aside technical definitional issues, there is no real commonsense doubt but that the credited taxes had been imposed by the foreign government in replacement for the individual or corporate income tax that would have been imposed by the United States had the economic activity occurred within the United States. This plainly desirable flexibility of the pre-1970s credit was attacked by the Service, and ultimately discarded in the 1983 regulations, because the Service doubted its ability to persuade a court that payments to the oil producing countries were royalties, not taxes. That unfortunate tactical decision should now be reversed.

Recall the hypothetical tax on farming discussed above. Prior to the mid-1970s there would have been little doubt but that the tax would be treated as part of an income tax within the U.S. conception and thus creditable. After the issuance of Revenue Ruling 78-62, the substitution of a nonacquiescence in *Keen*, and the issuance of the 1983 regulations, the contrary result surely would be reached. Clearly, the tax would not, standing alone, be treated as an income tax. On the other hand, the tax might still be creditable under current law if it could be regarded as an inseparable part of a law that concededly was an income tax.

## VI. SEPARATE LEVIES AND PREDOMINANT CHARACTERS

The Service came to embrace the creditability of taxes containing proxies and estimating devices presumably because it recognized that in these instances, the foreign governments were seeking to impose a tax on the same specific items of income or gain that the United States sought to tax. The mechanics and procedures might be alien to the U.S. experience, but the result was the same. Since that result would produce the very double taxation that the foreign tax credit was enacted to reduce, granting the credit quickly came to be viewed as appropriate. At the same time, the Service has always been far more reluctant to allow a credit for a foreign tax that is imposed upon specific items of income that the United States has determined not to tax. That reluctance has been reflected in a variety of doctrines that impose further, and unnecessary, limits on the creditability of foreign taxes.

While the broad view of what can be treated as income taxation which prevailed until the 1970s is preferable as a matter of tax policy, that approach does raise two additional definitional issues of concern here. First, by hypothesis, the tax for which credit is sought contains elements that are not used in the income tax laws of the United States and that might not, standing alone, constitute the taxation of income. At some point, under the most flexible approach to crediting, the non-income tax elements of the law in question will so alter the character of that law that it can no longer be treated as a creditable income tax. To identify that point some test will be required to determine when a tax that contains nonconforming elements will nevertheless be treated as an income tax. Second, it is necessary to consider the scope of the tax in issue. Clearly, before the creditability of a tax can be tested, its boundaries must be defined; its divisibility must be determined. However, this divisibility issue interacts with the conformity issue in important ways.

If the scope of the tax to be tested is broadly defined to treat all loosely related elements of the tax law as a single indivisible tax, that would seem to suggest that more foreign taxes will be credited than under a narrower approach to divisibility. Certainly that will be true if the conformity test is also a liberal one. If the inclusion of a significant non-income tax provision within a single indivisible law will not cause the overall law to be treated as a noncreditable tax, then a broad approach to the scope of the laws to be tested will result in an expansive approach to crediting.

On the other hand, if a strict approach to conformity is taken, one requiring the foreign law to closely resemble U.S. income tax law before crediting is allowed, then a broad approach to divisibility actually would result in substantially fewer foreign taxes becoming eligible for the credit. In fact, such an approach would deny the credit to a wide range of taxes that were without question imposed upon net income, but had become contaminated by the inclusion of nonconforming elements within the scope of the law. Obviously, such an approach, in failing to minimize international double taxation, would be objectionable both as a matter of policy and as a matter of international comity. While it would reduce the volume of nonconforming taxes that were credited, it would accomplish that at the expense of barring credits for a greater number of conforming provisions. Accordingly, were the Service to seek to reduce the number of payments to governments that were eligible for the credit, applying a strict conformity rule to a broad approach to divisibility would seem undesirable.

Other things being equal, the more narrowly the scope of the tax to be tested is defined, the smaller will be the number of foreign taxes eligible for the credit. Moreover, under a narrow definition of scope, the approach taken to conformity becomes of little significance. If the tax is divided into fragments, those conforming to U.S. tax law will be credited and those not conforming will not be credited. Thus, divisibility alone will control eligibility for the credit.[56]

In terms of the hypothetical example, if the entire law is a single indivisible tax and a moderately liberal approach is taken to conformity, the tax on farmers will be creditable as a part of a broader income tax. Under a strict approach to conformity, however, none of the taxes paid under any provision of the law would be creditable. Under a narrow approach to divisibility, the tax on farmers will not be creditable while the taxes paid on other Schedules would remain creditable, regardless of the approach taken to conformity.

The key decision, therefore, concerns divisibility, not conformity. A broad approach to defining the scope of the tax to be tested will in practice require the use of a relaxed approach to the required degree of conformity. The resulting test will allow for relatively liberal crediting for foreign taxes. One the other hand, an approach to scope that requires fragmenting foreign tax systems renders the conformity issues insignificant and results in the crediting of significantly fewer taxes.

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56. In theory, at least, a narrow approach to divisibility, combined with a strict approach to conformity, could result in greater foreign tax credits than would a broad approach to divisibility coupled with notions of strict conformity. Under the narrower approach to scope, credits would not be denied for taxes that were essentially income taxes but that had been tainted by nonconforming elements. However, that advantage of a narrow definitional approach is somewhat illusory; the combination of a broad definition with a rigid approach to conformity is not viable in practice.

A. *Divisibility*

The existing regulations, at least as they are understood by the Service, take an extraordinarily narrow approach to divisibility.[57] In general, a foreign tax enactment is to be divided into the smallest components possible for the purpose of testing whether the provision constitutes an income tax in the U.S. sense of that term. That extreme narrowness, however, does not appear from the vague and relatively brief standard for divisibility set forth in the regulations. That text provides little beyond the bare concept that levies are separate taxes if they are imposed upon bases that are "different in kind, and not merely in degree."[58] Greater insights, however, can be gleaned from examples contained in the regulations. Initially, the notion of bases that are different in kind is illustrated by reference to the Code itself. The tax on corporations imposed by section 11 is said to be separate from the penalty tax imposed by section 541 on the adjusted taxable income[59] of personal holding companies and from the now repealed tax of former section 1491 on the appreciation (computed under normal income tax rules) in property transferred to foreign business entities.[60] Significantly, each of those taxes is functionally interrelated and employs a common computation of gain.

In a more telling example, the regulations describe a hypothetical foreign law that requires that income from different types of activities, such as mining and providing technical services, be computed separately, although presumably pursuant to common accounting rules, and imposes different rates of tax on each activity. The tax on each activity constitutes a separate levy unless net losses from one activities can be applied in reduction of the tax imposed on the other activities.[61]

Two aspects of these regulations operate to produce a high level of fragmentation. First, without expressly so stating, the regulations effectively create a powerful presumption in favor of the finding of multiple levies. Taxes that are manifestly complementary and conceptually coordinated, but which are imposed by different paragraphs, or even different clauses of the same paragraph, will be treated as separate levies unless it can be shown that, because of some netting of expenses or cross crediting of losses, the tax attributable to distinct activities cannot be identified.

57. Regs. § 1.901-2(d).

58. Regs. § 1.901-2(d)(1).

59. The tax is imposed on "undistributed personal holding company income" which is taxable income as normally computed subject to the handful of adjustments listed in IRC § 545.

60. Regs. § 1.901-2(d)(1).

61. Regs. § 1.901-2(d)(3), ex. 3 & 4.

Second, the regulatory test for separateness is purely mechanical. No weight is to be given to the purpose or function of a taxing provision within its own legal environment or to the interaction of the provision with other aspects of a nation's taxing system. The examples contained in the regulations plainly indicate that a tax will be fragmented if it is mechanically possible to trace a portion of the total tax liability to distinct elements of the taxpayer's income. The issue thus turns on the mechanic detail of the taxing statute. It may even be the case that, notwithstanding that income from different sources is combined and subject to a progressive rate of tax, the result will still be treated as a series of separate taxes if a netting of income and loss is not permissible.[62] This mechanical approach seems to derive from a somewhat confused, result-oriented opinion in *Lanman & Kemp-Barclay & Co. of Colombia v. Commissioner*,[63] a case discussed in some detail below.

Returning again to our illustrative example, even though the tax on farming may not, standing alone, constitute an income tax, the tax is plainly a integral component of an income tax that is designed to approximate the effect of an income tax on a narrow segment of the economy. Hence, it ought to be eligible for the credit. However, under the existing regulations, it seems clear that income reported on each Schedule would be regarded as a separate levy and tested individually for conformity to income taxation.[64] In that event, the tested tax will be creditable only if it meets the test for conformity to U.S. notions of income taxation. That test of the "predominant character" of the tax will be considered further below. Here it is sufficient to note that the tax on low acreage farmers, considered separately, would surely fail that test. As discussed above, under a narrow approach to divisibility, the test for conformity is of little importance. Nonconforming taxes, like the tax on farming, will generally not be eligible for the credit.

The approach of the Service to the divisibility issue is undeniably harsh. It is also surprising in that it is counterintuitive and sharply at variance with the normal use of language by either nonspecialists or tax technicians. Under the regulations, single, integrated taxing statutes are treated as comprised of numerous "separate levies," each imposed on a segment of a nation's economic activity and separately creditable. This peculiar approach

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62. While at one time the Service treated income subject to a progressive rate of tax as subject to a single levy, that rule has been omitted from the current regulations. See Gen. Couns. Mem. 32,859 (June 15, 1964) (explaining Rev. Rul. 64-260, 1964-2 C.B. 187) and Gen. Couns. Mem. 36,441 (Sept. 26, 1975).

63. Lanman v. Commissioner, 26 T.C. 582 (1956).

64. That result might be altered if the income from farming were combined with the income on other Schedules and subject to a progressive rate of tax on the aggregate as would occur in the United States. However, because the regulations are oddly silent on the point, even that result is not certain.

did not flow naturally from the language or purpose of the credit but rather was designed to limit the creditability of nonconforming elements in foreign taxing systems. The reasons for the adoption of this approach again are illuminating and are to be found in the historical evolution of the provision.

The early cases did not address either of these issues, at least not expressly. However, it is fairly clear that the courts in such cases as *Keen* and *Burk* were influenced by the fact that they were examining a single feature of a broader tax that fit squarely within the general understanding of an income tax. The decisions, while devoid of reasoning, are consistent with a broad approach to divisibility and, of course, reflect a liberal approach to conformity. The Service, however, with no more analysis, seems to have initially sought a narrow scope to the laws to be tested in order to limit creditability. Thus, for example, in an early ruling on a Mexican tax which enumerated in separate clauses the business activities subject to tax, each clause was treated as a distinct tax to be separately tested for creditability.[65]

In 1936, however, in *Hubbard v. United States*, the Commissioner succeeded in persuading the Court of Claims that, if an item of income that was taxed by a foreign government were not in fact subject to taxation by the United States, no credit could be claimed for the portion of the foreign tax attributable to that item because that item of income was not in fact subject to double taxation.[66] In the years following that victory, the Commissioner began to take a broader view of the scope of the foreign tax that is to be tested for creditability, relying on *Hubbard* to limit the crediting of nonconforming foreign taxes. By the early 1950s the Commissioner had arrived at a reasonably balanced approach to the divisibility issue. Thus, a 1952 ruling considered the creditability of a Cuban tax on the receipt of a stock dividend, a receipt that would not have been taxable in the United States.[67] The ruling concluded that, since the provision was "part of the over-all Cuban tax law" which had previously been ruled to be a creditable income tax, "the fact that some of the items taxed are nonincome items is not material" because the tax is "indivisible."[68]

The courts soon concluded, however, that the decision in *Hubbard* lacked support in the statute and was erroneous as a matter of policy.[69] By 1952 it had become clear that the victory in *Hubbard* would no longer be

65. I.T. 2620, 11-1 C.B. 44 (1932).

66. Hubbard v. United States, 17 F. Supp. 93, 96, 84 Ct. Cl. 205 (Ct. Cl. 1936).

67. I.T. 4074, 1952-1 C.B. 87.

68. Id. at 87-88. See also Rev. Rul. 272, 1953-2 C.B. 56, 57, which took a similar approach to the unity of an income tax law, and Rev. Rul. 67-329, 1967-2 C.B. 257.

69. Helvering v. Nell, 139 F.2d. 865, 871 (4th Cir. 1944).

followed[70] and in 1954[71] the Commissioner conceded the loss, thus terminating that brief chapter in the interpretation of the credit. However, the Service almost immediately responded to the loss of the *Hubbard* rule by returning to a narrow approach to divisibility. That about-face is dramatically illustrated by the inconsistent treatment of Cuban taxes.

In 1953 the Service had considered the creditability of the taxes imposed by two paragraphs of a Cuban law which imposed taxes in addition to the generally applicable income tax.[72] Article 14 of the law levied a flat tax on the value of the capital of every company and plainly was not an income tax. Article 15 imposed a tax on profits in excess of 10% of the value of the capital taxed under the first tax. Although an excess profits tax is a creditable tax, the Service concluded that neither tax was creditable. While the ruling was notably devoid of reasoning, the Service evidently concluded that the taxes were indeed indivisible but that, in this case, the resulting levy did not conform to the U.S. conception of an income or excess profits tax.

In Revenue Ruling 56-51[73] the Service re-examined that conclusion. Explaining that the earlier ruling was based on the assumption that the two taxes were "interrelated and interdependent," on reflection the Service concluded that the mere fact that the second tax employed the valuation made for the first tax did not cause the taxes to be so integrated that they must be treated as a single tax. Considered separately, the second tax was an excess profits tax and creditable. The Service cautioned, however, that if the tax had been a single tax imposed on both items, the creditability of the tax would be an all or nothing proposition determined by the "predominant character" of the unified tax.[74]

This brief summary of the wavering history of the Service's approach to divisibility serves to underscore the role that the doctrine has played under the credit. Divisibility has never been used as a value-neutral step in the definition of a creditable tax. Indeed, as currently employed it does not even reflect an intrinsic quality of the foreign tax law to be tested. Rather, divisibility turns out to be a result-oriented doctrine, a malleable concept used to control the scope of the foreign taxes that are eligible for the credit. The

70. In Brace v. Commissioner, 11 T.C. Memo (CCH) 906-07 (1952), the court referred to the Commissioner's argument as an "attempt to revive an extinct question."

71. Rev. Rul. 54-15, 1954-1 C.B. 129.

72. Rev. Rul. 31, 1953-1 C.B. 225.

73. Rev. Rul. 56-51, 1956-1 C.B. 320.

74. In Rev. Rul. 64-260, 1964-2 C.B. 187, the IRS considered a tax system that added gross compensation income to notional income from property and subjected the result to a single rate that apparently was progressive. The Service ruled that the tax was unified, that its predominant character determined creditability and that as a whole it did not fall within the U.S. concept of an income tax. Here a broad approach to the tax law was taken but for the purpose of denying the credit.

narrow approach of current law is not at all necessary to the interpretation of the credits; other approaches have been employed in the past. Rather, as in other features of the current credit, divisibility is simply one of the devices used to prevent the creditability of nonconforming elements in foreign tax systems. The Service has particularly sought to use a narrow approach to divisibility to bar the crediting of foreign taxes that are imposed on amounts that are not subject to tax under U.S. practice. That regulatory approach, however, is defective for the very reasons that the courts rejected the Service's alternative approach in *Hubbard*.[75]

Under the overall limitation on the ability to claim a foreign tax credit, a taxpayer may not claim a credit for an amount of foreign tax in excess of the U.S. tax on the taxpayer's foreign source income determined under U.S. standards. That is, while the United States and the foreign jurisdiction might not choose to tax exactly the same items at exactly the same time, the taxpayer would not be able to claim a full credit for the foreign tax paid unless the aggregate amount of income subject to tax in the foreign country equaled the aggregate amount of foreign source income determined under U.S. law. In view of this limitation on the credit, the further limitation imposed under *Hubbard* was redundant and thus inappropriate.

The effect of these limitations can best be seen by example. Assume that the taxpayer derives two items of income from foreign sources: a $100 stock dividend that is taxed by the foreign government but is not taxed by the United States (Item A) and other income of $100 which is not taxed by the foreign government but is taxed by the United States (Item B). The taxpayer also derives $100 of U.S. source income (Item C). The foreign tax rate is 45% while the U.S. rate is 35%. The tax would be computed as follows:

| | |
|---|---|
| Net Income for foreign purposes (Item A) | $100 |
| Foreign tax at 45% | 45 |
| Net Income for U.S. purposes (Items B & C) | 200 |
| U. S. tentative tax at 35% | 70 |

The section 904 limitation on the crediting of the foreign tax would limit the credit to the fraction of the tentative U.S. tax of $70 equal to the foreign source income computed under U.S. concepts of $100 (i.e., Item B) over the taxpayer's world wide income computed under U.S. concepts of $200. Thus, the limitation is $35 and that is the maximum amount that may be credited currently. Thus:

| | |
|---|---|
| Foreign tax credit | (35) |
| Final U.S. tax | 35 |

75. See Dexter v. Commissioner, 47 B.T.A. 285 (1942).

While the taxpayer will have a credit that may be carried over and used in future years of $10, that future use remains subject to the same overall limitation.

Whether this taxpayer has been subject to international double taxation that ought to be relieved by the foreign tax credit will depend upon one's perspective. Viewed narrowly, as the Service has continually sought to do, the stock dividend has not been subject to double taxation since the United States did not tax it. Similarly, the other income has not been subject to double taxation since the foreign government did not tax it. However, viewed more broadly, the taxpayer's foreign source income as a whole has been subject to tax in both jurisdictions. More particularly, this taxpayer, which did have foreign source income computed under United States concepts, did pay a foreign income tax. In that broader sense, which the courts have generally adopted, the taxpayer has been subject to double taxation that should be relieved by the foreign tax credit.

The judicial rejection of *Hubbard* was entirely consistent with the broad approach to crediting reflected in the *Keen* line of authority. Creditability is not a matter of comparing taxes imposed on specific items of income. Rather, the entire income tax imposed upon the taxpayer's entire taxable income from foreign sources was creditable subject only to the overall limitation imposed by the predecessor to section 904. That broader approach to crediting seems plainly preferable from the perspective of sound tax policy. In the foregoing example, a taxpayer that pursued a business opportunity in the foreign jurisdiction rather than in the United States would be subject to an income tax that functionally replaced the tax that would have been imposed under our Code. The fact that the taxpayer's income has been defined somewhat differently under foreign law than it would have been in the United States seems quite irrelevant to the potential double taxation. If the credit is denied, the essential purpose of the credit is not being served.

The existing approach to divisibility, however, reflects an effort to deny that credit. The effect of that approach readily can be seen if the assumption is added that the foreign tax on the stock dividend is regarded as a separate levy from the tax on the other income. Standing alone, the tax on the stock dividend would not constitute an income tax in the U.S. sense under the regulations, and thus the $45 tax paid to the foreign government would not be creditable at all. As a result, the taxpayer would be subject to full double taxation. This use of extreme divisibility is designed to achieve the same result that had been rejected on the merits as a part of the judicial rejection of *Hubbard*.

This narrow approach to divisibility is furthered by employing a mechanical, rather than a functional, approach to the definition of a separate levy. That approach seems to have originated in the 1956 Tax Court decision in Lanman.[76] In that case, which is the first case in which a court gave serious consideration to the issue of whether taxes were separate or unitary, the Service successfully used its newly narrowed approach to divisibility to limit the crediting of a foreign tax.

Colombia, which had a creditable income tax of long standing, enacted a patrimony tax for the purpose of increasing the progressivity of the overall tax structure and fine-tuning its distributional impact. The patrimony tax was imposed on the net worth of the taxpayer's assets, other than assets exempt from the tax, and thus resembled a property tax. However, under Colombian jurisprudence, the tax was regarded as a tax on imputed income, or the potential return from unproductive or under-productive assets. The Tax Court accepted the assertion that the patrimony tax was designed as a supplement to the income tax to reach the otherwise untaxed benefit that the wealthy classes derived from the use of property. Citing Revenue Ruling 56-51, the taxpayer then argued that the Colombia tax system imposed a single tax which was predominantly an income tax and thus creditable.

The Court quite properly concluded that the fact that the government of Colombia may have regarded the patrimony tax as integrally related to the income tax did not control the determination of whether the tax was creditable. That rejection of the foreign characterization of these taxes as interlocking, however, did not establish the converse: the mere rejection of the significance of the Colombian government's view did not establish that the two taxes were not related. Nevertheless, the court did not proceed to consider whether, from the perspective of the United States, the conceded purpose and effect of the patrimony tax was relevant to the question of whether the tax was an inseparable component of a broader income tax. Rather, the court ignored that issue altogether and proceeded to an examination of the mechanical details of the computation of the tax. Since the computation of the patrimony tax could be accomplished without reference to the computation of the income tax, the taxes could be separated and thus were divisible for purposes of the credit.[77]

Although the approach was refined and developed over the years, the basic approach of *Lanman* was adopted by the Service. Three years following

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76. *Lanman*, 26 T.C. 582 (1956).

77. *Lanman* is one of those difficult cases that are correctly decided for all the wrong reasons. The treatment of the patrimony tax as part of the income tax by the Colombian authorities was suspect. That position had been adopted to avoid the consequences of an agreement by the government not to impose any taxes but income taxes on certain investors who were not involved in the tax case. More importantly, the patrimony tax did not appear to be correctly designed if it were to function as a supplemental tax on imputed income. The tax apparently was imposed even though the property in question was put to productive use and the income thereby generated subject to the income tax.

*Lanman* the Service applied a similarly aggressive approach to carving up the German trade tax for the purpose of disallowing a credit for a minor but nonconforming portion of the tax.[78] Divisibility was based upon the mechanical, computational details of the law rather than by any analysis of the purpose or function or effect of the law. Thus form, and relatively unimportant form at that, came to prevail over substance. The consequence of this approach was sharply to limit the scope of creditable taxes.

B. *Conformity*

Once the boundaries of a tax have been established, it must be determined whether the tax so defined is an income tax and thus creditable. That determination requires the application of a standard for prescribing just how closely the foreign tax must resemble the United States conception of an income tax in order to be creditable. The early authorities tended to ignore the need for a standard or at least the need to articulate the standard applied. In a vague manner, both rulings[79] and cases[80] seemed to apply an I'll-know-it-when-I-see-it test to the existence of an income tax containing nonconforming elements. Later authorities seemed to recognize the need for such a test and articulated the degree of conformity required using words such as "essential" and "substantial."[81] It is not clear, however, that those authorities were intending to enunciate a considered test for the degree of conforming or were simply employing somewhat randomly selected language.

By the late 1950s, however, the practice within the Service had become settled. Consistently with the relatively liberal approach taken to what constituted income taxation, "the Service has taken the position that when a unified tax is imposed by a foreign country its predominant character will determine whether the tax is an income tax . . . ."[82] That test continued to be applied internally by the Service into the mid-1970s. Thus, in a pair of General Counsel Memoranda issued in 1975,[83] the Service recited that the foreign tax will be creditable if it is "predominantly an income tax in the American sense—i.e. is imposed on a tax base consisting predominately of realized net gain."

78. Rev. Rul. 59-208, 1959-1 C.B. 192, modified on a different issue in Rev. Rul. 63-268, 1963-2 C.B. 290.

79. E.g., I.T. 4074, 1952-1 C.B. 87.

80. E.g., Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 (3d Cir. 1943).

81. Commissioner v. American Metal Co., 221 F.2d 134, 140 (2d Cir. 1955).

82. Gen. Couns. Mem. 32,859 (June 15, 1964), citing Rev. Rul. 56-51, 1956-1 C.B. 320. See also Gen. Couns. Mem. 33,348 (Oct. 7, 1966).

83. Gen. Couns. Mem. 36,304 (June 10, 1975) and Gen. Couns. Mem. 36,441 (Sept. 26, 1975).

As the office of Chief Counsel was beginning to explore its options for challenging the creditability of the payments made to foreign government by the oil producers, one of the legal obstacles identified was the predominant character test. In the 1966 Memorandum concluding that the state of the law did not support denying credits for those payments, it was observed that under that test, "it would be hard to say" that the typical tax on oil producers would not qualify as an income tax.[84]

Predictably, therefore, in formulating the Service's multi-faceted attack a decade later, the predominant character test was identified as one of the aspects of prior law that required change. Thus, the most aggressive of the General Counsel Memoranda[85] noted the lack of uniform usage in the courts and asserted that the use of the term predominant character by the Service thus "creates ambiguity." Accordingly, in the future the Service should discuss creditability in terms of "substantial equivalence."[86] While the point is not belabored in the Memorandum, it is plain that its author believed that the new test would materially reduce the likelihood that foreign taxes containing nonconforming elements would be treated as creditable income taxes. Unfortunately for this semantic attack on crediting, in the very next year, the Tax Court, in a strong opinion by Judge Raum, clearly adopted the long-standing predominant character test.[87] Partly in response to that opinion, the existing regulations, adopted in 1983, abandon the effort to revise the verbalization of the test for conformity and expressly provide that a foreign tax will be treated as an income tax if the "predominant character of that tax is that of an income tax in the U.S. sense."[88] However, that retreat may not be as complete as first might appear. Indeed, the regulations may not reflect a retreat at all.

Under prior law, a tax law would be treated as meeting the predominant character test if the U.S. Tax Court generally recognized the law as an income tax notwithstanding that it contained significant nonconforming elements.[89] During the 60-year period prior to the mid-1970s, regardless of whether specific reference is made to a predominant character test, a substantial number of foreign taxes that did not closely conform to U.S. law were nonetheless found to be creditable. By contrast, under the current regulations, the concept of "predominant character" is not defined. However,

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84. Gen. Couns. Mem. 33,348 (Oct. 7, 1966).

85. Gen. Couns. Mem. 37,263 (Sept. 21, 1977) which formed part of the basis for Rev. Rul. 78-63, 1978-1 C.B. 228.

86. The rulings issued on the basis of these GCMs did precisely that. See, e.g., Rev. Rul. 78-61, 1978-1 C.B. 221, 223.

87. Schering Corp. v. Commissioner, 69 T.C. 579 (1978).

88. Regs. § 1.901-2(a)(1)(ii).

89. *Schering Corp.*, 69 T.C. 579. See also Rev. Rul. 56-51, 1956-1 C.B. 320.

the regulations do provide that the predominant character of the tax will not be that of an income tax in the U.S. sense unless the tax is found to be "likely" to reach net gain in the normal circumstance in which it applies.[90] That in turn will be the case if the tax, "judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements." Because a foreign tax must be found to meet each of these relatively narrow and specific tests in order to be creditable, the degree to which a foreign tax may vary from the U.S. income tax has narrowed substantially—notwithstanding the nominal retention of the predominant character test.[91] In fact, in the years following the promulgation of the present regulations, it is difficult to pinpoint a single case or ruling that holds a tax to be creditable under the predominant character tolerance that would not have been creditable if strict conformity to U.S. tax law had been required. Quite plainly, the predominant character test does not mean the same thing today that it meant in the 1950s and '60s. Indeed, it is not clear that the test has any real meaning today at all.

Because of the narrow approach to divisibility, the degree of conformity and the predominant character test are not as important in practice as might have been supposed. Nevertheless, to the extent that the test matters to particular taxes and taxpayers, this test as well has become quite narrow in application. As in the case of the Service's approach to estimation and approximation devices, this narrow approach was not a result of a considered approach to the reduction of international double taxation but rather was a by-product of a wide-ranging, and generally unnecessary, attack on the crediting of oil royalties.

## VII. "IN LIEU OF" TAXES

If a tax, standing alone, does not constitute an income tax under U.S. concepts and does not constitute a part of a broader tax which is an income tax under those concepts, then the tax cannot be credited under section 901. However, all may not be lost. Even if a tax is not an income tax, it may nevertheless be credited against the tentative U.S. tax under section 903 if the tax is imposed "in lieu of" an income tax.

In the hypothetical example, the scope of the "in lieu of" tax becomes important in two distinct ways. First, as has been discovered, the tax on low income farmers may not be creditable under section 901. While that result

90. Regs. § 1.901-2(a)(3).

91. See Texasgulf Inc. v. Commissioner, 107 T.C. 51 (1996). Judge Colvin noted that "the task of deciding whether the predominant character of the OMT is that of an income tax in the U.S. sense is simplified because the terms and clauses in the regulations just described tie the 'predominant character' inquiry to several specific tests." 107 T.C. at 63.

may be objectionable, it will not be very important if the tax can nevertheless be credited under section 903. That result should be expected since the proxy tax imposed by Schedule 2 is plainly imposed in place of the income tax that otherwise would be payable. But, is the tax imposed "in lieu of" an income tax? Second, under Schedule 3 all businesses are subject to a minimum tax that is computed on a base that starts with asset values. Some businesses will pay that tax instead of the income tax. Again, the minimum tax is plainly imposed in place of the income tax, but will it qualify as an "in lieu of" tax?

Under the existing regulations to section 903, most of the restrictive qualifications that rendered the "in lieu of" provisions illusory prior to 1984 have been eliminated.[92] The only remaining test of note is the seemingly reasonable requirement that the "in lieu of" tax is "imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed."[93] That requirement includes at least two features. The foreign jurisdiction must impose an income tax on a broad segment of its taxpayers. And the income of the taxpayer from the activity subject to the tax for which the section 903 credit is sought cannot be subject to any income tax in that jurisdiction.

Neither of the taxes in the illustration would meet these tests and thus neither could be credited under section 903 even though both are quite obviously imposed as substitutes for the "otherwise generally imposed" income tax. The example does not raise the issue of the lack of a generally imposed income tax although that aspect of the regulation is treated briefly below. However, as is relatively common, the tax in question is imposed in place of one income tax to which the taxpayer is subject but does not replace all income taxes to which the taxpayer is subject because a temporary income tax supplements the regular income tax. As a result, assuming that second tax applies to low income farmers, as the Service interprets its regulations, the tax in question would be imposed "in addition to" the emergency tax, which is an income tax, and thus would not be creditable as long as the emergency tax remained in effect.[94]

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92. For a description of the prior regulations, see Owens, The Foreign Tax Credit, supra note 9, at 70-72.

93. Regs. § 1.903-1(b)(1).

94. If the income tax were the only tax imposed by the foreign jurisdiction, the tax on low income farmers might qualify for the § 903 credit although that is not free from all doubt. Taxpayers engaged in both farming and other taxable activities will be subject to both the regular income tax and the proxy tax on farm income. That possibility raises the question of whether the proxy tax is not in substitution for the income tax but is imposed in addition to that tax–in which event it would not be creditable under the quoted portion of the regulation. If farming is an activity separate from all others, however, such that the farming activity can be said to be exempt from the income tax, then the proxy tax on farming will be treated as imposed in substitution for the income tax on farming and thus will be creditable.

In a general sense, the substitution requirement derives from the arguments presented to Congress in support of the enactment of the "in lieu of" provision. The Senate Committee Report, for example, recites as one reason for the need for the liberalizing provision the possibility that a foreign government would impose a non-income tax in place of an income tax on a class of taxpayers.[95] However, General Counsel Memorandum 33348 discloses a narrower reason. The Memorandum observes that following the adoption of the "in lieu of" credit, the Service sought some test for distinguishing between the royalties and non-income taxes which were not creditable, and the non-income taxes which had just become creditable notwithstanding that they were imposed on a base consisting of gross receipts or total sales.[96] "The answer seems to lie in whether the in lieu of tax was a substitute for an income tax which would otherwise apply" [emphasis in original].

Without a doubt, some manner of substitution requirement is needed to properly define the scope of the "in lieu of" credit. As long as the basic section 901 credit is limited to foreign income taxes, the scope of the section 903 credit cannot be broader than taxes that take the place of a creditable income tax. However, the technical narrowness of the existing rule is not necessary to that purpose and has improperly barred tax credit relief. As seen in connection with other aspects of the credit, the "in lieu of" credit is susceptible to a wide range of interpretation. The simple language of the provision, however, suggests a broad construction: a foreign tax should be creditable if it is imposed by a foreign government to generate revenue that otherwise could have been generated by an income tax. When that fundamental character of a foreign tax is present, added technical limitations that would deny the credit should be highly suspect. Such a broad construction of the provision would make section 903 widely applicable. The regulations, however, continue to apply a relatively narrow construction that sharply limits the availability of the credit. The issue here, as before, is whether a broad or narrow construction best serves the purposes that the credit was enacted to serve. The history of the provision suggests, although it does not prove, that Congress at least intended a relatively broad construction.[97]

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Here that result seems likely. Thus, were the income tax the only tax imposed, the tax on farming would be creditable, the correct result.

95. S. Rep. No. 1631, 77th Cong., 2d Sess., 131 (1942).

96. Gen. Couns. Mem. 33,348 (Oct. 7, 1966).

97. There is some contemporaneous support for this view. See the well-known remarks of the Chair of the Senate Finance Committee recounted in Elisabeth A. Owens, The Foreign Tax Credit, supra note 9, at 71 n.148.

The excessively narrow scope of the foreign tax credit has become a matter of concern to Congress on two separate occasions. The first re-examination, which occurred in 1942, resulted in an expansion of the availability of the credit while the second, in 1954 did not. While both the Service and the courts had been fairly liberal in treating nonconforming taxes as income taxes, the number of less favorable authorities began to accumulate in the years following the decision in *Biddle*.[98] Of particular concern were the taxes based upon some version of gross, rather than net, income that many countries imposed on corporations engaged in certain industries such as mining, banking and shipping. Accordingly, industry proposed that the credit be extended to include foreign taxes imposed "on gross income or on some other basis" when the levy was "in substitution" for a creditable net income tax.[99] In response, Congress included in the Revenue Act of 1942 the predecessor of section 903 allowing a credit for taxes imposed "in lieu of" income taxes. While opinions differed on the cause,[100] there is no dispute but that few taxes were found to qualify under the new provision and the regulations initially issued thereunder. Writing nearly 20 years after the adoption of the "in lieu of" provision, Elisabeth Owens reported that the Service had ruled favorably under this section on only five foreign taxes.

The second attempt to expand the scope of the credit occurred in connection with the 1954 recodification of the income tax law. Responding in part to the criticism of the restrictive application of the 1942 legislation, the Treasury proposed that the credit be made available for the "principal" tax to which the taxpayer was subject in a foreign country. That proposal failed to pass when it became clear that an unintended consequence of the legislation would have been to reduce the number of foreign taxes that could be credited.[101] In the wake of this failure to achieve a broader credit, attention turned to other matters and the fundamental scope of the credit has not been addressed by Congress since 1954. While statutory interpretation arguments based upon the yellowing pages of legislative history are inherently weak, the record at least shows a Congress seeking to expand, not narrow, the availability of the credit. Expansiveness, however, has never been an attribute of section 903.

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98. E.g., Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 (3rd Cir.), cert. denied, 320 U.S. 739 (1943).

99. Revenue Act of 1942: Hearings Before the Committee on Finance on H.R. 7378, 77th Cong., 2d Sess. 217 (1942) (memorandum of Mitchell B. Carroll).

100. The principal early commentator on the credit, Elisabeth Owens, argued that while Senator George of the Finance Committee had placed the blame on overly restrictive Regulations, in fact the limited effect of the amendment was attributable to the language adopted by the Senate. See Owens, The Foreign Tax Credit, supra note 9, at 71-72 & n.148.

101. See Stanley S. Surrey, Current Issues in the Taxation of Corporate Foreign Investment, 56 Colum. L. Rev. 815, 820 (1956).

The narrowness of the existing regulations appears from the two features of the substitution requirement noted above. First, in order for there to be an "in lieu of" tax, the foreign jurisdiction must have a generally applicable income tax of which the tax in question is "in lieu." That means that for a tax to be creditable under this provision, the foreign country first must have adopted an income tax which remains applicable to a significant sector of the taxpaying public. It must then have exempted all or an identifiable segment of the income of a class of taxpayers from that income tax and have imposed a different form of taxation in place of that income tax on those taxpayers. In fact, the Service has taken the position that a replacement tax cannot be an "in lieu of" tax unless all taxpayers subject to the replacement tax are exempt from the income tax on a category of income; the mere fact that this taxpayer is exempt is not sufficient![102]

In practice, this somewhat convoluted requirement largely limits the usefulness of the "in lieu of" credit to those special industries, such as mining and finance, that tend to be subject to special tax regimes and are not subject to the general income tax.[103] The requirement plainly would prevent the crediting of a foreign tax if, as some countries have done and other considered, the countries repealed its income tax, or its corporate income tax, and enacted one or another version of a consumption or cash flow tax such as those sometimes proposed for adoption in the United States *in place of* its former income tax.[104] Similarly, some countries, for reasons unique to their experience, have appended features to what otherwise would clearly constitute an income tax that prevent the tax from qualifying as an income tax in the U.S. sense. For example, the initial Russian income tax limited the deduction of wages paid in excess of a fixed level in an attempt to retard wage inflation. The resulting tax may not have constituted an income tax for crediting purposes and clearly did not constitute an "in lieu of" tax because there was no other income tax.[105] Those results are manifestly wrong as a

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102. Priv. Ltr. Rul. 97-13-001 (Apr. 26, 1996).

103. See Bank of America Nat'l T. & S. Ass'n v. United States, 459 F.2d 513, 523 (1972); Rev. Rul. 78-61, 1978-1 C.B. 221.

Section 903 is also used today as the basis for crediting withholding taxes based on the gross amount of a payment. Prior to the adoption of the 1983 regulations, however, such withholding taxes were creditable as income taxes because they conformed to the withholding taxes that the United States imposed.

104. See, e.g., Belize Abolishes Corporate Income Tax, 1 Tax Notes Int'l 152 (July 20, 1998) (reporting that Belize had replaced its corporate income tax with an undescribed form of business tax); Jorge Martinez-Vazquez & L.F. Jameson Boex, Croatia Adopts Tax System to Market Economy, 13 Tax Notes Int'l 839 (Sept. 9, 1996) (reporting that Croatia had adopted a consumption tax on individuals).

105. See William P. Streng, Russian Federation Tax Legislation Impacting Russia Based Oil & Gas Operations: Endless (?) Transition, 15 Hous. J. Int'l L. 553, 570-71 (1993).

matter of sound income tax policy. More importantly, they fall far short of the relief needed to appropriately relieve instances of clear international double taxation.

The second restrictive feature of the regulations is in the requirement that the tax be in lieu of all income taxes imposed in the jurisdiction on the segment of the income of the taxpayer with respect to which the section 903 credit is claimed. It is not at all uncommon for a jurisdiction to impose more than one general income tax. Sometimes multiple taxes are imposed at the national level, as in our example, and sometimes, as in the United States, subnational governments impose taxes that parallel the tax imposed by the national government. Generally the tax proposed for crediting under section 903 is imposed in place of less than all of the income taxes imposed in the jurisdiction. When that occurs, the tax can never be credited as an "in lieu of" tax.

This somewhat shocking result is illustrated by the real world result in *Allstate Insurance Company v. United States*.[106] That case raised the question of whether the Canadian tax on insurance premiums received by a casualty insurance company could be credited under section 903. Several courts had previously found that very tax to be an "in lieu of" tax, but those decisions had involved life insurance companies. Under Canadian law, life insurance companies are not subject to the Canadian income tax but casualty insurance companies are. Thus, the court held that the tax on premiums, while creditable by life insurance companies, was not creditable by this taxpayer because the tax was imposed, not in substitution for the income tax, but in addition to the income tax.

Had the taxpayer in *Allstate* been subject to two income taxes, both would have been creditable. Moreover, if the tax on premiums had been imposed in place of both of those income taxes, the tax on premiums would have been creditable as an "in lieu of" tax. However, because the tax on premiums only replaced one of the income taxes, it could not be credited—an utterly bizarre result.

An equally inappropriate consequence of the substitution requirement occurs in connection with the imposition of alternative taxes, a point further developed in the following section and illustrated in the example by the alternative tax imposed under Article 12. As under our own Code, taxpayers in the hypothetical jurisdiction are required to pay an alternative tax if the amount of the tax exceeds the amount of the regular income tax. However, under the typical alternative tax, taxpayers remains subject to the regular income tax. When the alternative tax, rather than the income tax, is paid, the payment should without question be creditable under section 903 as the

106. 419 F.2d 409 (1969).

payment is plainly in lieu of the payment of the income tax. However, because the taxpayer remains subject to the income tax (although none is paid), the regulations treat the alternative tax as imposed in addition to the income tax and thus not at all creditable.

This surprising result is clearly required by the regulations when the minimum tax is smaller than the regular income tax so that some regular tax must be paid. In the example provided in the regulations, the taxpayer has an alternative tax liability of 30x and an income tax liability of 100x against which the 30x may be credited. The conclusion reached is that the 30x may not be credited under section 903 because it is imposed "in addition to, and not in substitution for, the generally imposed income tax."[107] That result is less clear under the regulations if the minimum tax exceeds the income tax so that only a minimum tax must be paid. In that event, it may be argued that the minimum tax is in complete substitution for the regular income tax and thus is creditable. However, the Service is evidently of the view that even if no amount of income tax is payable, a taxpayer remains subject to the income tax and thus a minimum tax can never be treated as an "in lieu of" tax.[108] While that result seems particularly harsh, it may nevertheless be required to avoid an even more absurd result. Plainly, if the minimum tax is one dollar less than the regular tax, none of it may be credited. To allow the crediting of the entire tax if it is one dollar more than the regular tax would be hopelessly irrational.

This feature of the section 903 regulations is particularly objectionable when viewed in connection with the regulations to section 901. The result in *Allstate* occurs because the "in lieu of" tax must be in substitution for *all* income taxes to avoid being characterized as imposed in addition to an income tax. Put differently, for the purpose of section 903, income taxes are not treated as separate taxes, each of which may be replaced by a non-income tax that is a creditable "in lieu of" tax. Rather, all income taxes are treated as a single tax which must be entirely replaced by the "in lieu of" tax for that tax to be creditable. That aggregation of what in fact are separate taxes occurs under the regulations for the purpose of reducing the number of foreign taxes that can qualify under section 903. As has been observed, under section 901, the regulations and the Service's practice require extreme fragmentation of what in common understanding would be treated as a single taxing provision--again for the purpose of limiting the number of foreign taxes that may be credited. The only unifying theme to these sharply inconsistent jurisprudential approaches is that both improperly restrict the scope of the foreign tax credit.

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107. Regs. § 1.903-1(b)(3), ex. 5.

108. See Rev. Rul. 91-45, 1991-2 C.B. 336 (Mexican Business Assets Tax).

The fundamental difficulty with the section 903 credit may lie in section 901. As long as the basic foreign tax credit is limited to income taxes, the supplemental credit must be limited to taxes that in some fashion substitute for the taxes otherwise creditable under the basic provision. Otherwise, the "in lieu of" credit would engulf the basic credit and that, at least, was not intended and would not be a sensible approach to defining creditable taxes. Given that limitation, it would be as difficult to draft, in definitive form, the reach of the "in lieu of" credit[109] However, as has already been developed in other contexts, the absence of a wholesale revision of the definition of creditable taxes does not justify the retention of the irrationalities of existing law. At the very least, taxes that replace less than all income taxes and taxes that reinforce income taxes, as do the alternative taxes, ought to be creditable under existing law.

While the minimum tax may not be creditable as an "in lieu of" tax under section 903, the taxpayer still has one argument in its favor. If the payment of the minimum tax can be viewed as the payment of the regular income tax, then that payment should be creditable under section 901.

## VIII. Multiple, Related Taxes

It is not at all uncommon in complex tax systems for a single payment to discharge two tax liabilities. In fact, the U.S. foreign tax credit is one example: the payment of the foreign tax discharges the taxpayer's liability for the U.S. income tax. One of the more frequent reasons for adopting such a system lies in the inherent difficulty of administering an income tax and the relative ease with which income can be concealed from understaffed tax collectors. In response to that reality, many government have sought more objective measures of income to use as a means of verifying or challenging reported actual income. Such measures can take a variety of forms, but the most natural approach to is enact an alternative minimum tax. In effect, the taxpayer's income tax base is not allowed to fall below the more objectively determined alternative.

The French tax involved in *Keen* was just such a minimum tax. The tax was imposed on an amount computed by reference to rent paid, unless actual income were greater, in which event the tax was imposed upon actual income. Currently, many Latin American countries have enacted one or another version of a "business assets tax" which consists of a very low rate of tax imposed upon the value of a business' assets.[110] The ultimate tax

109. Revisiting the 1954 principal tax proposal, this time as a substitute for § 903 rather than § 901, however, might be a good place to begin.

110. See Peter D. Byrne, The Business Assets Tax in Latin America—The End of the Beginning or the Beginning of the End?, 15 Tax Notes Int'l 941 (Sept. 22, 1997).

payable is the greater of the income tax or the assets tax. The evident premise of such a tax is that over time for any business to survive it must obtain some reasonable return on its invested capital. If the business is consistently reporting income below that return, it may be inferred that income is being concealed or improperly diverted to another jurisdiction. Thus, if 10% is a reasonable minimum rate of return in the economy and the prevailing rate of tax is 30%, the business ought to pay a tax at least equal to 3% of the value of the capital of the business. A 2% assets tax accordingly would function as an appropriate minimum tax that would limit the taxpayer's opportunities to evade the regular income tax—and would do so at a minimum administrative cost.

These minimum taxes are not separate property taxes. There are integral to the income tax system and are inseparable from that system.[111] The assets taxes do not result in a tax liability unless the income tax payable falls to suspicious levels. They are fairly clever devices that promote the efficient collection of the income tax and discourage the development of underground economies. Plainly the role of the United States should be to encourage the invention and use of such techniques. If the amounts paid under the kinds of minimum taxes seen in *Keen* and in use in Latin America are not eligible for the foreign tax credit, the scope of the credit is defective.

Minimum taxes of the business asset tax variety can assume a variety of forms, the selection of which is very largely arbitrary. Thus, the law might provide that taxpayers are liable for the assets tax but that the liability is discharged by payments of the income tax. Conversely, the law might provide that taxpayers are liable for the income tax but that the liability for that tax is discharged by payments of the assets tax. Perhaps the easiest formulation is to say that the taxpayer is liable for the greater of the tax imposed by the income tax or the assets tax. From the perspective of sound income tax policy, and even of simple good sense, it should not matter which of these formulations a country adopts. To the extent that the full amount paid under the combination of foreign income and business assets taxes is not creditable, international double taxation is not relieved. Unfortunately, such taxes do not fare very well under the credit.

Because the business assets tax is an approximation technique designed to define net income, it would be most appropriate to treat it as an income tax. As has been seen, however, like the tax in *Keen*, it would not be so treated today.[112] If the tax, standing alone, is not an income tax, it would

111. See Peter D. Byrne, The Business Asset Tax in Latin America—No Credit Where It Is Due, 9 Tax Notes Int'l 533 (Aug. 15, 1994).

112. See also Robert F. Hudson, Jr. & Gregg D. Lemein, U.S. Tax Planning for U.S. Companies Doing Business in Latin America, 27 U. Miami Inter-Am. L. Rev. 233, 261-63 (1995).

be appropriate to treat it as an inseparable part of a larger income tax and creditable for that reason. As has been seen, under the narrow approach to divisible taxes, it would not be so treated. If the tax is not creditable as an income tax, since it is imposed in place of the income tax, it would be appropriate to treat it as an "in lieu of" tax. However, the tax is imposed in addition to the income tax and thus, as has been seen, it would not be treated as creditable under section 903. If the business assets tax is not creditable, at least the income tax remains creditable and the assets tax is a mere prepayment of that income tax. Thus, for that reason the payment should be creditable under the basic section 901 credit. Amazingly, perhaps even that may not be so.

The regulations to section 901 provide that if a taxpayer's liability for one tax is reduced by payments of a second tax, then it is the second tax that is deemed to be paid and not the first.[113] Only to the extent that the amounts paid pursuant to the second tax exceed the amount of the liability for that second tax is the payment treated as a payment of the first tax. Assume, therefore, that a foreign government wished to draft its law to provide that all taxpayers are liable for both the income tax and the assets tax but that payments of the assets tax, which were due on January 15th, would discharge the liability for the income tax for the prior year which was due on March 15th. If the taxpayer's liability for the assets tax equals or exceeds its liability for the income tax, then no amount of the income tax and no amount of the assets tax may be credited against its U.S. income tax liability. Here the assets tax is the "second" tax and thus is the one deemed paid. Under the regulations, no amount of the income tax is treated as paid—a result that is simply foolish.

But, it gets worse—much worse. The same paragraph of the regulations also provides that if the taxpayer's liability is the greater of its liability under the income tax or its liability under the assets tax, then the entire amount paid is treated as paid pursuant to the tax that imposes the greater liability. Thus, for example, if the taxpayer's liability for the income tax is 1000u (i.e., units of the foreign currency) and its liability for the assets tax is 999u, then the entire 1000u may be credited against the U.S. income tax. However, if its liability for the assets tax were 1001u, then no amount may be credited! That result is unacceptably irrational.

To some extent, of course, these results can be avoided by the foreign countries that draft business assets or other minimum tax provisions. By casting their income tax as the second tax, payments of that tax will be

113. Regs. § 1.901-2(e)(4)(i).

creditable.[114] However, neighboring jurisdictions should not be required to alter the structure of their internal fiscal legislation to accommodate the pointless irrationalities of U.S. tax law. In this context, at least, it is the United States that should amend its law to respond to the needs and desires of its neighbors, not the reverse.

As in the case of the crediting of proxies for net income, the history of how U.S. law assumed such an unsatisfactory form provides encouragement for the prospects of reform. Here, however, the story is short. Prior to the adoption of the 1983 regulations, the consequence of multiple levies apparently had been considered in only one case, *Queen Insurance Company v. Commissioner*.[115] Under a Canadian tax provision, the amounts paid under a tax, which was assumed to be not an income tax, reduced the taxpayer's liability under the general income tax. The Board of Tax Appeals quite sensibly treated the payment of the first tax as a payment of the income tax and thus creditable. The Second Circuit, in a per curiam opinion that placed controlling stress on the technical language of the Canadian statute, held that the taxpayer had paid the first tax, not the income tax, and that the payment was not creditable.[116]

In the preamble to the final revision of the regulations under section 901, the Treasury characterized the regulations as adopting the rule of *Queen Insurance*, acknowledged the criticism of the result reached by that case, but determined to retain that rule which "respect(s) foreign law in determining which levy or levies are paid."[117] Neither of those bases for the regulations are persuasive. The decision in *Queen Insurance* is of little significance. The Service routinely declines to follow far stronger judicial authority than a single per curiam reversal. The reference to foreign law is hard to even take seriously. As discussed in the early portions of this article, the Treasury has gone to some lengths to establish the proposition that the characterization of a taxing statute as an income tax under foreign law is of no significance to its characterization for the purposes of the foreign tax credit; rather, U.S. concepts apply. For the Treasury to reverse that approach in this portion of the same regulations and to defer here to foreign law rings of disingenuousness. Moreover, the better view would seem to be that it does not matter which tax is deemed to be paid. If the payment of the alternative

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114. Revenue Ruling 91-45 was designed to explain to our Latin American neighbors how they should draft their assets taxes to avoid the loss of credits. 1991-2 C.B. 336.

115. 40 B.T.A. 484 (1939).

116. See Helvering v. Queen Ins. Co., 115 F.2d 341 (2d Cir. 1940), cert. denied 312 U.S. 706 (1941).

117. T.D. 7918, 1983-2 C.B. 113, 115.

tax discharges the liability for the income tax, then both are paid and to the extent of the liability for the income tax, the payment ought to be creditable.

Why the Treasury adopted such a harsh position on multiple taxes does not emerge with any clarity from the historical record. Perhaps that conclusion is sufficient. If there was no persuasive reason for the adoption of the rule, and the rule is not sensible, the conclusion that the rule can and should be changed is hard to escape. However, oil royalties may well have played a part in this aspect of the credit, as well. In some countries, the payments made by the oil producers could be deducted from their liability for the general income tax in a manner similar to the current business assets taxes.[118]

## IX. CONCLUSION

The discussion over the preceding pages has sought to demonstrate two things. In the most fundamental respects, the scope of the U.S. foreign tax credit is far too narrow. In order to properly ameliorate the consequences of international double taxation, many more foreign taxes payments should be creditable against the U.S. income tax on foreign source income. Second, there is no substantial justification for the existing contours of the credit, and thus there is no rational impediment of importance to the reformation of the credit. The more appropriate scope of the credit that initially prevailed was discarded largely as a by-product of an overly enthusiastic attack on the abusive crediting of royalties—a problem that today has been resolved satisfactorily by others means.

The scope of the section 901 definition of a creditable tax has never been addressed by Congress except when it sought to expand the scope of the credit by the addition of the predecessor to section 903. The narrowing that occurred in the 1970s occurred entirely through a revision of the regulations. Given that history, the expansion of the credit does not require congressional intervention. The Treasury is entitled to reconsider its 1983 regulations and to return to the broader approach to crediting that it then abandoned. It should do so.

118. See Priv. Ltr. Rul. 86-11-001 (Nov. 20, 1985); Priv. Ltr. Rul. 68-07-081230A (July 8, 1968).