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Characterization of an Income Tax for the Purpose of the Foreign Tax Credit

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CHARACTERIZATION OF AN INCOME TAX FOR THE PURPOSE OF THE FOREIGN TAX CREDIT

I. Introduction

This note is concerned primarily with section 901 of the Internal Revenue Code of 1954, which reads as follows:[1]

> (a) [T]he tax imposed [on corporations] by this chapter shall . . . be credited with . . .
>
> (b) the amount of any income . . . taxes paid or accrued . . . to any foreign country . . . .

This foreign tax credit, which in various modifications has been part of the federal income tax since 1919, is the principal provision for mitigating international double taxation of income from foreign sources. In essence, it permits taxpayers to offset United States income tax liability in the amount of income and excess profits taxes paid to foreign countries. By virtue of the foreign tax credit, a taxpayer is not required to pay more tax on his foreign income than the United States tax or the foreign tax, whichever is the larger. Where the foreign rate is lower than the United States rate, the taxpayer pays to the United States the excess of his American tax liability over his foreign tax liability. Where the foreign rate is higher, the tax credit completely offsets federal tax liability.[2] An example of how the credit works and its economic effect can be shown by comparing it with a deduction approach. Assume that the United States tax rate is 50%, the foreign rate is 30%, and net foreign income, before payment of the foreign tax, is $1,000. If the foreign tax of $300 is treated as a deduction, the net income subject to the United States tax becomes $700 and the United States tax is $350. Under the credit approach, net income remains $1,000, the tentative United States tax is $500, but against it is credited the foreign tax of $300, so that United States tax liability is reduced to $200. Thus the economic benefits of the credit approach are substantial. At his option, the taxpayer may forego the foreign tax credit and claim a deduction instead.[3]

To receive this favorable tax treatment, however, the foreign tax

1. The force to energize the definitive provisions of § 901 flows from § 33: "The amount of taxes imposed by foreign countries and possessions of the United States shall be allowed as a credit against the tax imposed . . . to the extent provided in section 901."

2. The relevant sections in the present code are Int. Rev. Code of 1954, §§ 901-05.

3. Int. Rev. Code of 1954, §§ 164, 901(a). If a taxpayer claims a credit against tax for foreign taxes he cannot claim deductions for others during the same year. From year to year, however, he may change from deduction to credit or vice versa. See also Shere, *Taxation of American Business Abroad*, N.Y.U. 7th Inst. on Fed. Tax 812 (1949).

must be characterized as an income tax within the meaning of section 901.[4] The purpose of this paper is to explore the various problems encountered in characterizing foreign taxes.

II. THE PROBLEM OF CHARACTERIZATION

While federal taxes in the United States may fall into a few familiar patterns, it is not so the world over. Some countries do not have income taxes at all, or have only low-rate income taxes. Instead, there may be a bewildering array of taxes—some are naive devices, some contractual arrangements, some historical relics, and others unique for a variety of reasons. There are taxes on gross receipts, on gross income, on units produced—as in the case of natural resources—on single items such as interest or dividends, on income computed in presumptive fashion (through resort to various factors such as multiples of the rental value of a building), on exports, on remittances abroad, or on the purchase of foreign exchange. Which of these is an "income tax" within the meaning of the foreign tax credit device? The Internal Revenue Service has largely used the yardstick of similarity to the United States concept of an income tax, but it has not clearly defined that concept. Moreover, in the application of this vague standard the emphasis is sometimes placed on the purpose or name of the tax. Thus, one tax may qualify because it is measured by income, and another may not because it is a privilege tax or a tax on the export of capital, even though it too is measured by income. Sometimes presumptive taxes qualify because they are part of an income tax statute, and sometimes they do not because the "net" or "profit" element is not clear. Qualification very often depends on purely fortuitous elements in the history or statutory structure of the foreign tax system. For example, it is generally required that the tax not only must be on income but also must be part of an income tax statute and historically connected with it.[5]

This general discussion indicates that an income tax for the purpose of the credit is not always the income tax as conceived by the layman. Thus the characterization problem must be examined in terms of (1) the legislative history of the credit device, (2) the theoretical bases for a qualifying tax, and (3) rulings of the courts and the Internal Revenue Service.

A. Legislative History

Until 1918 all foreign taxes were treated as deductible expenses, in

4. An exhaustive treatment of all aspects of the foreign tax credit device is found in OWEN, THE FOREIGN TAX CREDIT (1960).
5. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment,* 56 COLUM. L. REV. 815, 819-20 (1956).

the same manner as state and local taxes. In 1918 efforts were made to exempt foreign income from the United States tax. The principal ground advanced for this relief was the alleged competitive disadvantages suffered by American corporations operating branches abroad because the United States taxes were much higher than the taxes to which competing local enterprises were subject. The Congressional response was to eliminate double taxation, but its focus was on the foreign income taxes. The payment of a foreign income tax was elevated from the status of a deduction from gross income to that of a credit against the United States tax, with the result that any foreign tax less than the effective United States rate was eliminated; in this sense double taxation disappeared.[6] Surrey analyzes the consequences of the decision.

> There are a number of important policy considerations which flow from this adoption in 1918 of a foreign tax credit. Basically, the Congress thereby reaffirmed its historical decision to tax the United States citizen and corporation on world-wide income. The argument that this approach placed our corporations at a disadvantage in foreign markets because of the United States tax was rejected, but the argument based on the burden of double taxation was persuasive. The United States would therefore retain its jurisdiction to tax on world-wide income, but it would recognize the interests of the country of source in also taxing the income arising therein. This recognition of source jurisdiction would extend as far as giving primary effect to the source jurisdiction in order to prevent the heavy burden that would otherwise fall on the United States taxpayer having fiscal responsibilities to two national jurisdictions. To provide this protection for the United States taxpayer, our Government would consider its own tax claims met to the extent that a tax payment had been made to the country of source.[7]

The Revenue Act of 1918[8] provided, in the case of a citizen of the United States or of a domestic corporation, that the United States tax would be credited with the amount of any "income, war profits and excess profits taxes" paid during the taxable year to any foreign country. No limitations were imposed upon the credit allowed. The "overall" limitation was added in 1921,[9] and the 1932 act required

6. There is no legislative history as to the source of this solution, but Dr. T. S. Adams, economic advisor to the Treasury in 1918, stated that he proposed the credit to Congress. Adams, *International and Interstate Aspects of Double Taxation,* 1929 NATIONAL TAX A. PROCEEDINGS 193, 198.

7. Surrey, *The United States Taxation of Foreign Income,* 1 J. LAW & ECONOMICS 72, 74 (1958).

8. Revenue Act of 1918, ch. 18, §§ 222(a)1, 238(a), 40 Stat. 1080. The intent of the credit was to remove the "severe burden" resulting from high tax rates of "certain foreign countries." H.R. REP. No. 767, 65th Cong., 2d Sess. 11 (1918). Discussion in the House indicates another purpose was that the tax laws should not discourage "men from going out after commerce and business in different countries." 56 CONG. REC. 677-78 (App. 1918).

9. Revenue Act of 1921, ch. 136, §§ 222(a)5, 238(a), 42 Stat. 258. The overall foreign tax credit allowed to a taxpayer could not exceed the total United

that the amount of the credit allowed for tax paid to any one country must not exceed the United States tax on the income attributable to that country.[10]

In 1942, credit was allowed for taxes imposed by foreign countries where such taxes were "in lieu of" income taxes.[11]

B. Theoretical Bases of the Criteria for the Foreign Tax Credit

Underlying the statutory criteria for the credit device are two basic premises: 1. United States foreign policy encourages the export of capital, or foreign investment. 2. Incomes from foreign and domestic investment should pay the same tax, a consequence flowing from the progressive rate system.

The first of these premises is one which is familiar to any person who has read newspapers since the inception of the Marshall Plan. It is a basic premise of American foreign policy and, as such, lies somewhat beyond the province of tax law.

The second premise, however, demands our attention since it is inextricably intertwined in the theory of taxation. Two views of the equitable tax burden are possible and will produce different conclu-

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States tax on all his income. For a further discussion of the legislative history of the acts of 1918 and 1921, see Burnet v. Chicago Portrait Co., 285 U.S. 1, 8-9 nn.6 & 7 (1932).

10. Revenue Act of 1932, ch. 209, § 131(b)1, 47 Stat. 211.

Discussion in the House indicates that there was opposition to the credit on the ground that it discriminated against domestic investors who could only deduct state and local taxes. The provision was renewed, however, when it was pointed out that (1) American corporations claimed they could not compete against foreign companies without the credit, (2) the United States would lose the benefit of the net profit from foreign operations if American corporations were driven out, (3) loss of the credit would "seriously" interfere with export trade. 75 CONG. REC. 6489-90 (1932). One reason stated for crediting foreign income taxes and deducting state and local income taxes was "that all the income earned in this country is earned under the protection of our laws and guaranties, safeguards, and privileges that we give to persons and property, but incomes earned abroad are earned under the protection of laws and safeguards of other countries." *Id.* at 7049.

11. Revenue Act of 1942, ch. 619, § 158(f), 56 Stat. 857. The report of the Senate Finance Committee sets out two reasons for the amendment.

1. "Many of the income tax laws of a foreign country, especially those in the Latin American countries, provide for taxation on an arbitrary basis in lieu of the tax on net income."
2. "In the interpretation of the term 'income tax,' the Commissioner, the Board, and the courts have consistently adhered to a concept of income tax rather closely related to our own, and if such foreign tax was not imposed upon a basis corresponding approximately to net income it was not recognized as a basis for such credit. Thus if a foreign country in imposing income taxation authorized, for reasons growing out of the administrative difficulties of determining net income or taxable basis within that country, a United States domestic corporation doing business in such country to pay a tax in lieu of such income tax but measured, for example, by gross income, gross sales or a number of units produced within the country, such tax has not heretofore been recognized as a basis for a credit. Your committee has deemed it desirable to extend the scope of this section." S. REP. No. 1631, 77th Cong., 2d Sess. 47-48, 131-32 (1942).

sions. If the principle of equal tax treatment is limited to the taxes of any *one* country, that is, the tax burden imposed by the taxes of the investor's country of domicile, it follows that the United States investor abroad should be taxable only on such income from his foreign investment as remains after all charges, including tax paid abroad, are deducted. This approach is similar to United States treatment of state income taxes.

Under the supernational view, the principle of equal treatment is applied to the *combined* domestic and foreign tax, so that the investor pays the same total (domestic plus foreign) tax on his foreign investment income as he would pay if the income were derived from only domestic sources. This is the system of the tax credit.

Since present United States policy is designed to mitigate double taxation by equalizing the tax on income earned in this country and that earned abroad, it follows that a credit should be given only for taxes that are not passed on, since the rate of return after taxes is the controlling factor. Under this approach, all foreign taxes must be divided into two groups, those which fall on profits and those which do not. To an economist, taxes which are a function of profits will reduce the rate of return, while taxes which are a function of cost, output, or gross receipts, may be passed on to the purchaser of the goods or service. Using a system of classification based on economic realities would produce theoretical tax equity regardless of whether the foreign legislature intended that a tax be "shifted."

As a later discussion of the judicial and executive decisions will indicate, this suggested classification of creditable taxes is somewhat broader than the law presently provides and is perhaps too simplified a solution. Present knowledge of the concept of shifting is insufficient to provide hard and fast rules. Furthermore, if the credit includes certain foreign taxes other than the income tax, should not the credit extend to similar taxes on the United States side of the picture? For example, if a United States taxpayer is allowed to credit a foreign property tax against his United States income tax, will he not have an advantage over the domestic investor who can only deduct such a tax? And even where the tax is not shifted, the net rate of return on investment may be increased where, for example, a foreign tax is used to provide public services, thereby reducing business costs.[12]

C. Judicial and Executive Construction of "Income Tax"

In none of the legislative history discussed above did Congress define "income tax." Furthermore, the comparative brevity of the

12. Musgrave, *Criteria for Foreign Tax Credit,* in TAXATION AND OPERATIONS ABROAD 83 (Tax Institute 1957).

history and the absence of any thorough studies in the area left those charged with the task of construing the credit provision open to the partisan broadsides of the government, which was interested in collecting the revenue, and of taxpayers' counsel, who were interested in avoiding as much taxation as possible. The result was that often the term "income tax" was not construed in light of the congressional purpose behind the credit device, especially in cases where the foreign country's tax structure was not grounded on the income tax as the principal tax.

One of the earliest problems to arise was whether the foreign tax should be characterized by the law of the United States or by the law of the foreign country. In *Flint v. Stone Tracy Co.*,[13] the Supreme Court stated that "much weight" should be given to the characterization of the tax by the lawmaking power. Though the tax in *Flint* was imposed by a state and not by a foreign government, the same principle was applied to a foreign tax in the 1929 case of *Herbert Ide Keen.*[14] France imposed a tax on income, with income presumed to be equal to at least seven times the rental value of the residence which was occupied by a taxpayer not domiciled in France. The credit was allowed:

> Whatever may be the nature of the tax, it is imposed upon what *the French Government determines to be income*. . . . The fact that under the law the taxable income is determined in a manner different from the taxable income under the Revenue Act of 1921 does not change the nature of the tax. The fact that the net income of the petitioner as computed under the Revenue Act of 1921 was much in excess of the income of the petitioner determined for the purposes of the French tax does not change the character of the tax paid.[15]

The Board of Tax Appeals followed the *Keen* doctrine in 1936 when it decided that a Cuban tax on the net proceeds of public service companies was an income tax for purpose of the credit.[16] The *Keen* case was cited with approval and great weight was given to the characterization of the tax by the Cuban Supreme Court.

Apparently realizing that tax evasion could occur through a foreign country labelling all taxes as income taxes in order to attract foreign investment, the judiciary made an abrupt turnabout. In the first appellate court case deciding the question of characterization, the

13. 220 U.S. 107, 145 (1910).
14. 15 B.T.A. 1243 (1929).
15. *Id.* at 1246. (Emphasis added.) *Cf.* James R. Hatmaker, 15 B.T.A. 1044 (1929) (credit denied because French tax was not paid in the taxable year in question); Hugh C. Wallace, 17 B.T.A. 406 (1929) (credit denied because taxpayer had earned no foreign income for the taxable year in question).
16. Havana Elec. Ry., Light & Power Co., 34 B.T.A. 782 (1936). See also New York & Honduras Rosario Mining Co. v. Commissioner, 168 F.2d 745 (2d Cir. 1948).

Third Circuit stated that "it is conceded that in the application of the statute [Quebec Mining Act] the criteria prescribed by our revenue laws are determinative of the meaning of the term 'income tax' used therein."[17]

After stating that the foreign tax shall be characterized according to United States law, the court in *Keasbey & Mattison Co. v. Rothensies* proceeded to give the criteria by which the tax would be judged.

> These commonly accepted criteria . . . may be easily ascertained. . . . [A]n income tax is a direct tax upon income. . . . The defined concept of income has been uniformly restricted to a gain realized or a profit derived from capital, labor, or both. . . . It seems logical to conclude that any tax, if it is to qualify as a tax on income . . . is subject to the same basic restrictions. . . . [T]axes imposed on . . . franchises, privileges, etc., are not income taxes, although measured on the basis of income.[18]

The court concluded that in reality the tax was on the mining privilege, since (1) neither gain nor profit was required for tax liability and (2) the basis of the tax was gross output less deductions incurred in the mining operation and not those incident to "general conduct" of the business. Since the taxpayer was in the business of operating mines in Quebec, the second ground of the decision is dubious. The better solution would have been to credit taxpayer with the amount of taxes paid on income computed by the deduction for total business expenses.[19]

This narrow construction of "income tax" was not followed in the 1948 case of *New York & Honduras Rosario Mining Co. v. Commissioner,*[20] where the taxpayer had contracted to pay Honduras at least five per cent of the liquid profits arising from its mining operations. In reversing the Tax Court,[21] *Keasbey & Mattison Co.* was distinguished on four grounds: (1) there was tax liability only if profits existed; (2) if taxpayer and the Honduran government disagreed on the amount of net profits, the tax would be levied on the sum which the United States would have taxed; (3) the deductible expenses

17. Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894, 897 (3d Cir.), *cert. denied,* 320 U.S. 739 (1943). No authority was cited for this proposition, nor was there any discussion of the *Keen* case. *Accord,* Commissioner v. American Metal Co., 221 F.2d 134 (2d Cir. 1955); Abbott Labs. Int'l Co. v. United States, 160 F. Supp. 321, 331 (N.D. Ill. 1958), *aff'd per curiam,* 267 F.2d 940 (7th Cir. 1959); Lanman & Kemp-Barclay Co., 26 T.C. 582 (1956).

18. Keasbey & Mattison Co. v. Rothensies, *supra* note 17, at 897.

19. *Id.* at 898. The fact that the decision was in 1943, at the height of the war effort and at a time when revenue was sorely needed, probably influenced the strict construction of the statute by the court. The court realized the inapplicable "in lieu of" provision might bring about a different result, but stated that this "is at least presumptive evidence that Congress recognized that the prior act was of limited application."

20. 168 F.2d 745 (2d Cir. 1948).

21. 8 T.C. 1232 (1947).

under Honduran law were similar to those allowed by the United States income tax laws; and (4) Honduras levied a separate excise tax on the mining operation.

The government argued that since the tax was payable in advance and non-refundable if taxpayer stopped operations, it was not based on income.[22] The court held that this was immaterial: "To hold otherwise would defeat the purpose . . . to encourage domestic corporations to do business abroad without having to operate through a foreign corporation . . . ."[23]

Keasbey & Mattison and *New York & Honduras Rosario Mining Co.* could be said to be within the twilight zone of section 901. Many cases have arisen, however, that have been within the traditional view of an income tax. Thus a British tax equal to 5% of profits as a "national defense contribution";[24] a tax of 6% levied by the Dominican Republic on freight and passenger fares and cargo receipts;[25] a Philippine tax on all net income received from all sources within the Philippine Islands by a non-resident alien individual not engaged in a trade or business;[26] a Japanese tax of 5% on corporations;[27] a Jamaican tax on chargeable income determined by either an invariable or adjustable rate depending on variations in the base price of the taxpayer corporation's product;[28] and a tax imposed by Curacao, Netherlands West Indies, on "net advantages"[29] were all income taxes for the purpose of the credit. On the other hand, a Cuban tax on capital;[30] a Japanese tax based on the per capita basis of juridical persons;[31] a German tax based on business capital or total of wages paid;[32] and

22. See Commissioner v. American Metal Co., *supra* note 17.
23. 168 F.2d at 749.
24. I.T. 3171, 1938-1 Cum. Bull. 192.
25. I.T. 3997, 1950-1 Cum. Bull. 63. *But cf.* Continental Ins. Co., 40 B.T.A. 540 (1939) (Canadian tax on gross premiums received by insurance company minus rebates, returns and amounts paid for reinsurance held to be like an excise tax and not within the credit provision).
26. Rev. Rul. 7, 1953-1 Cum. Bull. 224.
27. Rev. Rul. 58-548, 1958-2 Cum. Bull. 382.
28. Rev. Rul. 60-146, 1960-1 Cum. Bull. 276.
29. I.T. 3774, 1945-1 Cum. Bull. 204.
30. Rev. Rul. 31, 1953-1 Cum. Bull. 225.
31. Rev. Rul. 58-548, *supra* note 27.
32. Rev. Rul. 59-208, 1959-1 Cum. Bull. 192. The tax on business capital was tied to business returns and was "divisible into separate parts"; its components should be considered separately and credit was allowed for taxes paid that were allocated to business returns. See also Rev. Rul. 56-51, 1956-1 Cum. Bull. 320, where Cuba levied a tax of 15% on any profits in excess of 10% of the value of taxpayer's capital. Rev. Rul. 31, 1953-1 Cum. Bull. 225 was modified from refusing to allow a credit as an income tax or a tax "in lieu of" an income tax to allowing a credit on the basis of payment of an excess profits tax. The excess profits tax was separable from another tax for which credit was not allowed.

In a similar situation, a Canadian excess profits tax law provided for a refund of that portion of the tax representing 20% of the amount of profits above 116.67% of normal profits. It was held that since the refundable a turnover tax superimposed on the French income tax[33] were not found to be within the United States concept of the income tax.

One line of cases has held that the fact the tax is levied upon a single source of income is immaterial. Taxes paid upon income from securities have been credited,[34] even when the tax might include an item not taxable in the United States.[35] A Canadian tax on income from United States sources which is paid to trustees of a Canadian trust, who in turn distribute it to beneficiaries in the United States, was within the realm of the credit provision,[36] as was a Canadian tax on the shareholder on dissolution and distribution.[37] And although a tax imposed by Mexico[38] and Bolivia[39] was upon the mining industry only, the credit was allowed.

There have been three decisions by the Treasury Department involving foreign taxes designed to raise revenue for other than the historical functions of government. While credit for an Argentine tax at the rate of 7% per month for a social security system was granted,[40] a "tax" levied by Brazil in the amount of a 15% surtax for developing basic industry was not allowed as a credit.[41] Here, however, the tax was to be repaid with a bonus in the form of "economic re-equipment bonds," bearing 5% interest, and the Brazilian tax authorities allowed taxpayer to carry the 15% payment on his books as an asset. The third case involved a 5% tax on net profits to meet the needs of an Ecuadorian Labor Council composed of one-half of the wage-earning employees of taxpayer's business.[42] Holding that the tax was levied to

portion of the tax was definitely ascertainable at the time of payment, credit would be given only for the tax remaining after deduction of the refundable portion. I.T. 3624, 1943-1 CUM. BULL. 438.

33. I.T. 2070, III-2 CUM. BULL. 250 (1924).

34. Columbian Carbon Co., 25 B.T.A. 456, 473 (1932) (interest from British government bonds).

35. I.T. 3998, 1950-1 CUM. BULL. 64. The Cuban tax on "dividends" could presumably include stock dividends.

36. Rev. Rul. 55-414, 1955-1 CUM. BULL. 385.

37. Rev. Rul. 57-348, 1957-2 CUM. BULL. 434. The payment received was held to be a dividend equal to a portion of the undistributed income on hand.

38. I.T. 3945, 1949-1 CUM. BULL. 88. Since the tax was on the value of the ore produced, and costs of production were immaterial in computing it, the tax was held to be on the privilege of mining.

39. I.T. 2070, III-2 CUM. BULL. 250 (1924).

40. I.T. 4111, 1952-2 CUM. BULL. 141.

41. Rev. Rul. 59-70, 1959-1 CUM. BULL. 186. Brazil's characterization of the payment as a tax was immaterial. *Accord,* Rev. Rul. 60-56, 1960-1 CUM. BULL. 274.

42. I.T. 3768, 1945-1 CUM. BULL. 204. Bailey v. Drexel Furniture Co., 259 U.S. 20 (1922) and United States v. Butler, 297 U.S. 1 (1936), were cited. Since the "tax" was payable directly to the workers council, it would seem that the payment could be considered part of wages and therefore deductible. Yet the purposes behind the Argentine social security tax and this tax were the same: providing for the welfare of the employees. It would seem that the distinguishing factor would be the body to whom the payment was made, although for the purpose of characterization such a distinction seems illusory.

regulate industries, and not to raise revenue, the credit was disallowed.

Taxes computed in a presumptive fashion, especially in connection with the value of property, have been troublesome. In the *Keen* case, discussed above, the court apparently realized that the French tax did not necessarily reflect income: "This tax is imposed upon alien residents *without regard to their actual income*."[43] The *Keen* decision was narrowed in the case of *Hugh C. Wallace*,[44] where the court held that although the tax was on income, no credit would be allowed because taxpayer received no income from sources outside the United States during the taxable year. Thus the Board placed itself in the illogical position of holding the French tax was an "income tax" (on income earned in France, of course), but the taxpayer had earned no income without the United States to which the credit could be applied. The logical position would have been that the French tax should be considered an income tax for purpose of the credit only when taxpayer *actually* earned foreign income.

The Second Circuit Court of Appeals in 1937 rejected an attempt to stretch the *Keen* doctrine to cover a British tax requiring the lessee of premises to pay tax on any surplus value of property that the British act determined was not rented for true value.[45] The tax was on the use of the land, said the court, "it is not paid upon accumulated profits except by the fiction of treating the value of the land when occupied as a profit."[46] The Internal Revenue Service, apparently feels there is life remaining in *Keen*, for a Haitian tax on income computed in the alternative on a "fixed rate basis" of five times the yearly rental value of realty which taxpayer occupies for his trade or business was held to be within the credit.[47]

D. Taxes Deemed To Have Been Paid

Once it has been determined that the foreign tax in question can be characterized as an income tax, other problems may then arise. Two of the more significant of these are: (1) was taxpayer liable for the American tax against which he claimed the credit, or (2) was he

43. Keen v. Commissioner, *supra* note 14, at 1245. (Emphasis added.) The Board was probably persuaded by the fact that this tax was part of the French income tax statute.

44. 17 B.T.A. 406 (1929). For another case involving French income taxes, but not stating the provisions of the statute, see Chester D. Griesemer, 10 B.T.A. 386 (1928).

45. F. W. Woolworth Co. v. United States, 91 F.2d 973 (2d Cir. 1937).

46. *Id.* at 977. Since the stipulation of facts did not separate that part of the tax which was paid upon rents received from property of which taxpayer was lessor from that part paid by taxpayer as lessee, no credit was allowed for any of the taxes.

47. Rev. Rul. 272, 1953-2 CUM. BULL. 56. See also Abbott Labs. Int'l Co. v. United States, *supra* note 17.

personally liable for the foreign tax for which he claimed the credit. The statutory basis for the first problem is section 911, which provides as follows:[48]

> (a) The following items shall not be included in gross income and shall be exempt from taxation . . . .
>
> (1) In the case of . . . a bona fide resident of a foreign country . . . amounts received from sources without the United States . . . .
>
> (2) [A]n individual . . . who [for] 18 consecutive months is present in a foreign country . . . during at least 510 full days in such period, amounts received from sources without the United States . . . .

Hubbard v. United States[49] illustrates this problem. Here plaintiff paid British taxes on income earned in England, and he lived abroad for a sufficient length of time to exempt this income from United States taxes. The court refused to allow taxpayer to credit these British taxes against taxes due on other income earned within the United States, stating that the evil of double taxation aimed at by the statute was not present, for the statute only applied to income that would not be exempt from United States taxes.[50]

The second problem centers around the word "paid" in section 901(b)1 and usually arises when a foreign government has taxed a native person or corporation which then transmits its income after taxes to the American taxpayer. In the leading case of *Biddle v. Commissioner*,[51] shareholders in British corporations were required to report as income dividends actually received plus amounts reflecting their respective proportions of the tax paid by the corporation on profits distributed as dividends. Taxpayer claimed credit for this tax reported in his British return. The Board of Tax Appeals refused to allow credit for the taxes, holding (1) they were not income received from, nor a legal obligation discharged by the corporation, and (2) the fact that the tax rate was that of the corporation and not of the individual indicated the tax was imposed upon the corporation. The

48. INT. REV. CODE OF 1954, § 911.
49. 17 F. Supp. 93 (Ct. Cl. 1936).
50. See L. Helena Wilson, 7 T.C. 1469 (1946). Here Canada taxed the payment of a legacy received from a Canadian trust which was exempt from United States taxes. There was no double taxation, since the income was not subject to United States taxes, and the credit was not allowed. See also Helvering v. Queen Ins. Co., 115 F.2d 341 (2d Cir. 1940) (since Canada allowed taxpayer to credit excise taxes paid against income tax liability, taxpayer claimed a credit for the excise tax; the court disagreed); I.T. 4002, 1950-1 CUM. BULL. 68 (Dominican excise tax on the export price of crude and ordinary sugar produced was allowed as a credit on taxpayer's income tax liability; credit allowed under the "in lieu of" provision). The different results are due to the "in lieu of" provision, INT. REV. CODE OF 1954, § 903.
51. 302 U.S. 573 (1938). *Accord,* Trico Prods. Corp., 46 B.T.A. 346 (1942); Irving Air Chute Co. v. Commissioner, 143 F.2d 256 (2d Cir. 1944), *cert. denied,* 323 U.S. 773 (1945).

Supreme Court agreed, stating that the liability for the tax ran only to the corporation. Even though the British law refunded the tax to the individual if his income was not taxable, this was based on the concept, not recognized in the United States, that the corporation tax was passed on to the shareholders, and United States law did not impose a legal duty on shareholders receiving dividends to pay the tax on corporation profits. The ultimate test, said the court, was "whether it is the substantial equivalent of payment of the tax as those terms are used in our own statute."[52] Thus the authoritative source for the characterization of payment of a foreign tax is to be found in United States law.

In a case decided a year after *Biddle,* however, the Board of Tax Appeals, relying upon a "substantial equivalent" rule, found that British and Canadian taxes deducted from royalties paid to taxpayer were imposed upon him. The Canadian corporation was held to be only an agent for payment; the British corporation was considered to have paid the taxes as those of taxpayer even though the tax was not assessable against him. Here the British corporation was denied a deduction for "taxes paid," leading to the conclusion that it was not liable for their nonpayment.[53]

III. Credit Under the "In Lieu of" Provision

The "in lieu of" provision,[54] passed in 1942, was intended to broaden the area of creditable taxes because of the narrow construction of

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52. 302 U.S. at 579. *Accord,* F. W. Woolworth Co. v. United States, *supra* note 45.

53. Crawford Music Corp., 40 B.T.A. 284 (1939). *Accord,* I.T. 2762, XIII-1 Cum. Bull. 64. *Cf.* Elgin Nat'l Watch Co., 17 B.T.A. 339, 362 (1929) (credit disallowed where taxpayer failed to show his connection with the paying corporation—a wholly-owned subsidiary of the foreign corporation with which taxpayer had contracted). See also Charles W. Bowring, 27 B.T.A. 449, 453-63 (1932).

Under the United States-United Kingdom tax convention, adopted in 1945, the *Biddle* result is rejected, for a United States shareholder of a corporation resident in United Kingdom is deemed to have paid the United Kingdom tax appropriate to the dividends received by him, if he elects to include the gross amount of the dividends in income. Convention with the United Kingdom Respecting Double Taxation and Taxes on Income and Protocol, Apr. 16, 1945, 60 Stat. 1377, T.I.A.S. No. 1546. In the absence of such an agreement, the *Biddle* result still prevails. Brantman v. United States, 167 F. Supp. 885 (N.D. Calif. 1958) (credit disallowed on tax imposed by the then Crown Colony of Singapore); Abbott Labs. Int'l Co. v. United States, *supra* note 17, at 326-27.

54. "[T]he term 'income . . . taxes' shall include a tax paid in lieu of a tax on income . . . ." Int. Rev. Code of 1954, § 903. Treas. Reg. § 1.903-1(a) (1957) lists three requirements for an "in lieu of" tax: (1) Such country or possession has in force a general income tax law; (2) The taxpayer claiming the credit would, in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax; and (3) such general income tax is not imposed upon the taxpayer thus subject to such substituted tax.

"income taxes" by the executive and the judiciary.[55] In the first judicial construction of the section, the Ninth Circuit[56] stated that the area of creditable taxes was now "clearly broader":

> The Commissioner contends that a foreign tax must have some relation to profits . . . . This was true prior to 1942 when foreign tax credits were allowed on foreign income taxes only. . . . The 1942 amendment is clearly broader in scope providing credits for foreign taxes "in lieu of a tax upon income". . . .
>
> The report of the Senate Finance Committee on proposed [§ 903] expressly states that foreign taxes measured by "gross sales" would constitute a credit. . . . Manifestly gross sales have no relation to profits. Gross sales are however analogous to "net premiums".[57]

Thus the 3% tax imposed by Canada on net premiums from insurance was within the credit.[58]

Different results were reached by the courts in applying the "in lieu of" provision to two different Cuban taxes. In *Compania Embotelladora Coca-Cola v. United States*,[59] taxpayer had been exempt from the Cuban profits tax, but had paid a production tax instead. In 1941, plaintiff also became liable for an income tax. The government claimed that since the production tax was "in lieu of" an income tax until 1941, the imposition of an income tax in 1941 was in lieu of the profits tax from which taxpayer had been exempt through payment of the production tax, and thus taxpayer was no longer entitled to a credit for the production tax. Holding that the government had failed to show that the income tax was paid in lieu of the profits tax, the court allowed the credit. On the other hand, *Guantanamo & W. Ry.*, a 1958 decision by the Tax Court, refused credit for a Cuban tax on "gross receipts" where taxpayer was given credit for Cuban income taxes paid, stating the gross receipts tax was parallel to the income tax and not in lieu of it.[60]

These decisions can be distinguished on the grounds that the tax

55. Musgrave, *supra* note 12. Prior to 1942, the Internal Revenue Service issued a series of rulings strictly limiting the taxes of foreign countries which might be credited against United States taxes. Many of the taxes were actually levied on income, but, for administrative convenience, were applied on an arbitrary basis. See Hinkel, *Foreign Tax Credits*, N.Y.U. 17TH INST. ON FED. TAX 391, 395 (1959).

56. Northwestern Mut. Fire Ass'n v. Commissioner, 181 F.2d 133 (9th Cir. 1950).

57. *Id.* at 135.

58. *Accord*, Philadelphia Mfrs. Mut. Fire Ins. Co., 10 CCH TAX CT. REP. 999 (1951). The Internal Revenue Service has stated it will not follow *Northwestern Mut. Fire Ass'n.* Rev. Rul. 58-475, 1958-2 CUM. BULL. 385 (2% Quebec tax on premiums).

The court also held that the "in lieu of" provision must be characterized by United States law. 181 F.2d at 134.

59. 139 F. Supp. 953 (Ct. Cl. 1956).

60. Guantanamo & W. Ry., 31 T.C. 842, 851, 856 (1959).

in *Guantanamo* was parallel to and completely separate from the income tax, while the *Embotelladora* tax appeared to be supplemental to the income tax.[61] A further basis for the *Guantanamo* decision was that the tax on "gross receipts" just could not be a tax on *income*. It should appear, however, that this was the kind of tax intended by Congress to be within the "in lieu of" provision.

In the legislative history of the "in lieu of" provision, the examples given of a tax "in lieu of" an income tax are taxes measured by gross income, gross sales or the number of units produced.[62] Thus the question arose in *Lanman & Kemp-Barclay & Co. of Columbia*[63] whether a Columbian tax on patrimony was creditable. Columbia law stated the tax was "an annual tax, complementary and accessory to the tax on income, on the patrimony" and further stated that "the tax on income . . . and the additional one on patrimony shall be considered one and indivisible."[64] Taxable patrimony was defined as "the difference between the rights or duties appreciable in money which a taxpayer may have, on one part, and the debts which burden these rights, plus the capital which the law exempts from tax . . . ."[65] Holding that the characterization of the tax as an indivisible part of the income tax by the Columbian courts was immaterial, the court stated that a property tax having no relation to income or production was not intended to be within the provision, apparently relying on the following sentence of the legislative history:

> Thus if a foreign country in imposing income taxation authorized, *for reasons growing out of the administrative difficulties of determining net income or taxable basis* within that country, a United States domestic corporation doing business in such country to pay a tax in lieu of such income tax but *measured, for example by gross income, gross sales or a number of units* produced . . . .[66]

If the courts in future decisions view the legislative history so as to exclude from the provision taxes levied for reasons other than administrative difficulties and taxes determined other than by gross income, gross sales, or number of units produced, the liberalizing effect of the provision will be diminished.

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61. The court's opinion does not expressly state that the tax is supplemental, but the inference is that the tax is an integral part of the Cuban provisions for taxation of income. 139 F. Supp. at 955. See Rev. Rul. 59-7, 1959-1 CUM. BULL. 183; I.T. 3903, 1948-1 CUM. BULL. 70.

62. Note 12 *supra*.

63. 26 T.C. 582 (1956). *Accord*, Abbott Labs. Int'l Co. v. United States, *supra* note 17. Columbia also levied a tax on income.

64. 26 T.C. at 583.

65. *Id.* at 584.

66. S. REP. No. 1631, 77th Cong., 2d Sess. 131-32 (1942). (Emphasis added.)

IV. Conclusions

As the previous discussion indicates, a simple listing of the requirements for an "income tax" or a tax "in lieu of" is impossible. The only solution is to analyze the foreign tax in question with respect to its relationship to the fiscal structure of the country,[67] being guided by the decisions construing the foreign tax credit provisions of the Code. A consideration of the purposes of the credit provisions could simplify the analysis, but there seems to be considerable disagreement over the policies underlying the provisions. One problem, for example, is the extent to which the foreign tax credit should be used as an instrument of fiscal policy to encourage foreign investment.

One affirmative solution to this problem would go so far as to abolish altogether taxes on foreign source income thereby greatly stimulating foreign investment. This proposed exemption would result in a break with the traditional concept that the income tax is a method whereby those who enjoy the benefits of citizenship should share in the financial support of the government. It would also result in a loss of revenue which would probably increase as more domestic corporations geared their expansion programs to foreign countries to take advantage of tax-free income. Whether fiscal policy should thus indiscriminately encourage an increase in the export of American capital is at least questionable.[68]

Another suggestion would be to abolish the credit provision and substitute the deduction approach. Thus foreign income taxes would be treated as are state and local income taxes. An advantage certain to flow from such an approach would be to make unnecessary the determination of whether a tax falls within or without the credit provisions. Musgrave feels that the deduction approach combined with a lower rate of taxation on foreign income would be more equitable.[69] Surrey, however, casts doubt on the current belief that tax advantage enters significantly into the question of foreign investment.[70] Certainly a study of the relative effect on foreign investment of the deduction approach as opposed to the credit method would be required before the deduction approach could be adopted.

If it is determined that the credit device is preferred to the exemption or deduction approaches, the next problem is whether the device should be changed. As pointed out earlier in this paper, it appears

67. The necessity for this determination flows from the *Guantanamo* rule denying credit for taxes parallel to the income tax.

68. Note, 68 Harv. L. Rev. 1036 (1955). See also Shere, *Taxation of American Business Abroad,* N.Y.U. 7th Inst. on Fed. Tax 812, (1949).

69. Musgrave, *Criteria for Foreign Tax Credit,* in Taxation and Operations Abroad 83 (Tax Inst. 1959).

70. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment,* 56 Colum. L. Rev. 815 (1956).

from the point of view of economics that the types of taxes creditable are too narrow. There has been substantial criticism of the limited nature of the credit provision.[71] In the House version of the 1954 code, an election to credit either a "principal" tax or income taxes was proposed. A principal tax was defined as a tax which was not an income tax, was selectively applied, and was the principal tax burden of the taxpayer in the foreign country. Due to the opposition of business groups who feared that the proposal would narrow the types of taxes creditable as income taxes, this approach was rejected by the Senate Finance Committee. An investigation by Barlow and Wender indicates, however, that this consideration is not an important one in the decision to invest.[72] They recommend that excise taxes imposed upon income items, property taxes which affect the rate of income, or excess profits taxes be included within the credit provision.[73]

All of these suggested devices for handling foreign source income, however, are equally subject to criticism on another ground. Investment often occurs in areas which are already heavily industrialized and not in the underdeveloped areas of the world. Presuming that foreign policy would best be served by channelling investment to these underdeveloped areas, a treatment of foreign source income which applies indiscriminately to all foreign investments is an inefficient fiscal device for furthering this facet of foreign policy.

Tax equity—the inherent purpose of the progressive rate system—must be weighed against any foreign policy objective of encouraging overseas investment through preferential tax treatment. From the viewpoint of tax equity, the arguments of those favoring a change to the deduction approach are not persuasive, for the comparison between deduction of usually low-rate state taxes and deduction of often high-rate foreign government taxes is not valid. Yet under the existing credit device, the narrow construction of "income taxes" and taxes "in lieu of" by the courts and the Internal Revenue Service has not effected equality of taxation in many cases.

Perhaps the best reconciliation of the many conflicting policies underlying the foreign tax credit would be to give preferential treatment by tax treaties to investment income from those areas where

71. *E.g.*, 98 Cong. Rec. 8308 (1952) (letter of Senator George (D., Ga.) to Secretary of the Treasury Snyder).

72. Barlow & Wender, Foreign Investment and Taxation 313 (1955). For example, where a corporation pays a high patrimony tax and thereby is allowed a reduction of its excess profits tax, there may be manipulation to understate its patrimony and overpay the excess profits tax, since the profits tax is creditable and the patrimony tax is not.

73. *Ibid.* There is also recommended the allowance of export and mining taxes as a credit and correlation, where appropriate, of our tax provisions with special foreign tax incentives directed toward encouraging new investment. Barlow & Wender, *op. cit. supra* note 72, at 314.