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New Developments in the Foreign Tax Credit: The Treasury Department Attempts to Define an Income Tax

*David F. Nitschke**

In order to alleviate the double taxation of income earned overseas by United States taxpayers, the Internal Revenue Code contains a foreign tax credit. This provision, which enables a taxpayer to credit certain foreign taxes he has paid or accrued, has been reinterpreted recently by the Department of the Treasury. In this article, Mr. Nitschke discusses several 1978 revenue rulings and proposed regulations issued in 1979 that have altered the definition of a foreign tax that qualifies as an "income tax" and, thereby, have reduced significantly the kind of foreign taxes eligible for the credit. Upon examination of prior rulings and case law, Mr. Nitschke concludes that the Treasury's attempt to redefine an "income tax" has resulted in an inflexible rule that is neither supported by precedent nor underlying policy considerations.

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The foreign tax credit provisions of the Revenue Code¹ have received increasing attention as the Department of the Treasury and the Internal Revenue Service have issued new rulings on the creditability of foreign taxes, first, in the form of revenue rulings and, most recently, in the form of proposed regulations. One of the principal issues addressed in the revenue rulings and the proposed regulations is whether a foreign tax qualifies as an "income tax" within the meaning of section 901, eligible for the foreign tax credit. This article discusses the definition of "income tax" which emerges from the new rulings and regulations and concludes that, in certain areas, the Treasury and the Service have adopted rules which, to an unprecedented degree, define that term by reference to the characteristics and provisions of the United States federal income tax law. As a result, the new rules generally have the effect of reducing the number of foreign taxes eligible for the credit.

HISTORY AND OPERATION OF THE FOREIGN TAX CREDIT

The foreign tax credit, which became law in 1918,² was enacted to facilitate foreign investment and "to mitigate the evil of double taxation"³ of foreign source income earned by United States taxpayers. Double taxation existed then, and can exist today, because United States taxpayers are subject to federal income tax on earnings from foreign, as well as domestic, sources.⁴ Like all of its predecessors, present section 901(b) allows United States taxpayers a credit against their federal income tax liability for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States."⁵

Before the foreign tax credit was introduced, the only statutory mechanism for alleviating double taxation was the allowance of a de-

¹ The principal foreign tax credit provisions are contained in §§ 901-907 of the Internal Revenue Code of 1954, as amended (hereinafter referred to as the Code). Except as otherwise indicated, all statutory references are to the Code.

² See Revenue Act of 1918, ch. 18, §§ 222, 238, 40 Stat. 1057 (1919). Since that time, the basic statutory provision has remained essentially the same.

³ The credit was first extended to taxes accrued, as well as taxes paid, in 1924. See Revenue Act of 1924, ch. 234, §§ 222(c), 238(c), 43 Stat. 253 (1924). The rest of the language quoted in the text has been in the statute since 1918.

⁴ *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932). See also H.R. REP. NO. 767, 65th Cong., 2d Sess. 11 (1918).

⁵ This is the rule generally applicable to United States citizens, resident aliens, and domestic corporations, all of which are subject to federal income tax on their worldwide income. It also applies to foreign corporations and nonresident aliens engaged in a trade or business within the United States with respect to foreign source income which is subject to U.S. tax at graduated rates. See I.R.C. §§ 901(b), 906.

duction for taxes paid to foreign countries.⁶ The deduction mechanism, however, only partially relieves double taxation because deductions reduce federal income tax by a percentage equal to the taxpayer's marginal tax rate, rather than by the full amount of the deduction. For example, each dollar of foreign tax deducted by a corporation taxed at the rate of forty-six percent reduces the corporation's federal income tax liability by the amount of only \$0.46. By contrast, the foreign tax credit provides a dollar-for-dollar reduction of the taxpayer's federal income tax liability, because each dollar of foreign tax paid or accrued is, in effect, treated as payment of a dollar of federal income tax liability. Because the foreign tax credit was intended to relieve double taxation of income earned abroad, foreign taxes may be credited only against federal income taxes imposed on foreign source income. This is accomplished generally by limiting the amount allowable as a foreign tax credit in a particular taxable year to the amount of the taxpayer's pre-credit federal income tax liability multiplied by a fraction, the numerator of which is foreign source taxable income, and the denominator of which is total taxable income.⁷

Since the inauguration of the foreign tax credit the courts and the Internal Revenue Service have examined numerous foreign taxes to determine whether they constitute "income taxes" eligible for the credit. Because the statute simply limits creditable foreign taxes to "income taxes,"⁸ and does not define this term, the courts and the Service have had to struggle on their own with this definition. Summarizing their efforts, one commentator observed: "They have largely used the touchstone of similarity to the United States concept of an income tax."⁹ Unfortunately, few concrete rules have been devised to apply this standard to actual foreign taxes.

The Internal Revenue Service beginning in 1976, and more significantly in 1978, has reexamined its previous administrative position toward the income tax question, and has adopted for the first time

⁶ Foreign taxes still may be deducted under § 164. All foreign taxes eligible for the credit in a particular taxable year must, however, be either deducted or credited at the taxpayer's election. A taxpayer may not deduct some of these taxes while crediting others. See I.R.C. § 275(a)(4).

⁷ See I.R.C. § 904. This limitation, in one form or another, has been present in the foreign tax credit provisions since 1921. For a discussion of the history of the foreign tax credit limitation and its application, see Dale, *The Reformed Foreign Tax Credit: A Path Through the Maze*, 33 TAX L. REV. 175 (1978). Section 907 additionally limits foreign tax credits relating to foreign oil and gas income.

⁸ Credit is also allowed for foreign "war profits" and "excess profits" taxes, which are not discussed in this article.

⁹ Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 819-20 (1956).

specific rules for determining when a foreign tax falls within this definition. While its 1976 pronouncements were restricted to foreign taxes on mineral extraction income, the Service's series of revenue rulings issued in 1978 primarily dealt with the more general question of what is an income tax under section 901. Shortly thereafter, on June 15, 1979, the Department of the Treasury announced the issuance of proposed regulations under sections 901 and 903. For the first time, detailed rules concerning the creditability of foreign taxes under section 901, including the definition of an income tax, were prescribed in regulation form.

The proposed regulations¹⁰ generally define "income tax" within the meaning of section 901 as a tax computed on the basis of "realized net income." Drawing on principles announced in the 1978 revenue rulings¹¹ the proposed regulations conclude that a tax is levied on "realized" income if it is levied at or after the occurrence of an event which would trigger imposition of the federal income tax or if the tax is imposed on the fair market value of exported property at the time of export.¹² They consider that a tax is levied on "net" income if the taxpayer is permitted a reasonable opportunity to recover the significant expenses and capital expenditures incurred in earning the income.¹³ The proposed regulations additionally provide that a foreign tax which satisfies these requirements to the same degree as the United States federal income tax will qualify as an "income tax."¹⁴

Because the proposed regulations, in large part, either adopt positions taken in the Internal Revenue Service's 1978 revenue rulings, or vary those positions in response to criticism of them, a complete understanding of these rulings is necessary to analyze fully the proposed regulations. Therefore, the rulings will be examined in detail before turning to the particular provisions of the proposed regulations.

REVENUE RULING 78-61

From a definitional perspective, the first and most significant of

¹⁰ Proposed Reg. § 1.901-2, 44 Fed. Reg. 36071 (1979) (to be codified in 26 C.F.R. Part 1). Throughout the rest of this article the word "Proposed" will be abbreviated to "Prop." except when beginning a sentence in the text.

¹¹ The principles set forth in the 1978 revenue ruling were foreshadowed in News Release, IR 1638, July 14, 1976, [1976] 6 FED. TAXES (P-H) ¶ 55,387, which contained general guidelines for determining whether charges imposed on the extractive minerals industry by foreign governments which own the mineral resources would be treated as creditable income taxes or royalties. See also Rev. Rul. 76-215, 1976-1 C.B. 194.

¹² Prop. Reg. § 1.901-2(b)(3)(i), 44 Fed. Reg. 36071, 36073 (1979).

¹³ Prop. Reg. § 1.901-2(b)(4)(i), 44 Fed. Reg. 36071, 36073 (1979).

¹⁴ Prop. Reg. § 1.901-2(c)(1), 44 Fed. Reg. 36071, 36074 (1979).

the 1978 rulings is Revenue Ruling 78-61,¹⁵ which examines the creditability of the Ontario mining tax.¹⁶ This tax was imposed on mining profits from the sale of mineral output of a mine in Ontario, the incorporation of such mineral output in the manufacturing process, and the sale of treated mineral output, *e.g.*, smelted or refined ore.¹⁷ In order to determine whether this tax qualified as a creditable income tax, Revenue Ruling 78-61 purported to distill certain principles from existing case law and administrative decisions.

Revenue Ruling 78-61 states that qualification as an income tax "depends on whether [the foreign] tax constitutes an 'income tax' as determined from an examination of the Federal income tax laws of the United States,"¹⁸ as distinct from the foreign tax law. If this examination reveals that the foreign tax is "the substantial equivalent of an 'income tax' as that term is understood in the United States,"¹⁹ then the foreign tax will be considered a creditable income tax.

Whether the foreign tax is the substantial equivalent of an income tax in the United States sense depends, according to Revenue Ruling 78-61, primarily on the measure of the tax and the tax base.²⁰ The tax must be tested by reference to the entire class of taxpayers subject to the tax.²¹ Moreover, the ruling takes the position that, when a foreign tax imposed on a limited tax base or a limited class of taxpayers includes a provision at variance with the substantial equivalence test, the importance of that aberrational provision is necessarily magnified by

¹⁵ 1978-1 C.B. 221.

¹⁶ The Ontario mining tax at issue was imposed by § 3(1) of the Mining Tax Act, ONT. REV. STAT. c. 275 (1970) (amended 1971) [hereinafter cited as Ontario Mining Tax Act].

¹⁷ *Id.* at §§ 1(i), 3(3). See also 1978-1 C.B. at 224.

¹⁸ 1978-1 C.B. at 223. This test is drawn from the often quoted dictum in *Biddle v. Comm'r*, 302 U.S. 573, 578-79 (1938):

Section 131 [the predecessor of § 901] does not say that the meaning of its words is to be determined by foreign taxing statutes and decisions, and there is nothing in its language to suggest that in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterization and classifications of the legislation. The phrase "income taxes paid," as used in our own revenue laws, has for most practical purposes a well understood meaning to be derived from an examination of the statutes which provide for the levying and collection of income taxes. It is that meaning which must be attributed to it as used in § 131.

¹⁹ *New York & Hond. Rosario Mining Co. v. Comm'r*, 168 F.2d 745, 747 (2d Cir. 1948). Rev. Rul. 78-61 varies the test to require the foreign tax to be "the substantial equivalent of the income tax in the United States sense," citing as authority *Comm'r v. Am. Metal Co.*, 221 F.2d 134 (2d Cir. 1955), *cert. denied*, 350 U.S. 829 (1955), and *F.W. Woolworth Co.*, 54 T.C. 1233 (1970), *nonacq. on other issue*, 1971-2 C.B. 4. Both of these cases, however, state the test as given in the text. The variation used in Rev. Rul. 78-61 is obviously a more difficult test to satisfy, but the extent to which this variation is the basis for the Service's definition of an "income tax" is unclear.

²⁰ 1978-1 C.B. 221, 223.

²¹ *Id.*

the limited scope of the tax base or class of taxpayers.²² The result of this position is, in effect, a more stringent test for creditability of foreign taxes which are imposed only on certain items or types of income or which are imposed only on certain classes of taxpayers.

Revenue Ruling 78-61, relying on prior case law and ruling authority, sets forth three requirements that must be satisfied if a foreign tax is to be considered the substantial equivalent of an income tax in the United States sense. They are: (1) the gain on which the foreign tax is levied must be realized in the United States sense; (2) the purpose of the foreign tax must be to reach net gain and it must be so structured as to be almost certain of doing so; and (3) the foreign tax must be imposed on the receipt of income by the taxpayer rather than on transactions, such as sales, or the exercise of a privilege or franchise, such as exploiting natural resources.²³

Realization of Income Requirement

The first requirement for satisfying the substantial equivalence test is that the gain on which the tax is levied must be realized in the United States sense.²⁴ Although the U.S. federal income tax is imposed on the constructive or deemed receipt of income in certain cases, Revenue Ruling 78-61 takes the position that, on the whole, the U.S. federal income tax is imposed on gain that has been actually realized.²⁵ Revenue Ruling 78-61 concludes that a foreign tax, to be creditable as an income tax, must evidence a degree of realization substantially equivalent to that evidenced by the United States income tax.

The ruling held that the Ontario mining tax does not satisfy this requirement because it is imposed when mineral output is incorporated in a manufacturing process.²⁶ Therefore, the tax is not imposed on the receipt of realized income in the "United States sense." The Ontario

²² *Id.*

²³ *Id.* at 223-24.

²⁴ *Id.* at 223.

²⁵ As authority for this position, Rev. Rul. 78-61 cites *Eisner v. Macomber*, 252 U.S. 189 (1920), in which the Supreme Court held that a common stock dividend paid on a pro rata basis with respect to common stock was not realized income, and thus Congress had no authority to tax it as income under the Revenue Act of 1916. *Eisner v. Macomber* has been substantially limited as precedent by both the courts and Congress. See *Estate of Whitlock*, 59 T.C. 490, 508-09 (1972), *aff'd in relevant part*, 494 F.2d 1297 (10th Cir. 1974), *cert. denied*, 419 U.S. 839 (1974); *Albert L. Dougherty*, 60 T.C. 917 (1974) (both restricting authority of *Macomber* to its own facts in holding that § 951(a)(1)(B) of the Code is constitutional). Even *Macomber's* application to the taxation of stock dividends, with which it was specifically concerned, has been restricted. See I.R.C. §§ 305(b), 305(c) (which expressly limit the holding in *Macomber* to common-on-common and preferred-on-common pro-rata stock dividends).

²⁶ 1978-1 C.B. 221, 224.

mining tax is also levied on realized gain. It is imposed on mining profits from the sale of mineral output²⁷ and the sale of treated mineral output.²⁸

The fact that the tax reaches realized gain was apparently ignored by the Service because the Ontario mining tax is "an indivisible tax imposed on a very limited tax base."²⁹ Since mining profits constitute a single tax base, the tax is treated as a single, indivisible tax for purposes of testing its creditability under section 901.³⁰ Moreover, the Ontario mining tax is a tax of limited application, taxing only mining profits. According to Revenue Ruling 78-61, any aberration from the United States concept of realization in such a tax is magnified in importance. Therefore, the Ruling seems to say that the entire tax fails the realization requirement because the levy of the tax when mineral output is incorporated into a manufacturing process is such an aberration.³¹

Revenue Ruling 78-61 does not discuss the quantitative or qualitative importance of this "aberration" in the context of the entire Ontario mining tax. The ruling also fails to mention whether the tax is ever actually levied on unrealized income from output incorporated in the manufacturing process, whether such levies are the norm or the exception, or whether they are significant enough, when compared to the total revenue gathered under the Mining Tax Act, to taint the entire character of the tax for foreign tax credit purposes. Consequently, the ruling implies that the mere presence of an "aberration" in a tax of limited application will cause it to fail the substantial equivalence test.

The source of Revenue Ruling 78-61's limited tax base/limited taxpayer rule that grants such significance to an "aberration" in a foreign tax of limited application is mystifying. No authority can be found for such a rule;³² nor do the decisions in *Commissioner v. Ameri-*

²⁷ ONT. REV. STAT. c. 275, § 3(3)(a) (1970).

²⁸ ONT. REV. STAT. c. 275, §§ (1)(i), 3(3)(c); 1978-1 C.B. at 222 (mining profits from such sales is either the market value of the output, if it can be determined, or the sales receipts of the treated product reduced by treatment costs and a treatment profit allowance).

²⁹ Rev. Rul. 78-61, 1978-1 C.B. 221, 224.

³⁰ *Lanman & Kemp-Barclay & Co. of Colombia*, 26 T.C. 582 (1956); Rev. Rul. 74-435, 1974-2 C.B. 204; Rev. Rul. 68-318, 1968-1 C.B. 342; Rev. Rul. 59-208, 1959-2 C.B. 192, *as modified by* Rev. Rul. 63-268, 1963-2 C.B. 290.

³¹ Rev. Rul. 78-61, 1978-1 C.B. 221, 225.

³² It may be true that taxes imposed on special industries or tax bases are or have been more susceptible to being treated as privilege taxes. *See* E. OWENS, *THE FOREIGN TAX CREDIT* 46 (1961). However, the cases themselves do not adopt such a rule. For example, the Second Circuit in *New York & Hond. Rosario Mining Co. v. Comm'r*, 168 F.2d 745, 748 (2d Cir. 1948), in allowing a foreign tax credit for a Honduras tax on mining profits (the rate of which was set by contract between the government and the taxpayer), made no mention of a special rule for taxes imposed on a single industry or a single tax base.

can Metal Co.,³³ *Keasbey & Mattison Co. v. Rothensies*,³⁴ and *Lanman & Kemp-Barclay & Co. of Columbia*,³⁵ which Revenue Ruling 78-61 cites as authority for the realization of income requirement, seem relevant.³⁶

The foreign taxes examined in these cases differ substantially from the Ontario mining tax. The Mexican tax considered in *American Metal* was imposed "when the ore is extracted from the subsoil, irrespective of its sale or its transportation to a smelter or its further processing."³⁷ The Colombian patrimony tax at issue in *Lanman* was imposed on the net value of a taxpayer's assets.³⁸ Neither of these taxes was intended to reach, in whole or in part, realized profits or income.

The Quebec mining tax involved in *Keasbey* also differs from the Ontario mining tax. The Quebec tax was imposed on annual profits "ascertained or fixed . . . from the gross value of the year's output, sold, utilized, or shipped during the year."³⁹ The tax was never based on actual sales receipts but on the appraised "gross value of the year's output," even if the output was actually sold.⁴⁰

Keasbey also differs dramatically in direction from Revenue Ruling 78-61. The court in *Keasbey* denied a credit for the Quebec mining tax on the ground that it was a privilege or excise tax, rather than an income tax.⁴¹ The fact that "the value of the [mining] output, the basis of the levy, [is] independent of realization of gain" only indicated to the U.S. Court of Appeals for Third Circuit that the Quebec tax was an excise tax.⁴² Since the court concluded that the tax was a privilege or excise tax, it did not consider the extent to which realization may be required of an income tax.⁴³

In apparently taking the position that any nonconforming provision causes a foreign tax of limited application to fail the realization of income requirement, Revenue Ruling 78-61 ignores the longstanding "predominant character" doctrine developed by the courts and the

³³ 221 F.2d 134 (2d Cir. 1955).

³⁴ 133 F.2d 894 (3d Cir.), cert. denied, 320 U.S. 739 (1943).

³⁵ 26 T.C. 582 (1956).

³⁶ See Foreign Tax Credit Subcomm., Comm. on Foreign Activities of U.S. Taxpayers, Section of Taxation, Am. Bar Ass'n, *The Creditability of Foreign Income Taxes: A Critical Analysis of Revenue Rulings 78-61, 78-62, and 78-63*, 32 TAX LAW. 33, 53-54 (1978).

³⁷ Comm'r v. Am. Metal Co., 221 F.2d 134, 137 (2d Cir. 1955).

³⁸ *Lanman & Kemp-Barclay & Co. of Colombia*, 26 T.C. 582, 584 (1956).

³⁹ 133 F.2d 894, 895 n.1 (3d Cir. 1943).

⁴⁰ *Id.*

⁴¹ *Id.* at 898.

⁴² *Id.*

⁴³ *Id.*

Service.⁴⁴ Under this doctrine, "it is the 'predominant character' of a foreign tax which controls its classification as an income tax under Section 901. . . ."⁴⁵

In Revenue Ruling 56-51, the Service stated:

It is not intended . . . to suggest that when a single tax is imposed on items which by United States standards are both income and nonincome items credit is allowable for the portion of the tax imposed on the income items but denied for the portion of the tax allocable to nonincome items. When such a unified tax is imposed by a foreign country, its predominant character will determine whether the tax is an income tax and credit will be denied for the entire amount of the tax or allowed for the entire tax subject to the limitations of section 904 of the Code.⁴⁶

Applying this doctrine, the courts and the Service have held that a foreign tax is creditable as an income tax even though it may fall on an amount which is either fully or partially exempt from United States income taxation.⁴⁷

Indeed, the "predominant character" doctrine is necessary in order for the United States income tax itself to satisfy the realization requirement, since that tax is not levied solely on realized income. Commissioner Kurtz of the Internal Revenue Service has testified that the United States income tax law has 80 deviations from a generally accepted definition of income involving \$95 billion in revenue.⁴⁸ There

⁴⁴ Schering Corp., 69 T.C. 579, 592-93 (1978). See also Rev. Rul. 56-51, 1956-1 C.B. 320; Rev. Rul. 55-505, 1955-2 C.B. 578; I.T. 4074, 1952-1 C.B. 87, declared obsolete in Rev. Rul. 68-100, 1968-1 C.B. 572. See also *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894, 898 (3d Cir. 1943); *Santa Eulalia Mining Co.*, 2 T.C. 241, 245 (1943), *acq.* 1946-1 C.B. 4, *appeal dismissed*, 142 F.2d 450 (9th Cir. 1944). See Foreign Tax Credit Subcomm., *supra* note 36, at 55.

⁴⁵ Schering Corp., 69 T.C. 579, 592 (1978). Neither judicial nor Service precedent discusses how the predominant character of a foreign tax is determined. Certainly, one course of analysis would be to compare statistically the amount of taxes levied on pre-realization taxable profits with the amount of taxes levied on taxable profits calculated from realized gain. An analysis could also be made of the proportion of the total taxpayers under the tax which computed the tax on unrealized profits.

⁴⁶ Rev. Rul. 56-51, 1956-1 C.B. 320.

⁴⁷ See generally *Helvering v. Nell*, 139 F.2d 865 (4th Cir. 1944) (consolidated with *Helvering v. Campbell*); Schering Corp., 69 T.C. 579 (1978); *James H. Brace*, 21 T.C.M. (P-H) 52,265 (1952); Rev. Rul. 72-126, 1972-1 C.B. 217; Rev. Rul. 68-622, 1968-2 C.B. 298; Rev. Rul. 55-505, 1955-2 C.B. 578; Rev. Rul. 54-15, 1954-1 C.B. 129 (Service agreed to follow the *Nell* and *Dexter* cases); I.T. 4074, 1952-1 C.B. 87, declared obsolete in Rev. Rul. 68-100, 1968-1 C.B. 572 (although declared obsolete, I.T. 4074 has been reaffirmed by a technical advice memorandum LTR7840001, dated September 15, 1977, holding that although a West German income tax is levied on stock dividends which would not be subject to United States income tax, it is a creditable income tax as part of the general income tax laws of West Germany). See also *United States v. Woodmansee*, 578 F.2d 1302 n.2 (9th Cir. 1978). But see *L. Helena Wilson*, 7 T.C. 1469 (1946).

⁴⁸ *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings on Tax Conventions Before the Sen. Comm. on Foreign Relations*, 95th Cong., 1st Sess. 5 (1977) (statement of Hon. Jerome Kurtz, Commissioner, Internal Revenue Service).

are a number of provisions in the Internal Revenue Code and the regulations which affect taxation of constructive or unrealized income.⁴⁹

Section 631(a) of the Code is particularly pertinent, since, under that section, an owner of standing timber or a holder of a contract right to cut it may elect to treat the cutting of the timber as a sale or exchange. Gain or loss is recognized and taxed in an amount equal to the difference between the fair market value of the timber as of the first day of the taxable year and the taxpayer's cost basis for depletion of the timber.

It is difficult to differentiate between the treatment accorded under section 631(a) and the Ontario Mining Tax Act. In both cases, a tax which is generally levied on realized income is imposed on unrealized gain from a depletable resource. In both cases there is a strong likelihood that most, if not all, of the unrealized gain subject to tax will be realized in the future, since it is reasonable to expect that the timber and the mineral output incorporated in the manufacturing process ultimately will be sold. In fact, it is the expectation of realization that caused Congress to enact section 631(a).⁵⁰

Although the cases and rulings cited as authority for the "predom-

⁴⁹ See I.R.C. §§ 56 (at least with respect to tax preferences other than capital gains), 305, 446, 451, 482, 551, 631, the Subpart F provisions (§§ 951-964), regulations under § 964, and Rev. Rul. 75-106, 1975-1 C.B. 31 (relating to the taxation of unrealized currency exchange gains).

Indeed, the regulations under § 482 expressly authorize the Service district director to ignore realization of income in making an adjustment under that section. Treas. Reg. § 1.482-1(d)(4) provides:

If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in § 1.482-2, notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized, or is realized during the later period. . . . The provisions of this subparagraph apply even if the gross income contemplated from a series of transactions is never, in fact, realized by the other members.

Treas. Reg. § 1.482-1(d)(4), T.D. 6952, 1968-1 C.B. 218, 221.

The authority to make such adjustments has been upheld by the courts as being consistent with the underlying intent of § 482 to assure that income and deductions are properly reflected among controlled entities. *Fitzgerald Motor Co., v. Comm'r*, 508 F.2d 1096 (5th Cir. 1975); *Kerry Inv. Co. v. Comm'r*, 500 F.2d 108 (9th Cir. 1974); *Kahler Corp. v. Comm'r*, 486 F.2d 1 (8th Cir. 1973); *B. Forman Co. v. Comm'r*, 453 F.2d 1144 (2d Cir.), *cert. denied*, 407 U.S. 934 (1972); *Latham Park Manor, Inc., v. T.C.* 199 (1977), *appeal docketed* (4th Cir. Dec. 6, 1978). See also *Ad Hoc Comm. on the Foreign Tax Credit*, Section of Taxation, Am. Bar Ass'n, *Comments Regarding Proposed Foreign Tax Credit Regulations*, 33 TAX. LAW. 35, 43-45 (1979). The authors of this article conclude that "realization in a specific fact situation has significance only as an event that has been designated as the time at which the tax will be imposed. It is a choice of administrative convenience and may be altered for some other policy reason." *Id.* at 45.

⁵⁰ It also should be noted that § 631(a) was enacted to allow the owner of timber, who milled the timber himself, the same capital gain treatment as a timber owner who sold directly to a mill. S. REP. NO. 627, 78th Cong., 1st Sess. 57 (1943); CONFERENCE COMM., REVENUE ACT OF 1943, H.R. REP. NO. 1079, 78th Cong., 2d Sess. 52-53 (1944). One wonders if the Service determined

inant character" doctrine primarily involved "aberrations" found in general income taxes levied on a general class of taxpayers and on a general income tax base, there is nothing in these authorities that limits the "predominant character" doctrine to such cases. Neither section 901 nor its legislative history offer any support for such a limitation. Section 901(b), as discussed above,⁵¹ refers simply to "income tax" with no further amplification. There is nothing in the statute or the legislative history that suggests that general income taxes and income taxes of more limited application are subject to different rules in determining their qualification under section 901.⁵² Indeed, the fact that taxes on oil and gas income, DISC income, and in certain cases, interest income are treated specially for foreign tax credit purposes in the Code, can be interpreted to reflect an intention to treat other qualifying taxes simply as income taxes.

In summary, Revenue Ruling 78-61 in its analysis of the Ontario mining tax fails to address two basic questions dictated by previous case law and rulings: (1) whether the fact that taxable profits are generated at the time mineral output is incorporated in the manufacturing process is inconsistent with the definition of "income tax" under section 901 in light of various provisions of the Code that result in taxation of unrealized gain, and (2) even if inconsistent, whether the predominant character of the Ontario mining tax is a levy on realized gain in a "United States sense."

Net Gain Requirement

Revenue Ruling 78-61, citing the Court of Claims and Tax Court decision in the *Bank of America* cases,⁵³ states that the second requirement a foreign tax must satisfy is that its purpose must be to reach net gain and it must be so structured as to be almost certain of doing so.⁵⁴

whether a similar intention was present in the taxation by the Ontario mining tax of unrealized income.

⁵¹ See text accompanying note 5 *supra*.

⁵² See H.R. REP. NO. 767, 65th Cong., 2d Sess. 11 (1918); 56 CONG. REC. 677-78 (Appendix) (1918) (remarks of Reps. Kitchin and Borland).

⁵³ *Bank of America Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513 (Ct. Cl.), *cert. denied*, 409 U.S. 949 (1972); *Bank of America Nat'l Trust & Sav. Ass'n*, 61 T.C. 752 (1974), *aff'd mem.*, 538 F.2d 334 (9th Cir. 1976).

⁵⁴ Rev. Rul. 78-61, 1978-1 C.B. 221, 223. Rev. Rul. 78-61 substantially alters the rule outlined by the Court of Claims in its decision in *Bank of America*. The Court of Claims stated that "a direct income tax is creditable, even though imposed on gross income, if it is very highly likely, or was reasonably intended, always to reach some net gain in the normal circumstances in which it applies." *Bank of America Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d at 519-20 (emphasis added).

The ruling further states, again relying on the Court of Claims decision in *Bank of America*, that generally a foreign tax is almost certain to fall on net gain if it is levied on income computed in such a manner that it is very unlikely that taxpayers generally subject to the tax will have to pay it when they have no net gain.⁵⁵

Revenue Ruling 78-61 recognizes that foreign taxes on gross dividends, interest, and royalties have been held to qualify as income taxes in the U.S. sense, because it is presumed that the expenses ordinarily connected with such income will almost never exceed that income.⁵⁶ It also points out that similar taxes have long been imposed by the United States under sections 871(a)(1)(A) and 881(a)(1) upon dividends, interest, and royalties of nonresident aliens and foreign corporations which are not effectively connected with a trade or business in the United States. The thrust of these provisions is directed against net gain or profit.⁵⁷

The ruling points out that expenses incurred in producing gross trade or business income, on the other hand, are not inherently so slight as to insure that they will never exceed the amount of that gross income and thus, not produce a loss.⁵⁸ For this reason, the ruling concludes that a foreign tax on income that is derived from engaging in business in a foreign country, which does not permit the deduction of the generally significant expenses incurred in producing that income, is not almost certain to fall on net gain and this is not creditable.⁵⁹

Revenue Ruling 78-61 therefore held that the Ontario mining tax failed to satisfy this net gain requirement because it denied or limited the deduction of "significant" expenses in computing the profit on which the tax is levied.⁶⁰ The Ontario Mining Tax Act did not permit the tax-free recovery of the taxpayer's capital costs in acquiring the ore body or the right to mine through depletion or otherwise. The Act also did not allow a deduction for preproduction exploration expenses and,

⁵⁵ 459 F.2d at 524. Rev. Rul. 78-61 also cites the Court of Claims decision in *Allstate Ins. Co. v. United States*, 419 F.2d 409 (Ct. Cl. 1969).

⁵⁶ 1978-1 C.B. at 224.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ Interestingly, Rev. Rul. 78-61 does not mention the specific expenses that are deductible in computing taxable profit under the Ontario Mining Tax Act, but merely refers to them as "generally similar to deductions" allowed under the Code. The Ontario Mining Tax Act provides deductions for working expenses of the mine (salaries and wages), transportation, light, power, food and insurance costs, depreciation, post-production exploration and development expenses, and post-1965 preproduction development expenses for metal mines from which ore is smelted in Canada. ONT. REV. STAT. c. 275, §§ 3(d)-3(n).

in some instances, preproduction development expenses.⁶¹ Nor did it allow a deduction for interest or private mineral royalty expenses.⁶² As a result, the Ruling concluded that it was possible for a taxpayer to be subject to the Ontario mining tax, even though it had a net loss "in the United States sense from mining."

It seems clear from Revenue Ruling 78-61's analysis of the net gain requirement and its application to the Ontario mining tax that the Service considers the principal criterion for satisfaction of the net gain requirement in the case of a foreign business tax to be whether it is very unlikely that the tax will have to be paid when the taxpayer has no net gain "in the United States sense." Even though Revenue Ruling 78-61 carefully states that the Ontario mining tax failed to satisfy the net gain requirement because the tax may be levied when the taxpayer has a net loss "in the United States sense" rather than under the Internal Revenue Code itself,⁶³ the approach taken in the Ruling implies that reference to the Internal Revenue Code is necessary to determine whether a loss could occur. In fact, what seems to be necessary is an item-by-item comparison of the deductions allowed under the foreign tax law with those allowed under the Code and, ultimately, a comparison of the tax base for foreign tax purposes with United States "taxable income."

In support of its claim that each of the nondeductible expenses or costs under the Ontario Tax Act is "significant," Revenue Ruling 78-61 in some instances expressly, and in others tacitly, refers to the Internal Revenue Code. Although no weight presumably would be given to the denial of a deduction for "insignificant expenses" under this approach,

⁶¹ Rev. Rul. 78-61 mentions that § 3(3)(n) of the Ontario Mining Tax Act was added in 1969 to provide an annual deduction of 10% of the preproduction development costs of a producing metal mine brought into production after January 1, 1965, where the ore from the mine has been treated to at least the smelter stage in Canada. Under this provision, if some of the ore is smelted outside of Canada, the deduction is available only in the proportion that the selling value of the product of the ore treated in Canada bears to the selling value of all products of the mine. Rev. Rul. 78-61, however, concludes that since this deduction is not available to all mining companies, the inability to deduct this "significant" expense by some companies could make the difference between net gain and net loss. 1978-1 C.B. at 225.

⁶² Rev. Rul. 78-61 also discusses the impact of the treatment profit allowance on the net gain requirement. In order to arrive at the mining profit from treated output under § 3(3)(n) of the Ontario Mining Tax Act, the Ontario Mine Assessor deducts from the sales receipts of treated output, treatment costs, and a profit allowance for treatment of varying percentages of the original cost of the treatment facilities, *e.g.*, 8% for concentration, 16% for smelting. However, this allowance cannot be less than 15% or more than 65% of the combined profit from the mining and treatment functions. As a result, Rev. Rul. 78-61 concludes that the tax is not almost certain to fall on net gain from the mining function since at least 35% of the combined gain will always be treated as attributable to the mining function, even if none of the gain is actually attributable to it. *Id.* at 225.

⁶³ *Id.*

the Ruling provides no criteria for judging the insignificance of an expense. This omission could be viewed as reflecting an intention to require reference to the Code and the deductions thereunder for the identification of "insignificant" expenses.

As mentioned earlier, Revenue Ruling 78-61 relies heavily on the *Bank of America* decisions of the Court of Claims and the Tax Court for its net gain test.⁶⁴ In these cases, however, the issue was whether certain taxes imposed on what was purported to be a gross business and banking income in Thailand, the Philippines, Argentina, and, in the Tax Court decision, Taiwan, computed without allowance for deductions, qualified as creditable income taxes under section 901. Revenue Ruling 78-61, on the other hand, was addressing the question whether a tax on business profits which allows deductions for some, but not all, of the expenses deductible under the Internal Revenue Code, qualifies as an income tax.

The Court of Claims in *Bank of America* reviewed the legislative history under section 901 and a number of foreign tax credit cases and applicable revenue rulings.⁶⁵ It concluded that the term "income tax" in section 901(b)(1) covers all foreign taxes designed to fall on some net gain or profit, and includes a gross income tax, if, but only if, that tax is almost sure or very likely to reach some net gain, because costs or expenses are not so high as to offset the net profit.⁶⁶

It, therefore, held that the foreign gross income taxes at issue in the case did not qualify as income taxes under section 901(b)(1) because they did not allow any deductions for the costs and expenses of producing the income,⁶⁷ and it could not be said that there was only a minimal risk that the combination of the bank's expenses plus bad debt costs and other losses would outbalance its net gain or profit in any year.⁶⁸

Two years later, the Tax Court considered basically the same issue with respect to the same taxpayer, but for different taxable years. The Tax Court generally agreed with the Court of Claims' decision that these gross income taxes were not creditable because they were not "almost sure or very likely" to reach some net gain.⁶⁹

The general principle articulated by the Court of Claims and the Tax Court in the *Bank of America* cases was that a foreign tax on gross

⁶⁴ See text accompanying note 36 *supra*.

⁶⁵ 459 F.2d 513 (Ct. Cl.), *cert. denied*, 409 U.S. 949 (1972).

⁶⁶ *Id.* at 523.

⁶⁷ *Id.* at 524.

⁶⁸ *Id.*

⁶⁹ *Bank of America Nat'l Trust & Sav. Ass'n*, 61 T.C. 752, 762 (1974), *aff'd mem.*, 583 F.2d 334 (9th Cir. 1976).

income, to be a creditable income tax, must be directed at some net gain or profit. Since the foreign taxes at issue in those cases were gross income taxes and did not provide any deductions for costs or expenses, neither court described the kinds of expenses that must be deductible for a foreign tax to satisfy this test.

Revenue Ruling 78-61, however, did quote a portion of the Court of Claims' discussion of the decision in *Keasbey*⁷⁰ which involved a tax on business profits, as support for its net gain test. In *Keasbey*, it was held that the Quebec mining tax was an excise tax and thus not a creditable income tax because, in part, "[t]he expenses incident to the general conduct of the business, as distinguished from the cost incurred in the mining operation, are not deductible."⁷¹

The Court of Claims' reference to *Keasbey* is quoted with the underlined portion quoted by Revenue Ruling 78-61:

Conversely, the decisions cited by the defendant, all denying the credit, are consistent with the allowance of the credit for a gross income tax where that tax is sure or highly likely to reach some net gain. *Keasbey and Mattison Co. v. Rothensies* . . . aside from the point that the issue on which it turned was whether the Quebec Mining tax was a privilege or an income tax . . . involved a mining business which obviously could either have lost or made money in any particular year. In that context, it was significant that "the expenses incident to the general conduct of the business, as distinguished from the costs incurred in the mining operation, are not deductible" (133 F.2d at 893); those non-deductible expenses could easily have made the difference between a net profit and a loss. For that business it could not possibly have been said that the tax would always, or almost always, reach some net gain.⁷²

Taken alone, this quotation could be viewed as supporting Revenue Ruling 78-61's extension of the Court of Claims gross income tax test to foreign taxes on business profits that permit the deduction of some but not all, expenses.

When read in the context of the entire decision with its focus on the question whether a gross income tax is automatically an "income tax," however, the court's intention seems simply to point out that its position on gross income taxes is not inconsistent with the result of the *Keasbey* decision. The Court of Claims was attempting to reconcile its position that a foreign tax on gross income is creditable if it is certain or highly likely to reach some net gain with the *Keasbey* decision. It had previously stated that both the Board of Tax Appeals' decision in *Sea-*

⁷⁰ *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894 (3d Cir. 1943).

⁷¹ *Id.* at 898.

⁷² 459 F.2d at 520.

*train Lines, Inc.*⁷³ and the Tax Court's decision in *Santa Eulalia Mining Co.*,⁷⁴ were consistent with, and actually lent support to, its position that "a direct income tax is creditable, even though imposed on gross income, if it is very highly likely, or was reasonably intended to reach some net gain."⁷⁵ Both *Seatrain Lines* and *Santa Eulalia* held that taxes on gross business income qualified as "income taxes." Any further intention to express an opinion on the broader "income tax" issue of what kind of deductions are necessary to reach net income on a business profits tax, other than on gross income, is not indicated in the Court of Claims decision.

Even if one were to accept the premise that the Court of Claims in *Bank of America* intended by its reference to the *Keasbey* case to suggest that its foreign tax credit rule be applied to all foreign taxes, whether or not imposed on gross income, there is nothing in its decision in *Bank of America* that suggests that the court considered the phrase "net gain" or "net profit" to be synonymous with "taxable income" under the Internal Revenue Code. Certainly, the court's affirmation of the decision in *Seatrain Lines, Inc.*,⁷⁶ holding that a Cuban tax on gross business profits is a creditable tax, supports this conclusion. What the court gathered from its examination of United States income tax law, was simply that an income tax as that term is understood in the United States is a tax which is directed at some net gain or profit.

Similarly, Revenue Ruling 78-61's reliance on the *Keasbey* decision itself, and the decisions in *Allstate Insurance Co. v. United States*⁷⁷ and *Continental Insurance Co.*,⁷⁸ for support of its net gain requirement and the application of that rule to the Ontario mining tax, seems misplaced.

In the *Keasbey* decision, the Third Circuit Court of Appeals considered the fact that general expenses were not deductible under the Quebec mining tax as indicative of a tax on the mining privilege rather than on income, whether net, gross, or something else.⁷⁹ The use of such a fact to characterize a tax as an excise tax is quite different from concluding that the disallowance of those deductions prevents a busi-

⁷³ 46 B.T.A. 1076 (1942), *nonacq.* 1942-2 C.B. 31.

⁷⁴ 2 T.C. 241 (1943), *acq.* 1946-1 C.B. 4, *appeal dismissed*, 142 F.2d 450 (9th Cir. 1944).

⁷⁵ 459 F.2d at 519.

⁷⁶ 46 B.T.A. 1076 (1942), *nonacq.* 1942-2 C.B. 31.

⁷⁷ 419 F.2d 409 (Ct. Cl. 1969).

⁷⁸ 40 B.T.A. 540 (1939). Neither *Allstate* nor *Continental* involved the question of whether a foreign tax on business "profits" which allows a deduction for some, but not all, of the expenses incurred in producing such income, qualifies as an income tax. Both cases involved a Canadian insurance premiums tax levied on gross income or gross receipts.

⁷⁹ 133 F.2d at 898.

ness tax which is not an excise tax from always or almost always reaching net gain.⁸⁰ Furthermore, when the Third Circuit in *Keasbey* held that a foreign tax, to qualify as a creditable income tax rather than a franchise tax, must be measured by net income, it did not indicate that "net income" must be essentially identical to "taxable income" under the Internal Revenue Code. It also did not prescribe what expenses must be deductible in order for a tax to reach "net income."⁸¹

There also is little support in the Internal Revenue Service's prior rulings for Revenue Ruling 78-61's approach to the net gain requirement. While Revenue Ruling 74-435⁸² is cited as authority for Revenue Ruling 78-61's net gain test,⁸³ this ruling simply repeats the rule in the Court of Claims' decision in *Bank of America* that a foreign tax will qualify as an income tax within the United States concept if designed to reach net gain. The question whether the tax reached net gain was not at issue. The ruling involved the question of the creditability of a Swiss Cantonal tax levied on both a net profits base comparable to taxable income under the Code, and on the taxpayer's capital. Revenue Ruling 74-435 held that the tax was divisible into two separate taxes for purposes of section 901.⁸⁴ As such, the levy on net profits was held to qualify as a creditable income tax with no discussion.⁸⁵ The levy on capital, on the other hand, was denied creditability because it did not reach income.⁸⁶

Although there are prior rulings holding that a foreign tax is an income tax because it permits the deduction of expenses deductible under the Internal Revenue Code,⁸⁷ none have been found to deny creditable status to a foreign tax on the ground that some, but not all, "significant expenses" deductible under the Internal Revenue Code are not deductible under the foreign tax law.⁸⁸ Actually, the prior rulings like the judicial precedent available provide little guidance for determining what constitutes "income" for purposes of defining income tax

⁸⁰ But see E. OWENS, *supra* note 32, at 38.

⁸¹ 133 F.2d at 898.

⁸² 1974-2 C.B. 204.

⁸³ 1978-1 C.B. at 224.

⁸⁴ 1974-2 C.B. 204, 205.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ See, e.g., Rev. Rul. 60-146, 1960-1 C.B. 276.

⁸⁸ Some rulings describe an "income tax" as a tax on "income within the meaning of that term used or understood for Federal income tax purposes." See, e.g., I.T. 4083, 1952-1 C.B. 88 (declared obsolete in Rev. Rul. 70-293, 1970-1 C.B. 282; Rev. Rul. 7, 1953-1 C.B. 224). Others consider an "income tax" to be a tax on "income as defined for U.S. tax purposes," e.g., Rev. Rul. 57-62, 1957-1 C.B. 241, or a tax which is "within the U.S. concept of such a tax," e.g., I.T. 3837, 1947 C.B. 56 (declared obsolete in Rev. Rul. 70-293, 1970-1 C.B. 282).

under section 901.⁸⁹

The case law and previous rulings, however, have made it clear that a qualifying foreign tax need not be identical or substantially identical, to the United States federal income tax, nor have a tax base that is identical or substantially identical with taxable income under the Code. As the Tax Court in *Schering Corporation* points out: "Exact congruence between the foreign tax statute and American tax law is not necessary to establish that a tax is an 'income tax.'" ⁹⁰

Prior to the 1978 rulings, the courts and the Service have applied the predominant character doctrine which looks to the tax in its totality rather than to specific parts of the tax to determine whether it qualifies as an income tax. This approach seems equally applicable when determining whether a business tax which allows some deductions from gross income is designed to reach net gain. Accordingly, a tax would be considered to qualify as a tax on net gain if the predominant character of the tax was a tax on net gain, notwithstanding that certain major expenses were not deductible. While such a standard does not avoid difficult judgmental decisions as to when the deduction or lack of deduction evidences predominant character, it provides the flexibility required by the case and ruling authority, and, reflected in the United States tax system.

⁸⁹ But see E. OWENS, *supra* note 32, at 52 (concluding that the pre-1961 rulings and case law require a qualifying foreign tax imposed on general business receipts to have a tax base essentially identical to U.S. taxable income or to be based on estimated net income). Significantly, Owens also states that it is impossible from the rulings to determine the extent to which the foreign tax bases approximate the United States tax base; *i.e.*, how much or what kind of deductions are essential to arrive at "net income." *Id.* at 38.

⁹⁰ 69 T.C. 579, 592 (1978). Matching taxable income under the foreign tax law with taxable income under the Code is required not by § 901 in determining whether the foreign tax qualifies as an income tax, but by § 904 in calculating the amount of qualifying tax paid or accrued that is creditable in the taxpayer's taxable year. Section 904 generally limits the amount of a taxpayer's foreign tax credit in his taxable year to the proportion of his pre-credit federal income tax in that year that his overall foreign source taxable income computed under U.S. tax principles, bears to his overall taxable income. Thus, any concern that a foreign tax will offset United States Federal income tax where there is no parallel base subject to the United States tax is prevented to a certain degree by § 904. See *Bank of America Nat'l Trust & Sav. Ass'n v. United States*, 419 F.2d at 524 n.8. It is, of course, true that under the present "overall" limitation (comparing a taxpayer's overall foreign income with his worldwide income) in § 904 foreign income taxes imposed at lower rates than the federal income tax rate can be averaged with foreign taxes imposed at rates exceeding the federal income tax rate. Thus, it is possible for a foreign tax which is imposed on an income base greater than the federal income tax base to be creditable. This result is, however, inherent in the "overall" limitation. On the other hand, under the "overall" limitation, losses from one country can absorb a U.S. taxpayer's foreign source income from another country, thereby reducing the amount of foreign taxes on such income which will be creditable. It should be noted that those qualifying taxes, which exceed the limitation under § 904, may be carried back two years and forward five years. I.R.C. § 904(c).

Even under the United States federal income tax law, a taxpayer may be taxed when he operates at a loss. Under section 465 of the Code, taxpayers can not claim losses from certain activities in excess of the amount "at risk" against income from other activities.⁹¹ Capital losses cannot be deducted by a corporate taxpayer unless the taxpayer has capital gains and then only to the extent of those gains.⁹² Moreover, under the minimum tax provisions of the Code a taxpayer who is in a net loss situation may be subject to U.S. income tax if he has certain tax preference items.⁹³

Receipt of Income Requirement

The third and final requirement for qualification of a foreign tax as a creditable income tax is stated in Revenue Ruling 78-61 as follows:

[I]n order for a foreign tax to qualify as an income tax in the United States sense, the tax in question must be imposed on the receipt of income by the taxpayer rather than on transactions such as sales or the exercise of a privilege or a franchise, such as exploiting natural resources.⁹⁴

According to the Ruling, the Ontario mining tax did not satisfy this receipt of income requirement because the tax can be imposed when the output of the mine is incorporated in a manufacturing process, even though realized income may not be received at that time.⁹⁵ Consequently, Revenue Ruling 78-61 concluded that the Ontario mining tax is an excise tax levied on the mining privilege.⁹⁶ As evidence of this characterization of the tax, the Ruling pointed to the fact that the tax satisfied neither the realization requirement nor the net gain requirement.⁹⁷

The receipt of income requirement combines two principles developed in prior cases and rulings. The first of these is the obvious principle that, since section 901 grants a credit only for foreign *income* taxes, foreign sales, property, and excise taxes are not creditable.⁹⁸ The second principle is that the tax must be imposed "on the taxpayer in his status as an income recipient" and the purpose and function of the for-

⁹¹ See Nordberg & Schwartzstein, *The Foreign Tax Credit for Foreign Oil and Gas Income*, 29 PROC. INST. OIL & GAS L. & TAX. 479, 511-12 (1978).

⁹² I.R.C. § 1211(a).

⁹³ I.R.C. §§ 55-58. Rev. Rul. 77-396, 1977-2 C.B. 86, holds that the minimum tax is an income tax. See Nordberg & Schwartzstein, note 91 *supra*.

⁹⁴ 1978-1 C.B. 221, 224.

⁹⁵ *Id.*

⁹⁶ *Id.* at 226.

⁹⁷ *Id.* at 225.

⁹⁸ *Id.* at 224.

foreign tax must be to reach income.⁹⁹

Under the ruling, excise taxes, whether levied on transactions, activities, or status, presumably are not "income" taxes because they are not intended to be so. A sales tax, a gift tax, an inheritance tax or estate tax is easily recognized as an excise tax imposed on and because of the occurrence of a transaction and independent of whether the taxpayer is the recipient of income. Other taxes may, however, combine characteristics of an income tax and an excise tax and it is these taxes which are most difficult to classify.

In this regard, Revenue Ruling 78-61 takes the position that "a tax, such as an excise tax that is imposed on subjects other than the receipt of income, is not creditable even if the measure of the tax base is net income."¹⁰⁰ In support of this position, the Ruling cites *St. Paul Fire & Marine Insurance Co. v. Reynolds*,¹⁰¹ *Motland v. United States*,¹⁰² and Revenue Ruling 58-3.¹⁰³

None of these authorities support the ruling's position. Both of the cases admittedly contain statements to the effect that a net-income-based foreign tax may be a noncreditable privilege tax,¹⁰⁴ but neither of the taxes at issue in those cases was levied on a net income base. Therefore, the statements on which Revenue Ruling 78-61 relies are simply dicta. Similarly, Revenue Ruling 58-3 deals with a Mexican mercantile tax imposed on gross receipts and gross income from certain transactions or operations. It contains no statement or discussion of the treatment to be afforded a net-income-based tax.

The position that a net-income-based foreign tax may be denied creditability as a privilege or franchise tax finds no direct support in the case law¹⁰⁵ or the revenue rulings issued prior to Revenue Ruling 78-

⁹⁹ See E. OWENS, *supra* note 32, at 54. Owens makes the broad statement that a "tax is an income tax only if it is imposed on the taxpayer in his status and function as an income recipient and if the tax has no purpose or function other than to reach income." *Id.* This statement probably goes too far, but it most likely influenced and served as the basis for the position taken in Revenue Ruling 78-61.

¹⁰⁰ 1978-1 C.B. at 224.

¹⁰¹ 44 F. Supp. 863 (D. Minn. 1942).

¹⁰² 192 F. Supp. 358 (N.D. Iowa 1961).

¹⁰³ 1958-1 C.B. 263.

¹⁰⁴ 192 F. Supp. at 361; 44 F. Supp. at 866.

¹⁰⁵ The two cases holding that a net-income-based tax is a noncreditable privilege or franchise tax, do not state the law. One Tax Court decision to this effect was vacated in *Havana Elec. Ry., Light & Power Co.*, 34 B.T.A. 782 (1936), *vacating* 29 B.T.A. 1151 (1934). The Service acquiesced in the 1936 decision. 1937-1 C.B. 11. The Second Circuit reversed a second Tax Court decision to this effect. *New York & Honduras Rosario Mining Co. v. Comm'r*, 168 F.2d 745 (2d Cir. 1948), *rev'g* 8 T.C. 1232 (1947). The Tax Court has accepted this reversal. See *Bank of America Nat'l Trust & Sav. Ass'n*, 61 T.C. 752, 762 n.9 (1974), *aff'd mem.*, 538 F.2d 334 (9th Cir. 1976).

61.¹⁰⁶ Moreover, the Internal Revenue Service until recently appears to have taken the position that a net-income-based tax is creditable even if it also resembles, or is in fact, a privilege tax.¹⁰⁷ In Revenue Ruling 70-228,¹⁰⁸ the Service held that the Guamanian business privilege tax, levied on a net income base, was a creditable foreign income tax. The ruling stated its rationale as follows: "A tax imposed on the basis of gross income less expenses incurred in earning such gross income is an income tax within the United States concept of the term."¹⁰⁹

This approach, under which a net income base is determinative, is supported by both the rationale and the result of the decided cases. Three leading cases illustrate the development of the rationale for such a result. In the first of these, *Keasbey & Mattison Co. v. Rothensies*,¹¹⁰ the U.S. Court of Appeals for the Third Circuit held that the Quebec mining tax was a noncreditable privilege tax. As evidence of this characterization, the court noted that the tax was not imposed on a net income base.¹¹¹

Subsequently, in *New York & Honduras Rosario Mining Co. v. Commissioner*,¹¹² the Second Circuit reversed a Tax Court holding that the net-income-based Honduran mining tax was a noncreditable privilege tax.¹¹³ The rationale for the Second Circuit's decision was that the tax was based on net income.¹¹⁴ Significantly, the court distinguished the *Keasbey* decision on the ground that "[t]he tax there in question was not laid upon income as we compute it but upon the 'gross value of the year's output' less the costs incurred in the mining operation."¹¹⁵

Finally, in *Commissioner v. American Metal Co.*,¹¹⁶ the Second Circuit revisited the concept of a privilege tax and reiterated the basis for its decision in the *Rosario* case. The *American Metal* court held that the Mexican production tax was a noncreditable privilege tax on the ground that its base was not income.¹¹⁷ According to the court, the

¹⁰⁶ See Foreign Tax Credit Subcomm., *supra* note 36, at 58-62.

¹⁰⁷ 1970-1 C.B. 160.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ 133 F.2d 894 (3d Cir. 1943).

¹¹¹ *Id.* at 898. The court's discussion of the lack of a net income base is somewhat ambiguous and has created confusion about the use of this characteristic. Since the court held that the tax was an excise tax, however, it did not need to determine the extent to which this characteristic is necessary for qualification as an income tax.

¹¹² 168 F.2d 745 (2d Cir. 1948).

¹¹³ *Id.* at 749.

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 748.

¹¹⁶ 221 F.2d 134 (2d Cir. 1955).

¹¹⁷ *Id.* at 140.

“determinative factor” in *Rosario*, and necessarily in *American Metal* as well, was the base upon which the tax was imposed.¹¹⁸

These cases support the position that whether a particular foreign tax is a creditable income tax or a noncreditable excise tax should be determined by reference to the base on which it is levied. If the base is net income, then the tax should be treated as a creditable income tax.

Apparently, the Service is concerned in Revenue Ruling 78-61 that some taxes which are both income taxes and excise taxes will be creditable if such an approach is adopted. It should be noted, however, that section 901(b) of the Code grants a credit for income taxes and does not restrict the credit, as Revenue Ruling 78-61 appears to do, to income taxes which are not also privilege or franchise taxes. Indeed, it has been observed that “[t]he U.S. rule of taxing the worldwide income of its citizens could be described as a tax on the privilege of citizenship, but it would still be an income tax imposed on net income.”¹¹⁹ Viewed in their proper historical perspective, Supreme Court decisions holding that the United States corporate income tax is an excise tax effectively recognize the dual personality of the United States federal income tax.¹²⁰ Thus, if the approach adopted in Revenue Ruling 78-61 were followed to its logical conclusion, a foreign tax identical to the U.S. federal income tax might not be creditable. This was not intended by Congress in enacting section 901 and its predecessors.

In summary, there is no basis in the statute or the case and ruling authority for granting the receipt of income test independent significance in determining whether a foreign tax qualifies as an income tax.

REVENUE RULING 78-62

Revenue Ruling 78-62¹²¹ generally applies the principles outlined

¹¹⁸ *Id.* at 138.

¹¹⁹ Ad Hoc Comm. on the Foreign Tax Credit, *supra* note 49, at 45.

¹²⁰ See, e.g., *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399 (1913); *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911). Although such cases held that the U.S. corporate tax as in effect prior to passage of the sixteenth amendment was not an income tax, it is evident from a comparison of early statutes and from the legislative history of the Revenue Act of 1913 that the nature and effect of the U.S. corporate tax was substantially the same both before and after passage of the amendment. The decision reached in such cases was necessary to avoid invalidating the tax prior to passage of the amendment. Given the lack of changes in the tax statute following the amendment, one has little choice but to conclude that, if the tax imposed by the Revenue Act of 1913 was an income tax, its predecessor was also an income tax. Similarly, if the tax imposed prior to passage of the amendment was an excise tax, it appears that its successor was also an excise tax. Since the nature, purpose, and effect of the tax was not changed substantially by the amendment, it must be concluded that the U.S. federal income tax has characteristics common to both income taxes and excise taxes.

¹²¹ 1978-1 C.B. 226.

in Revenue Ruling 78-61 to estimated net income taxes, often called "formulary taxes."¹²² The Ruling withdraws the Service's acquiescence in *Herbert Ide Keen*,¹²³ its acceptance of the position in *James R. Hatmaker*,¹²⁴ and modifies Revenue Ruling 272,¹²⁵ which held, as did the two cases, that taxes based on income estimated on the basis of the rental value of the taxpayer's property were creditable "income taxes." The Ruling concludes that none of the three requirements set forth in Revenue Ruling 78-61 was satisfied by these taxes, since they could be imposed regardless of whether any gain is actually realized and even if any gain actually realized is less than the estimated income.¹²⁶

Revenue Ruling 78-62 also announced that the Service will no longer follow the Tax Court's decision in *Burk Brothers*.¹²⁷ In that case, a tax on income deemed to arise from the purchase of goat skins in India by the Indian branch of a United States leather manufacturer was held creditable.¹²⁸ Taxable income for purposes of the Indian tax was equal to the excess of the sales price of the goat skins in Philadelphia, where the manufacturer processed the skins over the purchase price of the skins in Calcutta, where the branch purchased them, net of the Indian branch's expenses, including its transportation costs.¹²⁹

The tax in *Burk Brothers* raised the question whether a government's attempt to tax income allocated to a nonrealization event, the purchase of raw materials, by reference to estimated, rather than actual, income should cause the tax to be noncreditable even though similar treatment applies under the Internal Revenue Code to income from goods manufactured in the United States and sold abroad.¹³⁰ It also raised the question whether it is reasonable to deny a credit to tax because the foreign country has different income source and allocation rules than the United States.¹³¹ Revenue Ruling 78-62 concluded that the Indian tax did not satisfy¹³² the realization requirement because it was triggered by a purchase. In addition, since the tax was levied with-

¹²² E. OWENS, *supra* note 32, at 44.

¹²³ 15 B.T.A. 1243 (1929). The Service officially withdrew its acquiescence in *Keen* (VIII-2 C.B. 27 (1929)) in 1978-1 C.B. 2.

¹²⁴ 15 B.T.A. 1044 (1929).

¹²⁵ 1953-2 C.B. 56.

¹²⁶ 1978-1 C.B. at 227.

¹²⁷ 20 B.T.A. 657 (1930).

¹²⁸ *Id.* at 661.

¹²⁹ *Id.* at 659-60.

¹³⁰ See I.R.C. §§ 863-864.

¹³¹ Ad Hoc Comm. on the Foreign Tax Credit, *supra* note 49, at 59; Nordberg & Schwartzstein, *supra* note 91, at 502.

¹³² 1978-1 C.B. at 227.

out reference to the amount of income, if any, actually realized during the year, it was held to violate the receipt of income requirement as well.¹³³

In Revenue Ruling 78-62, the Service also revoked Revenue Rulings 56-658¹³⁴ and 59-192¹³⁵ which held that certain Cuban taxes imposed on the net income of sugar mill owners were creditable. The net income of the mill owners was computed by multiplying the amount of sugar manufactured in the mill by the average market price of sugar produced in the mills for the past three years and reducing the resulting amount by a sixty percent standard deduction to cover processing costs.¹³⁶ Revenue Ruling 78-62 held that these taxes were not creditable because they failed to satisfy the realization requirement of Revenue Ruling 78-61, *i.e.*, they were imposed on a nonrealization event, the manufacture of sugar.¹³⁷ In addition, the taxes did not satisfy the net gain requirement because the use of the standard deduction, rather than actual deductions, from gross receipts, insured that there would always be gain subject to the tax.¹³⁸

Revenue Ruling 78-62 does not indicate that any inquiry was made as to the purpose behind the standard deduction or the statistical basis for choosing the sixty percent deduction. In particular, the Ruling does not indicate whether the standard deduction was intended to reflect what was in fact the normal or average processing expenses and raw material costs for mill owners subject to the tax.

In this regard, it is interesting to note that Revenue Ruling 78-62 reaffirmed its acquiescence in the Tax Court's decision in *Santa Eulalia Mining Co.*¹³⁹ In that case, a Mexican tax on gross mineral participations was held to be creditable. Although the gross amount was reduced by only a limited number of deductions, Revenue Ruling 78-62 presumed that the expenses incurred by the taxpayers would never exceed the income from the participations, because the taxpayers were not engaged in the conduct of a mining business in Mexico.¹⁴⁰

It is difficult to argue that the estimated taxes at issue in *Keen, Hatmaker*, and Revenue Ruling 272 fall within the United States con-

¹³³ *Id.*

¹³⁴ 1956-2 C.B. 501.

¹³⁵ 1959-1 C.B. 191.

¹³⁶ *Id.* at 192.

¹³⁷ 1978-1 C.B. at 228.

¹³⁸ *Id.*

¹³⁹ 2 T.C. 241 (1943).

¹⁴⁰ 1978-1 C.B. at 228.

cept of an "income tax."¹⁴¹ On the other hand, it is difficult to accept the position of Revenue Ruling 78-62 that all estimated foreign income taxes are noncreditable. Based on the Ruling's approach, a tax on estimated net income can never satisfy the realization, net gain, or receipt of income requirements. Both the Internal Revenue Code¹⁴² and the case law suggest that in certain circumstances a tax on estimated income should not be denied creditable status. For example, under sections 863 and 864 of the Internal Revenue Code, the federal income tax is in certain cases levied on estimated income of nonresidents of the United States.

Furthermore, the *Bank of America* decisions, on which Revenue Ruling 78-61 so heavily relies, reaffirmed the Tax Court's decision in *Seatrains Ltd.*¹⁴³ that a three percent Cuban tax on the gross income of foreign shipping companies was a creditable "income tax," because the tax, through its rate, took into consideration the taxpayer's relevant costs and expenses. Thus, although the taxpayer would always be presumed to have income and to have expenses of a certain level, the tax was considered to fall on net gain. This authority, therefore, suggests, contrary to Revenue Ruling 78-61, that if it can be shown that a foreign tax was intended to reach realized net income, even if on an estimated basis, and the calculation of such net income could reasonably be anticipated to reach that income, the tax should qualify as a creditable income tax under section 901.

REVENUE RULING 78-63

Revenue Ruling 78-63¹⁴⁴ held that the Libyan surtax under the Libyan Petroleum Law¹⁴⁵ and certain Saudi Arabian taxes¹⁴⁶ were not the substantial equivalents of an income tax in the United States sense

¹⁴¹ This position is supported by *F.W. Woolworth Co. v. United States*, 91 F.2d 973 (2d Cir.), cert. denied, 302 U.S. 768 (1937), and *F.W. Woolworth Co.*, 54 T.C. 1233 (1970), which held that the tax under Schedule A of the British income tax law levied on income, estimated or imputed as the presumed annual rental value of property owned by the taxpayer, was not creditable since it was not based on the United States concept of income. See also Rev. Rul. 64-260, 1964-2 C.B. 187.

¹⁴² I.R.C. §§ 863-864.

¹⁴³ 46 B.T.A. 1076 (1942), nonacq. 1942-2 C.B. 31. Originally, the companies had been taxed at six percent of net profit derived from Cuban sources. In order to settle disputes over apportionment of expenses to revenues derived in Cuba, the three percent gross income tax was substituted.

¹⁴⁴ 1978-1 C.B. 228.

¹⁴⁵ Specifically, the surtax was imposed by art. 14(1)(a) of the Libyan Petroleum Law No. 25 of 1955, as amended through November 20, 1965. See *id.* at 229.

¹⁴⁶ The Saudi Arabian taxes at issue were the taxes under Royal Decree No. 17/2/28/3321, dated November 4, 1950, and under Royal Decree No. 17/2/28/7634, dated December 27, 1950. See *id.* at 231.

and, therefore, not creditable. In the case of the Libyan surtax the income on which it was levied was based on exports, an unrealizable event.¹⁴⁷ Further, the Libyan surtax and the Saudi Arabian taxes were imposed on "artificial" or "fictitious" income which was measured by an arbitrary posted price established by the respective governments.¹⁴⁸ This new Revenue Ruling thereby revoked Revenue Rulings 68-552¹⁴⁹ and 55-296.¹⁵⁰

The surtax under the Libyan Petroleum Law, which was in addition to the regular company tax, was imposed on holders of oil concessions in Libya to insure that Libya received sixty-five percent of the holders' profits.¹⁵¹ Income subject to the surtax could not be less than the number of barrels of crude oil exported from Libya multiplied by the applicable "posted price" which had been set by the Libyan government since 1965 in excess of the actual market price of such oil.¹⁵² Revenue Ruling 78-63 points out that some Libyan oil concessionaires actually sold Libyan crude oil at market price to unrelated parties, while others sold at posted price to purchasing affiliates which then resold at market price and suffered a loss.¹⁵³

The Saudi taxes, modified by individual agreements and understandings between the Saudi government and U.S. companies engaged in oil and gas production in Saudi Arabia, were imposed on "net profits" based (before 1977) on a posted price set by the government.¹⁵⁴ Generally, the posted price exceeded actual market price between unrelated purchasers.¹⁵⁵ The U.S. companies were required to sell in Saudi

¹⁴⁷ Rev. Rul. 78-63 concluded that the realization requirement could not be satisfied by the Libyan surtax. Since the income subject to the surtax could not be less than the number of barrels exported times the posted price minus certain allowances, Rev. Rul. 78-63 concluded that the surtax could be triggered regardless of whether a sale took place. It cited *Mottland v. Comm'r*, 192 F. Supp. 358 (N.D. Iowa 1961), which held that a two percent Cuban tax triggered by the export of capital regardless of whether gain was realized was not creditable; it also cited the Third Circuit's decision in *Keasbey*. But see earlier discussion of realization requirement in Rev. Rul. 78-61 at text accompanying notes 24-53 *supra*.

¹⁴⁸ Rev. Rul. 78-61 cited *F.W. Woolworth*, 54 T.C. 1233, 1260 (1972), holding that the tax under Schedule A of the British Income Tax Act of 1952 was not a creditable income tax, as authority for this position. It compared posted price income under the Libyan and Saudi taxes with the imputed rental value income under the British tax that the Tax Court in *Woolworth* concluded did not fall within the United States concept of income.

¹⁴⁹ 1968-2 C.B. 306.

¹⁵⁰ 1955-1 C.B. 386.

¹⁵¹ 1978-1 C.B. at 229.

¹⁵² *Id.*

¹⁵³ *Id.* at 230.

¹⁵⁴ *Id.* at 231.

¹⁵⁵ *Id.*

Arabia all oil produced in that country destined for export.¹⁵⁶

Levy of Surtax Upon Export

In holding that the Libyan surtax fails to satisfy the realization requirement because it may be imposed on income triggered by exports rather than sales, Revenue Ruling 78-63, like Revenue Ruling 78-61, ignores the "predominant character" doctrine.¹⁵⁷

Revenue Ruling 78-63 recognizes that the Libyan oil concessionaires sell Libyan crude oil to purchasing affiliates and to unrelated third parties.¹⁵⁸ In fact, most of the major oil producers in the Middle East sell all their petroleum in the country of production to a controlled trading company which sells it to third party customers or to other controlled parties. If such sales comprise substantially all of the sales of Libyan crude oil, the substantially all the exports, as defined in the Libyan petroleum law, are in fact sales, and the "predominant character" of the tax is a tax on realized gain.¹⁵⁹ Even if a substantial amount of the Libyan oil concessionaires' income which was subject to the surtax were triggered by export rather than the sale of the crude, there is little doubt that the exported oil would be sold and the gain that is taxed realized in the U.S. sense. The only difference between this tax and the U.S. income tax is the timing of the taxable event.¹⁶⁰

Furthermore, one can argue that Libya has a legitimate interest in deeming income from the export of petroleum produced to insure that

¹⁵⁶ *Id.*

¹⁵⁷ The "predominant character" doctrine dictates a determination of whether the surtax is ever levied on "exports" and, if so, how significant a quantitative impact such levies have on the total revenue collected under such tax. See text accompanying notes 44-47 *supra*.

¹⁵⁸ 1978-1 C.B. at 230.

¹⁵⁹ The Second Circuit apparently made a similar analysis in *New York & Hond. Rosario Mining Co. v. Comm'r*, 168 F.2d 745, 748 (2d Cir. 1948). In that case, the court held that a Honduras mining tax on "liquid profits" was a creditable tax, even though "liquid profits" were defined under a Honduras mining concession as the amount received from "exports" less operating expenses, amortization, and depletion. Although the court in this decision and in its subsequent decision in *Comm'r v. Am. Metal Co.*, 221 F.2d 134, 138 (2d Cir. 1955), considered the amount received from "exports" to be "gross income," it cannot be denied that a tax on receipts from "exports" was held to be a creditable foreign tax. It was apparently determined by the court that notwithstanding the language of the Honduras law and mining concession, receipts from "exports" were synonymous with actual sales receipts, and consequently, the taxes were levied on realized gain in the U.S. sense.

¹⁶⁰ This differs from the situation in *Motland v. Comm'r* and *Keasbey*, both of which were cited by Revenue Ruling 78-63 as authority for its position. In *Motland*, the tax did not reach gain or income, whether realized or not. It was imposed solely on the export of capital. As discussed earlier in this article, the Third Circuit in *Keasbey* never addressed the question whether the fact that the Quebec tax was levied on gross value rather than actual receipts disqualified it as an income tax per se. It simply found it to be an excise tax, and as such, not to be creditable.

it taxes profits generated within its jurisdiction. Since the United States protects this same interest in Code section 863(b)¹⁶¹ and 864(c)¹⁶² by deeming U.S. taxable income to be earned by foreign residents which have significant activities in this country but which realize income abroad, Revenue Ruling 78-63's position that the surtax does not satisfy a U.S. standard of realization of gain seems questionable.

Income Base on Posted Price

Revenue Ruling 78-63 also held that the Libyan surtax and the Saudi taxes were not creditable income taxes because they were based on a posted price in excess of actual market price. On this basis, they were levied on "artificial" or "fictitious" income.¹⁶³ In disqualifying these taxes, Revenue Ruling 78-63 appears to ignore the legislative history of sections 907 and 901(f) of the Code. In 1974, Treasury recommended to Congress legislation designed to limit the credit available on foreign oil and gas extraction income to the amount of U.S. tax that would be paid on foreign source petroleum income.¹⁶⁴ In hearings on the proposal, the Secretary of the Treasury recognized that the artificially high posted price, on which some foreign oil producing countries imposed taxes, raised a legitimate concern over whether the taxes were creditable.¹⁶⁵ The Secretary, however, urged Congress to accept the proposed limitation of foreign oil tax credits, and not to adopt legisla-

¹⁶¹ I.R.C. § 863(b) provides in part that gains, profits, or income from the sale of personal property produced (in whole or in part) within the United States by the taxpayer and sold outside the United States must be treated as derived partly from sources within the United States. Thus, if such income is connected to a U.S. trade or business or permanent establishment under a tax treaty in which the United States is a member, it will be taxable in the United States. Example (1) of Treas. Reg. § 1.863-3(b) illustrates the application of this provision. In this example, a manufacturer (foreign or U.S.) has a factory in the U.S. and regularly sells part of the factory's output to an unrelated party so that an independent selling price for the output is established. Thus, when the manufacturer sells some of the output through a sales branch overseas, the manufacturer's U.S. source taxable income shall be determined as if the factory sold the product in the U.S. to its foreign sales branch at the independent selling price.

¹⁶² I.R.C. § 864(c) and Treas. Reg. § 1.864-6(c) provide that income realized by a nonresident individual or corporation outside the United States will be treated as effectively connected with the conduct of a trade or business within the United States, and thus subject to United States tax, if the foreign resident or corporation has an office or fixed place of business in the United States, and thus subject to United States tax, if the foreign resident or corporation has an office or fixed place of business in the United States which is a material factor in the realization of such income. Such income may be calculated in the case of the sale of personal property outside the United States as if the property were sold by the nonresident individual or corporation in the United States.

¹⁶³ 1978-1 C.B. at 232.

¹⁶⁴ *Hearings on "Windfall" or Excess Profits Tax Before House Comm. on Ways and Means*, 93d Cong., 2d Sess. 145-52 (1974).

¹⁶⁵ *Id.* at 149-50.

tion denying the credit entirely for such taxes "unless it is determined that U.S. oil companies should not participate in foreign oil and gas production."¹⁶⁶ This position recognized that the absence of any credit would subject U.S. companies to substantially higher tax burdens than their foreign competitors.¹⁶⁷ In these hearings, it was pointed out that the Treasury Department, in responding to a letter from Congressman Vanik, had stated that all OPEC countries impose income taxes which qualify for the U.S. foreign tax credit, and had described how a typical posted price tax system operates in these countries.¹⁶⁸

Although there were a number of proposals in 1975 and 1976 to repeal the foreign tax credit for taxes paid on foreign oil and gas income because they did not constitute a creditable income tax, Congress rejected them in favor of the alternative recommended by the Treasury.¹⁶⁹ In 1975, Congress enacted section 907 which limited the amount of the taxes to 52.8% in 1975, 50.4% in 1976, and 50% in subsequent years of an economic interest holder's foreign oil and gas extraction income. Further, Congress added a new section 901(f) which denies otherwise qualifying income taxes of a nonholder from the purchase and sale of oil and gas at other than fair market value as a tax for tax credit and deduction purposes.

In so doing, Congress seemed to be responding at least in part to the concern over posted price taxing systems. Section 907(d), as originally enacted, provides that for purposes of chapter 1 of the Code, fair market value in lieu of posted price will be used in determining taxable

¹⁶⁶ *Id.* at 152.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 168-69.

¹⁶⁹ An amendment was proposed in March 1975, when the Tax Reduction Act of 1975 was pending in the Senate, which would have repealed the foreign tax credit on foreign oil related income and provided a deduction for such taxes. The proposed amendment would have also subjected foreign oil related income to a 24% tax. 121 CONG. REC. 7305 (1975). The proposed amendment was adopted after considerable debate in which the proponents expressed concern over current treatment of royalties as taxes. The Conference Committee deleted the Senate amendment and substituted a provision, substantially similar to the one adopted by the House Ways and Means Committee in 1974, which was enacted as § 907, and added a new provision, which is now § 901(f), in the Tax Reduction Act of 1975. CONF. REP. NO. 94-120, 94th Cong., 1st Sess. 69 (1975).

Again, in 1976, a Senate floor amendment to the bill that became the Tax Reform Act of 1976 would have treated as a royalty, rather than as a tax, any payment to a foreign government on income from extraction, production, or refining of oil and gas unless the foreign government imposed a substantially similar tax on income from other activities. H.R. REP. NO. 1515, 94th Cong., 2d Sess. 461 (1976). The conferees, however, deleted this amendment and made no substantive change to § 907, other than to reduce further the limitation on the foreign tax credit for oil extraction income in the case of a corporation, the percentage which is equal to the highest tax rate under § 11(b) of the Code (in 1976, 48%, in 1978, 46%). *Id.* at 461-62.

income in the case of foreign oil and gas extraction income. Section 901(f) provides that otherwise qualifying taxes in connection with the purchase and sale of foreign extracted oil and gas will not be a "tax" for tax credit or deduction purposes if the taxpayer has no economic interest in the oil and gas and it is purchased or sold at other than fair market value. Certainly these provisions when coupled with section 907 in general, connote an intention on behalf of Congress to qualify petroleum income taxes based on a posted price of an economic interest holder as both a "tax" and an "income tax" within the meaning of section 901.¹⁷⁰

Furthermore, in the Energy Tax and Individual Relief Act of 1974 Report of the House Ways and Means Committee, provisions almost identical to section 907, as enacted in 1975, were discussed. The Report stated:

[oil] companies have substantial excess credits from oil production activities in part at least because of the difficulty under present law of distinguishing deductible royalty payments from creditable taxes. . . . Besides increasing their tax rates, foreign countries have found other ways to impose higher tax rates on U.S. oil companies. . . . [T]hey often in effect overstate the income subject to tax by basing the tax on an artificially high posted price rather than on the market price for the oil. . . . Your committee recognizes the substantial difficulty of ascertaining whether a payment labeled a tax is, in fact, a tax or a royalty and believes that this difficulty has led to a distortion of the foreign tax credit mechanism in the oil and gas area for petroleum companies on the overall limitation. Consequently, your committee believes that an additional limitation should be placed on the use of excess credits arising from oil and gas production to offset U.S. tax on other foreign source income. . . . The bill provides that in determining taxable income from oil and gas which has been extracted abroad, the price at which the oil is transferred is to be its fair market value (arm's-length price) rather than the posted price. As a result the sales price received by the transferor and the purchase price paid by the purchaser is to be adjusted to reflect the arm's-length price where a posted price (or some other arranged pricing system) is in effect. The adjustment is made to the purchase price whether or not the purchaser has foreign oil and gas extraction income.¹⁷¹

This 1974 Committee Report, however, contains a footnote in its discussion of the predecessor of section 907 which reads as follows:

The payments of oil companies are designated as income taxes by the oil companies and by the foreign governments. At present the IRS agrees with this treatment. Your committee has made no judgment as to

¹⁷⁰ See Nordberg & Schwartzstein, *supra* note 91, at 491-92. See also STAFF OF HOUSE COMM. ON WAYS & MEANS, 95TH CONG., 1ST SESS., RECOMMENDATIONS OF THE TASK FORCE ON FOREIGN SOURCE INCOME 36 (Comm. Print 1977).

¹⁷¹ H.R. REP. NO. 93-1502, 93d Cong., 2d Sess., 61-66 (1974).

whether this treatment is correct for existing payments or for payments under any altered arrangements which may be made in the future. No inference should be drawn from this analysis of existing law or from the actions taken in this bill that your committee agrees, or disagrees, that current payments are properly treated as taxes rather than as royalties.¹⁷²

Having changed its position in 1974 on posted price income taxes, the Service in Revenue Ruling 78-63 apparently relies on this footnote as evidence that Congress did not intend in section 907 to respond to leave open the question of whether foreign petroleum "income" taxes based on posted price qualify as creditable income taxes under section 901—a view that has been adopted by the Staff of the Joint Committee on Taxation.¹⁷³

It seems more consistent, however, with the Report as a whole and the legislative developments occurring after the issuance of the 1974 Report, to construe the footnote as recognition by the Committee that, in responding to the posted price and the "royalty vs. tax" issues by what was to be section 907, the Committee considered the question whether such taxes should be treated as a "tax" or "income tax" under section 901, to be moot. To view it otherwise, seems to place in question the reason for the 1975 legislation.

Even if Congress intended to leave open the "income tax" question with respect to posted price petroleum taxes, Revenue Ruling 78-63's denial of a credit for the Libyan surtax and Saudi taxes as a result of the use of a posted price system is not free from question. According to this ruling, credit was denied on this basis because the tax was structured to levy on "fictitious" and "arbitrary" income.¹⁷⁴ In concluding that the income tax base of these taxes is "fictitious" and "arbitrary," Revenue Ruling 78-63 appears to look at the fact that the government established posted prices exceeded actual market price, and that the income based on such excess is not realized in the United States sense.¹⁷⁵

It can be argued that a tax imposed on income which is based on government established prices, even if such prices do not reflect market price, does not conflict with the United States concept of an "income tax." The U.S. government has reserved the right to adjust prices for

¹⁷² *Id.* at 61.

¹⁷³ STAFF OF THE JOINT COMM. ON TAXATION, EXPLANATION OF FOREIGN TAX CREDIT RULES APPLICABLE TO PETROLEUM INCOME AND DESCRIPTION OF ADMINISTRATION PROPOSAL (June 18, 1979) (for use by House Ways and Means Comm.).

¹⁷⁴ 1978-1 C.B. at 232.

¹⁷⁵ See also discussion of Rev. Rul. 78-62, where taxes based on estimated rather than actual receipts were considered to fail the realization and net gain requirements outlined in Rev. Rul. 78-61.

tax purposes on a basis other than actual market price to take into consideration auditing and other administrative difficulties with respect to certain industries and certain taxpayers. For example, section 482 enables the United States government to establish prices on which U.S. taxable income is based, which may or may not be considered to reflect actual market prices. In the petroleum industry, prices established by the Service under section 482 may vary significantly from the "fair market value prices" of the Department of Energy.

The United States government also directly controls pricing in such areas as oil and gas imports, farm price supports, and anti-dumping which may not reflect actual market price. Such pricing has been recognized by at least one court as a proper basis on which income is computed and taxed.¹⁷⁶ In addition, the Service has nonacquiesced in two Tax Court decisions in which it was held that a taxpayer who charged less than a government controlled price could not be taxed on the basis of the higher government price.¹⁷⁷ This can be viewed as representing a position in favor of computing tax liabilities on the basis of government prices even if higher than actual price.

The Ruling cites the Tax Court's decision in *F.W. Woolworth Co.*¹⁷⁸ in support of its position that the Libyan and Saudi taxes are imposed on "artificial income" and, therefore, do not qualify as income taxes, because taxable income under their posted price systems is based on above-market government prices. The tax at issue in *Woolworth* is, however, distinguishable from the Libyan and Saudi posted price taxes in the Ruling. In *F.W. Woolworth Co.*, the creditability of the tax levied by Schedule A of the British Income Tax Act of 1952 was at issue. The tax was levied upon the annual rental value of real property owned by the taxpayer. The Tax Court held that the tax was not a creditable income tax because it was not based on the United States concept of

¹⁷⁶ In *Shunk Latex Prod., Inc.*, 18 T.C. 940 (1952), *Commissioner's appeal dismissed* (6th Cir. 1953), *nonacq.* 1953-1 C.B. 7, the Tax Court gave effect, for tax purposes, to prices set under price controls in World War II even though reallocation of income under the predecessor of § 482 would have been otherwise justified. Although the Commissioner did not acquiesce, the court opinion indicates that he did not disagree with the principle that government price controls should govern, but with the conclusion that it applied to the taxpayer. See also *Dornbosch Bros., Inc.*, 46 T.C. 199 (1966) (Tax Court held that a U.S. brother corporation could deduct as a cost of goods sold the packing, crating, and loading charges of flower bulbs purchased from its Dutch sister corporation, since under Dutch law, bulbs were subject to a minimum export price and a maximum discount).

¹⁷⁷ The Service nonacquiesced in *Pittsburgh Milk Co.*, 26 T.C. 707 (1956), in 1976-2 C.B. 3, withdrawing its original acquiescence, 1962-2 C.B. 5, and nonacquiesced in *Antzingen-White House Dairy, Inc.*, 36 T.C. 173 (1961), in 1976-2 C.B., withdrawing its original acquiescence, 1961-2 C.B. 3.

¹⁷⁸ 54 T.C. 1233 (1970).

income (net income realized by the taxpayer).¹⁷⁹ The British tax base was the annual rental value of real property—not sales based on government controlled or posted prices as in the Libyan and Saudi cases. Even if the posted price exceeded market price in the Libyan and Saudi cases, taxable income is realized from actual sales. On the other hand, the British tax in *F.W. Woolworth* was levied on a base that had no connection with the U.S. concept of income, whether realized or not.

Revenue Ruling 78-63 also seems to find the Libyan surtax and the Saudi taxes deficient in respect to posted prices, because they are levied on a base, a portion of which does not represent realized or actual gain.¹⁸⁰ It is apparently this “phantom income” portion that leads the Ruling to call the income base “fictitious.” It is not certain, however, from the Ruling itself that these taxes are levied on unrealized gain. Revenue Ruling 78-63 indicates, with respect to the Libyan surtax, that some concessionaires actually sell at the posted price to their affiliates, and others sell to unrelated parties at a lower price, defined under the Ruling as “market price.”¹⁸¹ With respect to Saudi taxes, all export sales of Saudi oil were made at the posted price (before 1977), as required under individual agreements and understandings between U.S. oil companies and the Saudi government. In this case, these sales were made to affiliated trading companies of the producing company.

In its determination of whether the use of the posted price in calculating the Libyan and Saudi taxes satisfied the realized gain requirement, Revenue Ruling 78-63 refuses to recognize that the oil sales were in fact made at the posted price. The Ruling takes this position because the purchasers were affiliates of the concessionaires and made the purchase “only because [they were] required to do so.”¹⁸²

Refusal to recognize the sale to the affiliate at the posted price, however, appears to be in direct conflict with the longstanding independent corporate entity doctrine, whereby a corporation which is created for a bona fide business purpose or conducts business activities is treated as a separate legal entity under the Code.¹⁸³ That a corporation is controlled or dominated by its shareholders has not been held to warrant treating the corporation’s activities as those of the shareholders.¹⁸⁴ There does not appear to be any basis for avoiding the application of this doctrine and treating those affiliated trading companies

¹⁷⁹ *Id.* at 1260-63.

¹⁸⁰ 1978-1 C.B. at 232.

¹⁸¹ *Id.* at 230.

¹⁸² *Id.*

¹⁸³ See *Moline Properties v. Comm’r*, 319 U.S. 436, 438 (1943).

¹⁸⁴ *Nat’l Carbide Corp. v. Comm’r*, 336 U.S. 422, 429 (1949).

purchasing at posted price as other than separate entities in determining whether the realized gain requirement is satisfied. There are legitimate business reasons for creating such trading companies. They include, for example, providing expertise on world-wide trading and transportation of the producing company's crude oil and limiting the company's local legal and tax liability for its crude oil sales.

Therefore, the facts surrounding the sale of the petroleum by the producers becomes important when considering this question. If most of the sales of Libyan and Saudi oil were actually made at the posted price to affiliates or others, and the Libyan surtax and Saudi taxes were levied on the income therefrom, the use of posted price with respect to these taxes should not, under the "predominant character" doctrine, violate the realization requirement in Revenue Ruling 78-61.¹⁸⁵ Certainly, the Saudi taxes satisfy this requirement since all export sales by U.S. producers must be made at the posted price, and Revenue Ruling 78-61 should be revised accordingly. As far as the Libyan surtax is concerned, Revenue Ruling 78-63 should be reconsidered after further investigation of the facts surrounding the price at which export sales were made.

OTHER REVENUE RULINGS INVOLVING PETROLEUM TAXES

After Revenue Ruling 78-63, the Service issued three Revenue Rulings on the creditability of certain foreign taxes with respect to income generated from the extraction of oil and gas under sections 901 and 903. For the most part, these Rulings merely reaffirmed or amplified earlier positions of the Service in Revenue Rulings 78-61, 78-62, and 78-63 or its 1976 advance ruling guidelines under IR-1638 (July 14, 1976) on the creditability of tax paid to a foreign government which owns the minerals in place by a U.S. taxpayer which earns income from extracting such minerals.¹⁸⁶

¹⁸⁵ If the price realized by the oil concessionaire from sales to its affiliate is not reflective of an arm's-length price, the proper response for the Service would be to apply § 482 and its regulations rather than to deny the foreign tax's creditability. *See also* H.R. REP. NO. 1502, 93d Cong., 2d Sess. 66 (1974) (in discussing § 907's provision to disregard posted prices in computing foreign oil and gas extraction, the *Report* points out that § 482 can be used for allocating income between affiliated parties at fair market prices rather than posted prices). However, *see* Rev. Rul. 74-245, 1974-1 C.B. 124, holding that, where arm's length royalty payments from a foreign subsidiary to its U.S. parent would not be approved by a foreign government, any adjustments under § 482 would be deferrable under Treas. Reg. § 1.482-1(d)(6). *Quaere* whether the rationale of this ruling should apply to deny § 482 adjustments where a foreign government imposes a sales price in excess of fair market value for oil and gas produced in that country by a U.S. production company and sold to its trading affiliate.

¹⁸⁶ In Rev. Rul. 78-222, 1978-1 C.B. 232, it was held that the Indonesian corporate tax and

REVENUE RULINGS 78-233, 78-234, AND 78-235

Whereas the rulings discussed in the above section merely reaffirm or amplify Revenue Rulings 78-61, 78-62, and 78-63, Revenue Rulings 78-233,¹⁸⁷ 78-234,¹⁸⁸ and 78-235¹⁸⁹ have independent significance. They illustrate the application of the principles in Revenue Ruling 78-61 to gross income taxes imposed as withholding taxes. Revenue Rulings 78-233, 78-234 and 78-235 take the position that, to be creditable, foreign withholding taxes must be imposed only on nonbusiness income, since that is the type of income on which the United States imposes withholding taxes. As a result, the rulings cast considerable doubt on the creditability of many foreign withholding taxes.

Revenue Ruling 78-233 held that a tax of the State of Mexico imposed on interest is not a creditable income tax since it failed to satisfy the net gain requirement of Revenue Ruling 78-61. The Mexican tax is imposed at the rate of five percent on gross interest income received in the State of Mexico or from sources of wealth therein, without allowance for any deductions, and is payable by the person entitled to receive the interest.¹⁹⁰ If the interest is payable with respect to investments of foreign capital or investments made by a foreign person

dividend tax on income earned under modified production sharing contracts was a creditable income tax under § 901(b). These contracts were modified to meet objections in Rev. Rul. 76-215, 1976-1 C.B. 190, and to meet the ruling guidelines for the creditability of a tax imposed on extraction income where the sovereign owns the minerals in place under IR-1638. News Release, IR-1638, note 11 *supra*. In Rev. Rul. 78-222, the Service stated that the foreign tax base need not be identical to the U.S. tax base, but reaffirmed the holding in Rev. Rul. 78-61, 1978-1 C.B. 221, that it must allow for the deduction, without limitation, of the significant expenses paid or incurred by the taxpayer. It did add, however, that reasonable limitations on the recovery of capital expenditures were acceptable. It also reaffirmed IR-1638 and Rev. Rul. 78-63, 1978-1 C.B. 228, by stating that payments to a foreign government owning the minerals in place extracted by a United States taxpayer will be creditable where the tax is imposed on actual receipts of income and such income is determined on an arm's-length basis.

Rev. Rul. 78-424, 1978-2 C.B. 197, held that the United Kingdom petroleum revenue tax (PRT) does not qualify as a creditable income tax, failing all three requirements of an "income tax" outlined in Rev. Rul. 78-61. The Ruling concluded that the realization requirement is not satisfied because taxable profits include revenues from the valuation of oil at the time it is refined or processed. The net gain requirement is not satisfied because the PRT is applied on a field-by-field basis so that losses from one field cannot offset income of the others; and the third requirement is not met because the PRT is actually a production or severance levy.

Rev. Rul. 79-140, 1979-1 C.B. 239, citing Rev. Rul. 78-63, held that payments made to the Bahrain government pursuant to the Bahrain Income Tax Decree No. 80/1955, as amended by Decree No. 11 (Finance) 1966, and Decree No. 1/1977 on profits from petroleum production and refining are not payments of a creditable income tax under § 901 since taxable profits are based on a deemed posted price in excess of the actual market price.

¹⁸⁷ 1978-1 C.B. 236.

¹⁸⁸ 1978-1 C.B. 238.

¹⁸⁹ 1978-1 C.B. 237.

¹⁹⁰ The tax is imposed under arts. 257(I) and 259 of the Ley de Hacienda del Estado de Mexico

not having a representative within the State of Mexico, the debtor is required to withhold the tax.¹⁹¹

The Ruling recognizes that certain foreign taxes on the gross amount of particular items of income, such as dividends, interest, and royalties, have, prior to the release of Revenue Ruling 78-61, been held to qualify as creditable income taxes. Revenue Ruling 78-233 cites Revenue Ruling 73-106,¹⁹² which held that a Mexican tax on the gross amount of Mexican sourced royalties paid to nonresident aliens and foreign legal entities not established in Mexico, from sources within Mexico, for the use of patents, trademarks, and trade names constituted a creditable foreign income tax. Revenue Ruling 73-106 based its holding on the similarity of the Mexican tax to the United States withholding taxes on gross United States source income of nonresident aliens and foreign corporations that are not effectively connected with the recipient's conduct of a trade or business within the United States.¹⁹³

According to Revenue Ruling 78-233, however, the Mexican tax on interest is distinguishable from the taxes in Revenue Ruling 73-106 because it may be imposed on gross income which is derived from, or is effectively connected with, a trade or business under United States tax principles¹⁹⁴ within the State of Mexico.¹⁹⁵ Citing Revenue Ruling 78-61, the Ruling states:

expenses incurred in producing gross trade or business income are not inherently so slight as to insure that they will almost never exceed the amount of that gross income and thus not produce a loss. For this reason a foreign tax on income from engaging in business in the foreign country that does not permit the deduction of the generally significant expenses incurred in producing that income is not almost certain to fall on net gain.¹⁹⁶

Based on this principle and citing the Court of Claims decision in *Bank of America*, Revenue Ruling 78-233 held that the Mexican tax does not satisfy the net gain requirement because the tax "falls equally on creditors, such as banks, engaged in the trade or business of earning interest income in the State of Mexico (as determined under general principles found in section 864 of the Code), and creditors who are not

of January 1, 1971, by Decree No. 77, as amended through June 7, 1972, by Decree No. 155. See Rev. Rul. 78-233, 1978-1 C.B. 236.

¹⁹¹ *Id.*

¹⁹² 1973-1 C.B. 343.

¹⁹³ *Id.* at 344. See I.R.C. §§ 871(a), 881(a).

¹⁹⁴ I.R.C. § 864.

¹⁹⁵ 1978-1 C.B. at 236.

¹⁹⁶ *Id.*

so engaged.”¹⁹⁷ As applied to the former, the Mexican tax “will not be almost certain of reaching net gain since the business expenses attributable to the conduct of a trade or business of earning interest income within the State of Mexico are nondeductible.”¹⁹⁸

In Revenue Ruling 78-234, withholding taxes¹⁹⁹ imposed by the Republic of Tanzania on the gross amount of management and professional fees, dividends, interest, and royalties paid to a nonresident person not having a permanent establishment in Tanzania²⁰⁰ were at issue. Since each item of income forms a separate tax base on which the tax is separately computed, the ruling treats the tax²⁰¹ on each item as a separate tax under *Lanman & Kemp-Barclay & Co. of Colombia* and prior ruling authority.²⁰² Revenue Ruling 78-234 held that the withholding tax on management or professional fees fails the substantial equivalency test of a qualifying income tax, and therefore, is not creditable, since it fails to satisfy the net gain requirement.²⁰³ On the other hand, it held that the taxes on dividends, interest, and royalties qualify as creditable foreign income taxes.²⁰⁴

The result reached with respect to the tax imposed on management or professional fees is based on an analysis similar to that applied in Revenue Ruling 78-233 to the Mexican tax on interest. That is, the conclusion that the Tanzanian tax did not satisfy the net gain requirement and, therefore, was not the substantial equivalent of an income tax in the United States sense, was premised on a finding that the tax may be imposed on income which, under United States concepts,²⁰⁵ is considered derived from the conduct of a trade or business in Tanzania.

Under United States tax law, the performance of services is con-

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ Imposed by the Republic of Tanzania under § 49(1) of the East African Income Tax Management Act (1958) as modified by the East African Income Tax Management Act (1971) and adopted by the Republic of Tanzania in its Income Tax Act (1972). *See* Rev. Rul. 78-234, 1978-1 C.B. 237.

²⁰⁰ The term “permanent establishment” as used in the Tanzanian tax law is not defined in Rev. Rul. 78-234. Presumably, the term carries the meaning generally ascribed to it in bilateral income treaties. *See* note 222 *infra* (discussion of permanent establishment standard); Williams, *Permanent Establishments in the United States*, 29 TAX LAW. 277 (1976).

²⁰¹ The tax is 12½% on the gross amount payable as dividends and interest and 20% of the gross amount payable as royalties and management or professional fees.

²⁰² *See* note 30 and accompanying text *supra*.

²⁰³ 1978-1 C.B. at 238.

²⁰⁴ *Id.*

²⁰⁵ *See* I.R.C. § 864(b).

sidered a trade or business.²⁰⁶ Applying the rationale of Revenue Ruling 78-233, Revenue Ruling 78-234 concludes that a foreign tax levied on compensation for services must permit the deduction of expenses incurred to produce the income to satisfy the net gain requirement.²⁰⁷ Since under the Tanzanian withholding tax law no deductions are permitted, the tax, as it applies to management and preferred fees, does not satisfy the net gain requirement since theoretically it may be imposed on a taxpayer who suffers a loss.

Revenue Ruling 78-235 held that two Mexico City taxes on interest²⁰⁸—a 5% tax and an additional tax of 15% on the 5% tax—failed the net gain requirement, and hence, were not creditable income taxes under Section 901.²⁰⁹

The Mexico City taxes are imposed on the gross amount of interest income received from sources within Mexico City. Collection of the tax is assured by requiring the payor of taxable interest to require the payee to furnish evidence of current payment of the taxes or, in the absence of such evidence, to withhold and remit the taxes.²¹⁰ The taxes are imposed on all creditors, including those, such as banks, that are engaged in the trade or business of earning interest income within Mexico City.²¹¹

On the basis of this last fact, Revenue Ruling 78-235 held that the taxes were not creditable foreign income taxes for the same reasons set forth in Revenue Ruling 78-233. That is, the tax is not structured to reach net gain and is not analogous to U.S. withholding taxes, since it applies to gross trade or business income regardless of whether the taxpayer incurs a loss in earning the income.²¹²

The three Rulings depart substantially from existing authority in denying income tax treatment to all foreign taxes that, under the

²⁰⁶ See I.R.C. § 864(b)(1). That section provides a *de minimis* exception if a nonresident alien individual is an employee of a foreign employer not engaged in a U.S. trade or business, is present in the United States for less than 90 days during the taxable year, and earns no more than \$3,000 compensation for such services.

²⁰⁷ 1978-1 C.B. at 238.

²⁰⁸ Imposed under arts. 316(I) and 931(I), Title Five, Tax Law for the Department of the Federal District of Mexico. See 1978-1 C.B. at 238.

²⁰⁹ *Id.* at 239.

²¹⁰ Required by art. 321, Title Five, Tax Law for the Department of the Federal District of Mexico. See *id.* at 238.

²¹¹ Article 320, Title Five, Tax Law for the Department of the Federal District of Mexico. See *id.*

²¹² The additional 15% tax was denied creditability since it is measured by the payment of another tax, *i.e.*, the 5% tax, which is not an income tax. See *id.* at 239. See also Rev. Rul. 74-90, 1974-1 C.B. 181, and Rev. Rul. 70-133, 1970-1 C.B. 159, which are cited in support of this determination.

United States Internal Revenue Code, reach gross trade or business income. The *Bank of America* decisions,²¹³ which are the principal authority for the Rulings, do not support this conclusion. The Court of Claims made it clear in *Bank of America* that it did not deny *per se* "income tax" qualification to gross business income taxes when it stated:

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

For instance, it is almost universally true that a wage or salary employee does not spend more on expenses incident to his job than he earns in pay. A foreign tax upon the gross income of an employee from his work should therefore be creditable by the employee under § 901(b)(1) despite the refusal of the other jurisdiction to permit deduction of job-related expenses. The reason is, of course, that in those circumstances the employee would always (or almost always) have some net gain and, accordingly, the tax, though on gross income, would be designed to pinch net gain in the end—and would in fact have that effect. In those circumstances, a loss (excess of expenses over profit) is so improbable, and some net gain is so sure, that the tax can be placed on gross income without any real fear or expectation that there will be no net gain or profit to tax.²¹⁴

The Court of Claims again made this point when it concluded that the definition of an income tax based on its review of the pertinent case and ruling authority was well "comparable to gross income levies in the federal income tax system."²¹⁵ It stated that:

the term "income tax" in § 901(b)(1) covers all foreign income taxes designed to fall on some net gain or profit, and includes a gross income tax if, but only if, that impost is almost sure, or very likely, to reach some net gain because costs or expenses will not be so high as to offset the net profit.²¹⁶

Moreover, both courts in *Bank of America* affirmed the Board of Tax

²¹³ *Bank of America Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513 (Ct. Cl.), *cert. denied*, 409 U.S. 949 (1972); *Bank of America Nat'l Trust & Sav. Ass'n v. Comm'r*, 61 T.C. 752 (1974), *aff'd mem.*, 538 F.2d 334 (9th Cir. 1976).

²¹⁴ 459 F.2d at 519.

²¹⁵ *Id.* at 523.

²¹⁶ *Id.*

Appeals' decision in *Seatrains Lines, Inc.*,²¹⁷ in which a tax on gross business income was held to be creditable largely because the rate was set in a manner to reach net income.

It is not enough under these cases to conclude, as the Rulings do, that the expenses incurred producing gross trade or business income are not inherently so small as to insure that they will almost never exceed gross income and produce a loss. In *Bank of America*, the Court of Claims was concerned with taxes imposed on gross income or gross receipts of local branch offices of the taxpayer in Bangkok, Manila, and Buenos Aires. These offices made various types of loans, rendered trust and property management services, engaged in foreign exchange transactions, issued letters of credit, guarantees, travelers' and cashiers' checks, and engaged in trade paper acceptance transactions.²¹⁸ In short, the branches conducted substantial banking operations in the various locations. Although the court stated that a tax on gross income would not automatically be creditable, it did not reject such a tax out of hand, even when imposed on business income.²¹⁹ Rather, it examined the tax carefully to see whether it met the above quoted criteria of an income tax.

The same kind of examination is required in Revenue Rulings 78-233, 78-234, and 78-235. This is particularly important, since the taxes at issue in these Rulings are imposed on a single item of income which, for the most part, is of a passive character, *i.e.*, interest. They differ from the taxes in *Bank of America* which were imposed on income generated from substantial banking operations.

A review of other case and ruling authority relating to the qualification of foreign tax as an income tax confirms that the rulings' *per se* denial of creditability to foreign gross business income taxes is unprecedented. In fact, the Service in the past has published a number of rulings holding that various foreign taxes on particular items of gross income were creditable even though the taxes were imposed on persons earning such income in a local trade or business.²²⁰

The Service in Revenue Rulings 78-233, 78-234, and 78-235 again follows the U.S. Internal Revenue Code rather than the guidance de-

²¹⁷ 46 B.T.A. 1076 (1942), *nonacq.* 1942-2 C.B. 31. See text accompanying note 143 *supra*.

²¹⁸ 459 F.2d at 514-15.

²¹⁹ *Id.* at 518.

²²⁰ See, e.g., I.T. 4025, 1950-2 C.B. 50 (declared obsolete in Rev. Rule. 70-293), 1970-1 C.B. 282; I.T. 4013, 1950-1 C.B. 65 (declared obsolete in Rev. Rul. 71-498, 1971-2 C.B. 434); I.T. 3385, 1940-1 C.B. 103 (declared obsolete in Rev. Rule. 78-345, 1978-38 I.R.B. 12); I.T. 2620, XI-1 C.B. 44 (1932) (declared obsolete in Rev. Rul. 70-277, 1970-1 C.B. 280).

veloped by the courts and the Service in prior rulings to determine the creditability of the taxes in question. By requiring that a foreign withholding tax not be levied on income connected with or derived from a local trade or business within the meaning of section 864 of the Code, the Rulings ignore the substantially equivalent test developed by the courts.²²¹ As discussed throughout this article, a foreign tax, in order to qualify as an income tax within the meaning of section 901, need not be identical or almost identical to the United States federal income tax. It need only conform to the United States concept of an income tax.

The inappropriateness of the three rulings' section 864 "trade or business" standard is illustrated by Revenue Ruling 78-234. Revenue Ruling 78-234 based its holding that the Tanzanian withholding tax on management or professional fees is not a creditable income tax on the classification of the performance of services as a trade or business under section 864 of the Code. The Tanzanian law, however, relied on the internationally accepted permanent establishment standard in determining whether to apply the withholding tax on the gross amount of such fees. So long as the nonresident recipient of the fees did not have a permanent establishment in Tanzania, the withholding tax applies. If the nonresident had a permanent establishment, then the normal Tanzanian net income tax for residents and its own citizens applies.

Under sections 871(a), 881(a), 1441, and 1442 of the Code, withholding taxes are imposed at flat rates on income—generally income of a "passive" nature—derived by nonresident aliens and foreign corporations from sources within the United States. The items so taxed include dividends, interest, rents, royalties, and, in certain cases, capital gains. Withholding taxes are applied to the gross amount of income—*i.e.*, no deductions are permitted. Withholding taxes are not, however, generally imposed on income earned from or, in other words, "effectively connected with," the conduct of a trade or business within the meaning of section 864. Such income is subject to the normal graduated tax rates applicable to United States entities and individuals.

Thus, except where superseded by a tax treaty,²²² it is necessary to

²²¹ See generally *Ad Hoc Comm. on Foreign Tax Credit*, note 49 *supra*.

²²² The United States is a party to the bilateral income tax treaties which alter these rules. Under the treaties, a foreign corporation or individual ordinarily must maintain a "permanent establishment" in the United States before its U.S.-source business income will be taxed. A permanent establishment ordinarily exists only if the foreigner has a branch, office, factory, workshop, or warehouse in the United States, or an employee or a dependent agent in the United States who has general authority to contract, and habitually exercises that authority, for the foreign enterprise or fill orders out of inventory in the United States. See, *e.g.*, Convention for the Avoidance of Double Taxation, July 22, 1954, United States-Federal Republic of Germany, art. II(1)(c),

determine under section 864 whether a nonresident is engaged in a United States trade or business and whether the income is effectively connected with the conduct of such trade or business.²²³ Except with respect to a *de minimis* rule for employees of a foreign employer, the performance of services will always constitute a trade or business under section 864.²²⁴

It is difficult to understand how Revenue Ruling 78-234 can ignore the permanent establishment standard applicable in Tanzania in determining whether the tax is substantially equivalent to an income tax "as that term is understood in the United States."²²⁵ This standard has been adopted in the bilateral income tax treaties to which the United States is a party. In each of these treaties the permanent establishment standard, not the "trade or business" concept applies,²²⁶ and takes precedence over the rules under section 864.²²⁷ Thus, it can be said that the permanent establishment standard is truly a part of the United States income tax law and conforms with the United States concept of an income tax. Furthermore, the concept of a U.S. trade or business and the permanent establishment standards are compatible and play a similar role in an income tax system similar to that of the United States.

These standards are used to determine when local income earned by nonresidents has enough of a business nexus to be subject to the normal net income tax. If there is not such a nexus, the income is usually subject to a withholding tax. Withholding taxes are usually applied at substantially lower rates than the normal net income tax and are levied against the nonresidents' gross income typically to avoid the administrative and practical difficulties in allocating deductions to such income and collecting the tax thereon. Congress indicated this purpose

5 U.S.T. 2768, T.I.A.S. No. 3133. See Williams, *supra* note 200 (detailed discussion of permanent establishment standard).

²²³ I.R.C. §§ 864(b)-(c).

²²⁴ I.R.C. § 864(b)(1).

²²⁵ See note 19 *supra*.

²²⁶ See, e.g., Convention for the Avoidance of Double Taxation, July 9, 1970, United States-Belgium, art. 7(1), 23 U.S.T. 2687, T.I.A.S. No. 7463; Convention for the Avoidance of Double Taxation, July 22, 1954, United States-Federal Republic of Germany, art. III(1), 5 U.S.T. 2768, T.I.A.S. No. 3133, *modified by* Protocol, Sept. 17, 1965, 16 U.S.T. 1875, T.I.A.S. No. 5920; Convention for the Avoidance of Double Taxation, May 24, 1951, United States-Switzerland, art. III(1)(d), 2 U.S.T. 1751, T.I.A.S. No. 2316.

²²⁷ I.R.C. §§ 894(a), 7852(d). For a detailed discussion of the relationships between treaties and the Code, see Brecher, *Relationship and Conflict Between Income Tax Treaties and The Internal Revenue Code*, 24 TAX EXEC. 115 (1972).

at the time it adopted the United States withholding tax system.²²⁸ It was stated in the legislative history that the system "will be productive of substantial amounts of additional revenue, since it replaces a theoretical system impractical in a great number of cases."²²⁹

It also should be pointed out that there are instances in the Internal Revenue Code where a nonresident will be subject to United States withholding tax on his gross income effectively connected with a United States trade or business. This occurs if he fails to file a United States income tax return,²³⁰ or if he files a return where the income is not taxable until a following year in which he is not engaged in a United States trade or business.²³¹

In summary, Revenue Rulings 78-233, 78-234, and 78-235 depart substantially from the *Bank of America* decisions and prior case and ruling authorities. Furthermore, their inclusions of the United States trade or business concept into the determination of a creditable income tax is not warranted by, nor consistent with, the longstanding substantially equivalent test of a qualifying income tax under section 901. In particular, Revenue Ruling 78-234, holding that the Tanzanian tax on management and professional fees is not a creditable income tax, is not supported by the substantially equivalent test, or an examination of applicable United States federal income tax law. As for Revenue Rulings 78-233 and 78-235, the above authorities require an examination of the taxes at issue to determine whether they were designed to reach net gain and were very likely to reach net gain, and whether the predominant characteristic of the taxes is a withholding tax as that term is understood in the United States.

PROPOSED REGULATIONS

On August 25, 1978, the Internal Revenue Service invited comments from the public on a proposed regulation project under sections 901 and 903 of the Code to provide rules for determining whether a tax imposed by a foreign country is a creditable foreign income tax. Comments were furnished by many taxpayers, business associations, and tax practitioners. Most criticized the Service's position in the 1978 Revenue Rulings, and suggested a more flexible or liberal approach toward

²²⁸ Revenue Act of 1936, §§ 211(a), 231(a), 49 Stat. 1648 (1936).

²²⁹ H.R. REP. NO. 2475, 74th Cong., 2d Sess. 10 (1936).

²³⁰ See I.R.C. §§ 874, 882(c)(2).

²³¹ See *id.* at § 864(c)(1)(B); Treas. Reg. § 1.871-8(c).

the definition of an income tax under section 901.²³²

The issuance of proposed regulations under sections 901 and 903 was announced on June 15, 1979, and the proposed regulations were published in the Federal Register on June 20th.²³³ When finalized, the proposed regulations will supersede previous foreign tax credit rulings that are inconsistent and will be applicable to taxable years no later than June 15, 1979.²³⁴ The proposed regulations were intended to provide comprehensive guidance on most, if not all, the questions arising in the foreign tax credit area.²³⁵ An examination of the proposed regulations under section 901 will show that the Treasury's position with respect to the definition of an income tax still reflects on balance the restrictive approach taken in the rulings.

General Definition

Under Prop. Reg. section 1.901-2(b)(1), it is provided that "[i]n order for a foreign tax to be an income . . . tax for purposes of Sections 901 through 908, the tax must be computed on the basis of *realized net income*."²³⁶ This general rule seems to encompass essentially the realization and net gain requirements of an "income tax," provided by Revenue Ruling 78-61. It is interesting that the proposed regulations make no reference to the "receipt of income" requirement for a creditable income tax set forth in Revenue Ruling 78-61. Presumably, the Service dropped this requirement in response to the comments pointing out that such a test finds no support in the case and ruling authority.²³⁷

Section 1.901-2(b)(1) of the proposed regulations also adds a new

²³² See, e.g., Ad Hoc Comm. on the Foreign Tax Credit, note 49 *supra*; Foreign Tax Credit Subcomm., *supra* note 36, at 33-67; Nordberg & Schwartzstein, note 91 *supra*.

²³³ 44 Fed. Reg. 36071 (1979) (to be codified in 26 C.F.R. Part I).

²³⁴ The proposed regulations apply to taxable years beginning after June 15, 1979, with respect to a taxpayer that chooses to rely on a revenue ruling or regulation in effect on that date. Provisions in the proposed regulations which reflect the existing position of the Internal Revenue Service, however, will be applied to all open taxable years. Existing rulings which are inconsistent with the final regulations will no longer be effective after the issuance of final regulations, and the positions espoused in the proposed regulations will be applicable to ruling requests presently under consideration pending the issuance of final regulations. Treasury Dep't, *Summary of the Proposed Foreign Tax Credit Regulations and Related Material* (News Release B-1662) (June 15, 1979) [hereinafter cited as *Summary*], reprinted in [1979] 10 STAND. FED. TAX REP. (CCH) ¶ 6672.

It would appear from the proposed regulations that if an inconsistent ruling does not specifically apply to a tax in question, the proposed regulations, when promulgated, will be retroactive even if the revenue ruling holds that an identical tax of another country is creditable. *But see* Rev. Rul. 79-140, 1979-1 C.B. 239.

²³⁵ *Summary*, note 231 *supra*.

²³⁶ Emphasis added.

²³⁷ See, e.g., Foreign Tax Credit Subcomm., *supra* note 36, at 58-62.

rule to the definition of "income tax." This definition specifically excludes a tax, the liability for which depends on whether a credit for the tax is available in another country. The reason given for this exclusion is that such an income tax is not substantially equivalent to the U.S. income tax.²³⁸ That is, the United States, in imposing the federal income tax, does not distinguish between persons who can and cannot credit the tax against the tax liability of another country.²³⁹ This rationale seems tenuous at best.

The longstanding definition of an "income tax" articulated by the courts is not the substantial equivalent of the United States federal income tax but the "substantial equivalent of an income tax as that term is understood in the United States."²⁴⁰ The difference, as discussed earlier,²⁴¹ is more than academic. A foreign tax that is based on realized net income is the substantial equivalent of an income tax as that term is understood in the United States, regardless of whether the tax is imposed only on companies that are entitled to a credit in another country. To exclude such a tax from the definition of an income tax distorts the meaning of "income tax" by requiring a foreign tax, at least in this instance, to be the "mirror image" of the Code²⁴²—a position, as previously pointed out,²⁴³ that is without support in statutory, case, or ruling authority. Moreover, it sets a bad precedent. The proposed regulation, if carried to its logical conclusion, would enable the Service to argue that any foreign tax which does not completely mirror the Code, even though based on realized net income, does not qualify under section 901. This result certainly cannot be justified.

Consequently, while it may be in the interests of national policy to deny a tax credit for such taxes, such denial does not belong in the definition of "income tax." In fact, it is highly questionable whether the Treasury has the authority, under section 901, to deny the credit to such a tax. If such a posture is deemed necessary, it would seem necessary to implement it by legislative amendment, or by international or bilateral treaty or agreement.

Finally, Prop. Reg. section 1.901-2(b)(1) provides that foreign tax

²³⁸ 44 Fed. Reg. at 36073.

²³⁹ See text accompanying notes 18-19 *supra*.

²⁴⁰ See note 19 *supra*.

²⁴¹ See text accompanying notes 18-24 *supra*.

²⁴² It is difficult to reconcile this treatment with the Treasury's statement in the *Summary* of the proposed regulations that "[t]he characteristics of the U.S. tax system are not being applied, however, in a mirror-image fashion to require exact congruence with the U.S. tax code." *Summary*, note 234 *supra*.

²⁴³ See text accompanying notes 144-45 *supra*.

provisions regarding source of income or residence as a basis for tax jurisdiction are *generally* not taken into account in determining whether a tax is an income tax.²⁴⁴ By adopting this rule, the proposed regulations appear to reaffirm the Service's position in Revenue Ruling 78-62 not to follow the holding in *Burk Bros.*²⁴⁵ that an Indian tax levied on income deemed to arise from the purchase of goods is a creditable income tax. This position was based on the conclusion that the tax was levied without reference to income actually realized during the year. The fact that the Indian tax was imposed on income sourced under Indian law at the place of purchase was ignored, apparently as being irrelevant to the income tax determination.

It is not clear what the Treasury had in mind by modifying this rule with the word "generally." Perhaps this language was used to cover certain taxes which are excepted from the general realized net income rules. For example, "generally" may be intended to apply to foreign taxes imposed on the export of goods described under Prop. Reg. section 1.901-2(b)(3)(i)(C), which is discussed below.²⁴⁶ It might be argued that such taxes qualify as income taxes because foreign law provides that local source income is generated at the time of export. The Treasury, has indicated that such exceptions were made "to accommodate legitimate tax policy of foreign tax systems,"²⁴⁷ the implementation of which could be reflected in the foreign tax laws' source-of-income rules. On the other hand, the addition of "generally" may be intended simply to provide the Service with sufficient flexibility of action in future cases.

Income Requirement

Proposed Reg. section 1.901-2(b)(2) repeats the rule that the base on which the tax is computed must be income.²⁴⁸ The tax cannot be on wealth, accumulated profits, or other non-income amounts.²⁴⁹ A tax is not considered to be a tax on accumulated profits solely because it is computed on the basis of the average amount of net income realized in consecutive years prior to the year for which the tax is imposed.²⁵⁰ A tax is not an income tax if its base is the amount of wages paid by the

²⁴⁴ 44 Fed. Reg. at 36073.

²⁴⁵ 20 B.T.A. 657 (1930) (decided for the Commissioner on other grounds).

²⁴⁶ See text accompanying notes 252-53 *infra*.

²⁴⁷ Summary, note 234 *supra*.

²⁴⁸ 44 Fed. Reg. at 36073.

²⁴⁹ *Id.*

²⁵⁰ *Id.*

taxpayer or the value of capital or other assets.²⁵¹

This provision clearly reflects prior statutory interpretation and case and ruling precedent. Obviously, a foreign tax, in order to qualify as an "income tax" must reach income. There is, however, some uncertainty in Prop. Reg. section 1.901-2(b)(2)'s use of the term "accumulated profits." It provides that a tax on "accumulated" profits is not a tax on income,²⁵² presumably referring to an accumulated earnings tax similar to the one imposed by section 531 of the Code. A "tax on accumulated profits," however, may encompass much more. Even with the exception in the proposed regulations for taxes imposed on average net income in previous years, true income taxes may be disqualified because they have different tax accounting period rules than the Code. Hopefully, clarification of this point will be forthcoming in the final regulations.

Realization Requirement

Proposed Reg. section 1.901-2(b)(3)(i) requires generally that in order for a tax to be computed on the basis of realized net income and to qualify as an "income tax," it must be imposed at the time of realization of income.²⁵³ This section further explains that this requirement is satisfied if the taxable event (1) results normally in the realization of income by taxpayers under the income tax provisions of the United States Internal Revenue Code and regulations; (2) occurs after the realization of income under the Code and regulations; or (3) constitutes the export from the foreign country of stock in trade or other property which properly would be included in the inventory of the taxpayer if on hand at the close of the year, or of property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. However, in order for the export tax to satisfy the realization requirement, it must be computed on the basis of the fair market value of the export property at the time of export, and the foreign government must not impose any charge on the disposition of the exported property outside the country upon or after an event described in (1) or (2).²⁵⁴

The proposed regulations basically adopt the realization requirement set forth in Revenue Ruling 78-61, as expanded to cover taxes that levy on post-realization events and on the export of inventory-type

²⁵¹ *Id.*

²⁵² *Id.*

²⁵³ *Id.*

²⁵⁴ *Id.*

assets under certain circumstances.²⁵⁵ First and foremost, the tax satisfies the general realization of income requirement when it is levied on a normally realizable event in the context of the United States Code and regulations. The use of "normally" may indicate an intention to apply the "predominant character" doctrine to the extent of a tax's general similarity to the U.S. Code. If this is the case, it is a move away from Revenue Ruling 78-61, which totally ignored this doctrine.

On the other hand, the proposed regulations' use of "normally" in this case may evidence an intention to follow Revenue Ruling 78-61. This term may refer to the "substantially equivalent" portion of the realization test in the Ruling. In order to satisfy the realization requirement of Revenue Ruling 78-61, a foreign tax must be levied on gain which is realized to a substantially equivalent degree as gain is realized in the U.S. federal income tax.²⁵⁶

The proposed regulations, however, expand the realization test in Revenue Ruling 78-61 beyond the realization of gain generally found in the United States federal income tax laws. They provide that a foreign tax will be treated as imposed at the time of realization when the taxable event occurs *after* an event which normally results in the realization of income under the United States Internal Revenue Code and regulations.²⁵⁷

The application of this rule is illustrated in example (4) of Prop. Reg. section 1.901-2(d).²⁵⁸ In this example, a foreign country allows individuals to deposit amounts of earned income in a "retirement savings account" (RSA) and receive a deduction for the deposit for income tax purposes. When amounts are paid out of the RSA, country X subjects those amounts to a separate twenty per cent tax.

Although the RSA does not meet the standards of an Individual Retirement Account in section 408(a) of the Code, and no deduction would be allowed under section 219(a)(1) of the Code for the deposits, the example holds that the realization requirement is satisfied because the tax is imposed at the time of an event (withdrawal) which occurs after income is realized under the federal income tax laws.

The Treasury may have allowed the taxation of post-realization gains since the gain taxed in the foreign country had already been taxed in the United States. Perhaps it considered that the only difference between the two systems would be the timing of when the tax is

²⁵⁵ 1978-1 C.B. 221.

²⁵⁶ *Id.*

²⁵⁷ 44 Fed. Reg. at 36073.

²⁵⁸ *Id.* at 36075.

levied. If this is the case, it should be pointed out that a post-realization foreign tax would not necessarily tax the same income realized and taxed under the Internal Revenue Code. A number of events could happen between the time of realization under the Code and the time thereafter when the foreign tax would be levied to reduce materially the income subject to the foreign tax. These events could include, for example, market downturns, government price controls, and obsolescence. In any event, one wonders how many foreign taxes will be affected by this provision and, consequently, how broad an impact it will have on United States taxpayers.

The other exception in the proposed regulations to the Internal Revenue Code concept of realization involves taxes levied on the export of inventory-type assets.²⁵⁹ In including this exception, the proposed regulations reverse that part of Revenue Ruling 78-63 which held that the surtax under the Libyan Petroleum Law failed the realization requirement because the surtax can be imposed on profits computed at the time of export rather than from the sale of oil and gas.²⁶⁰ Apparently, the Treasury recognizes the interest of a country in ensuring that income arising from products produced in its country but sold outside do not escape taxation.²⁶¹ Further, it realizes that the United States tax law recognizes that inventory or goods in trade will normally be sold and gain realized in the United States tax sense shortly after export.

The proposed regulations also withdraw somewhat from the position set forth in Revenue Ruling 78-62 and Revenue Ruling 78-63 that an income tax must be applied against actual receipts rather than estimated receipts.²⁶² Presumably, this change in the case of exports reflects a recognition on the part of the Treasury that many "income taxes," including the United States federal income tax, may as a practical matter, tax estimated receipts in certain situations for legitimate policy objectives. This position seems compatible with the flexible approach toward the definition of income tax reflected in the prior case and ruling precedent.²⁶³ Unfortunately, the proposed regulations take an overly restrictive view of the value at which the income is taxed at

²⁵⁹ Prop. Reg. § 1.901-2(b)(3)(i)(c), *id.* at 36073.

²⁶⁰ See that portion of the discussion of Rev. Rul. 78-63 at text accompanying notes 144-62 *supra*.

²⁶¹ In the *Summary* of the proposed regulations, the Treasury stated that "specific exceptions to the general standards [of the U.S. tax system] have been provided in certain cases to accommodate legitimate tax policy objectives of Foreign Tax Systems." *Summary*, note 234 *supra*.

²⁶² 1978-1 C.B. 226; 1978-1 C.B. 228.

²⁶³ See text accompanying notes 44-52 *supra*.

export and of the involvement of the foreign government levying the tax after export.

The proposed regulations require that the tax on exports be computed on the basis of the fair market value of such property at the time of export. Example (3) of Prop. Reg. section 1.901-2(d) illustrates what is meant by fair market value at the time of export. In this example, a foreign country levies a tax on the net gain of petroleum companies determined when the petroleum is sold or exported, whichever event occurs first. The foreign country's tax board uses a set price for determining gain derived from exports based on a four-month average of prices used in arm's-length sales of similar or identical crude oil. The set price is determined retroactively every four months by the board and cannot be contested by taxpayers. Although the oil exported is properly included in the inventory of the taxpayer if on hand at the end of the year, and is taxed at the time of export, the tax does not satisfy the realization requirement because it is not computed on the basis of the fair market value of the petroleum of each taxpayer at the time of export.²⁶⁴

The approach in this example does not recognize the difficulties in calculating the fair market value of a product such as oil with its various grades and volatile prices punctuated by wildly fluctuating spot sales at prices which may be well above average market price. It may not be possible to arrive at the fair market value of a product on a specific date for a specific transaction without reference to average prices of a comparable product over a specified period of time.

It is difficult to see why the period of four months in example (3), over which prices are averaged to reach fair market value, is excessive. Indeed, there is no limit in the regulations under sections 863 and 864 of the Code for the period within the taxable year from which third-party sales may be used in determining the fair market value of products deemed under those sections to be sold in the United States.²⁶⁵ Furthermore, the Service, when determining a price for crude oil sold between related United States taxpayers for section 482 purposes, looks to an average market price over a specified period of time, rather than spot sale prices at the date of sale.²⁶⁶

²⁶⁴ 44 Fed. Reg. at 36074.

²⁶⁵ Treas. Reg. §§ 1.863-3(b), 1.864-6(c).

²⁶⁶ Although without precedential value, the application of the realization test in Prop. Reg. § 1.901-2(b)(3)(i), as modified by the substantial equivalence test of Treas. Reg. § 1.901-2(c)(1), is illustrated in a recent private letter ruling, LTR 8009045 (Dec. 4, 1979). In ruling that the taxes under the Thailand Petroleum Income Tax Act, as proposed to be amended, qualified as a credita-

The proposed regulations also provide that the export tax exception applies only if the foreign government does not impose a charge on the disposition outside the country of the same exported property upon occurrence of an event resulting in realization under the Code or an event after such an event.²⁶⁷ Apparently, this limitation is included to ensure that the tax upon export is in lieu of a tax on realized gain. The tax is presumably imposed to ensure that unrealized income with respect to the exported products is taxed before leaving the country's jurisdiction. Such an aim appears reasonable. Unfortunately, however, the proposed regulations as drafted would cover any charge by the for-

ble income tax, the Service concluded that generally the tax is imposed either at the time of sale, a realization event under Prop. Reg. § 1.901-2(b)(3)(i)(A), or at the time of export, a realization event under Treas. Reg. § 1.901-2(b)(3)(i)(C).

Under the Act as amended, gross taxable revenue includes in addition to petroleum sales receipts, the value of exported petroleum, the value of petroleum delivered to a refinery, the value of petroleum used by the companies for their own purposes, and the value of petroleum paid in satisfaction of a royalty. In the case of exports, the taxable value of petroleum is based on market price. The market price is defined as the price in an open market, or in the absence of an open market, the price which would be charged unrelated persons. It was represented to the Service that the Thai government will look to all the relevant facts and circumstances in determining market price and that the taxpayer has the right under Thai law, unlike example 3 of Prop. Reg. § 1.901-2(d), to appeal the government's determination. Although it is assumed that exported petroleum revenue is valued at the market price on the day of export, it is not so stated in the provisions of the Act furnished by the Ruling. Further, it is unclear how the market price at this date is to be determined other than to look to the open market.

In the case of delivery of petroleum for refining, the value of the petroleum shall be determined as of the date on which the refined product will be sold or exported and shall be included as revenue in the accounting period in which such export occurs. The determination of market price and quantity of petroleum shall be made by apportioning to the value of petroleum an appropriate portion of total sales proceeds to the refined products or total market price of exported refined production in a manner consistent with the accounting methods, rules and practices in the petroleum industry.

In the case of petroleum paid as a royalty, the ruling acknowledges that the imposition of the tax does not deviate from U.S. realization principles, and therefore would be considered to be levied on a realization event within the meaning of the proposed regulations' substantial equivalence test.

Finally, the Service concludes that although the appropriation of petroleum by a company for its own uses (other than for sales) generally would not be considered a realization event under United States principles, the amount of petroleum that petroleum companies as a class extract and use in their own operations is insignificant for purposes of applying the substantial equivalence test under Prop. Reg. § 1.901-2(c)(1). By ignoring such sales, the Service introduces a *de minimis* rule to the realization requirement under the proposed regulations and seems to confirm that the aberration rule in Rev. Rul. 78-61 will not be followed in the proposed regulations.

It is curious that LTR 8009045 makes no mention of the requirement in Prop. Reg. § 1.901-2(b)(3)(i) that in order for the export tax under Prop. Reg. § 1.901-2(b)(3)(i)(C) to satisfy the realization test, the foreign taxing authority many not impose any charge on the disposition outside the foreign country of the same exported property upon occurrence of an event described in Prop. Reg. §§ 1.901-2(b)(3)(i)(A) or (B).

²⁶⁷ Prop. Reg. § 1.901-2(b)(3)(i), 44 Fed. Reg. at 36073..

eign taxing country after the export, whether or not levied on the realized gain. Stamp taxes and other non-income type taxes may be imposed at the time of sale that are not in lieu of, or otherwise related to, the tax on the unrealized gain at export. As far as the realization requirement is concerned, their imposition should not affect the tax levied on exports.

It also should be mentioned that the special, more restrictive rule for determining whether a tax of limited application is a creditable income tax—the so-called “aberration rule”—introduced in Revenue Ruling 78-61, has not been incorporated into the realization requirement definitional provisions of the proposed regulations.²⁶⁸ In a number of the comments sent at the invitation of the Service with respect to its proposed regulations under sections 901 and 903, it was pointed out that the “aberration” rule had no basis or authority in the case law and rulings.²⁶⁹ Apparently, such comments convinced the Treasury to drop this rule at least as a specific factor in the realization determination in the proposed regulations.²⁷⁰ As will be discussed later, however, the proposed regulations incorporate a new aberration rule in their definition of separate charge which may have a much greater effect on denying income tax treatment.²⁷¹

Although not specifically addressed to the question of realization, there is another provision in the proposed regulations that affects the realization test for an “income tax.” Proposed Reg. section 1.901-2(c)(1) provides under the “Rules of Application” that a foreign tax must satisfy the “realized net income” test of Prop. Reg. section 1.901-2(b)(1) only to a degree which is substantially equivalent to the degree to which the U.S. income tax satisfies those requirements.²⁷²

It is not clear what is intended by this provision. With regard to the realization requirement, it can be said that it merely reiterates the test in Revenue Ruling 78-61 that a tax must be levied on realization in a degree substantially equivalent to the United States Code. If this were all that is intended, it would not only inaccurately describe the substantial equivalence test, as discussed earlier with respect to Reve-

²⁶⁸ See discussion of the realization requirement in Rev. Rul. 78-61, 1978-1 C.B. at 223-24, and in the text accompanying notes 24-52 *supra*. But see Lipson, *The Foreign Tax Credit: Dead or Alive?*, 57 TAXES 984, 993 (1979) (indicating that the “aberration rule” may still be applied by the Service after the issuance of the proposed regulations).

²⁶⁹ See Foreign Tax Credit Subcomm., *supra* note 36, at 54-55.

²⁷⁰ The regulations in question refer to those discussed in the Treasury Department’s *Summary*, note 234 *supra*.

²⁷¹ Prop. Reg. § 1.901-2(c)(2)(iii) will be discussed in the text accompanying notes 317-18 *infra*.

²⁷² 44 Fed. Reg. at 36074.

nue Ruling 78-61,²⁷³ but also add little to the realization definition under the proposed regulations. Moreover, section 1.901-2(b)(3)(i)(A) of the proposed regulations already provides that a tax, if levied on an event that normally results in realization of income under the Code,²⁷⁴ is computed on realized income.

Consequently, Prop. Reg. section 1.901-2(c)(1) may be intended to provide a safe harbor rule for a foreign tax to qualify as an "income tax" based on "realized net income." Under this interpretation, a foreign tax will qualify as an "income tax" if it satisfies the realization and net income requirements of the proposed regulations, to a degree substantially equivalent to which the United States federal income tax satisfies these requirements. Thus, in this case, the tax would qualify even if either or both of the tests in the proposed regulations are not met literally in all respects. If this is an accurate interpretation, the rule may have been added in response to criticism of the 1978 revenue rulings that they do not recognize in the realization requirement that the Code and regulations contain a number of provisions that levy against unrealized gain.

This interpretation, however, raises another question. It is unclear whether the safe harbor rule is intended to apply to any foreign tax that taxes unrealized gain in a manner which is substantially equivalent to the Code, or is intended to apply only to a tax which is the substantial equivalent of the United States federal income tax, including provisions taxing unrealized gain like section 482 or Subpart F.²⁷⁵ If the former is intended, then a foreign tax which has provisions substantially similar to the Internal Revenue Code provisions that tax unrealized gain, and which otherwise qualifies as an income tax, will qualify under the realization requirement. Under the latter, however, the application of the rule will be limited to those foreign taxes of general application which are substantially identical to the federal income tax. Further explanation and illustration of the rule in Prop. Treas. Reg. section 1.901-2(c)(1) is needed.

Proposed Reg. section 1.901-2(b)(3)(ii) also seems to clarify, if not expand, the scope of the realization requirement under Revenue Ruling 78-61. Under this provision, a tax is based on realized income if the foreign law requires the taxpayer to compute his tax liability based on its proportionate share of the income realized by an entity such as a corporation, trust, or estate which the taxpayer owns or controls, or in

²⁷³ See text accompanying notes 24-52 *supra*.

²⁷⁴ 44 Fed. Reg. at 36073.

²⁷⁵ I.R.C. §§ 951-964.

which the taxpayer has an interest. This provision apparently is intended to cover foreign taxes that have provisions similar to Subpart F of the Code that tax the beneficial interest holder of an entity for the income realized by the entity.²⁷⁶ This rule properly focuses attention, as far as the realization requirement is concerned, on the taxable event, rather than on the question of whether the entity or its interest holder is subject to the tax.

It should be pointed out that Prop. Reg. section 1.901-2(b)(3)(ii) does not change the realization requirement itself. Income still must be realized by the entity in which the taxpayer is an interest holder before this proposed regulation can apply. For example, if under a foreign tax law similar to section 482 of the Code and its regulations,²⁷⁷ interest income were allocated to a parent corporation as a result of an interest-free loan from its subsidiary which had no income, Prop. Reg. section 1.901-2(b)(3)(ii) would not apply because the income allocated had not been realized. The taxpayer would have to turn to the substantial equivalence to United States income tax rule in Prop. Reg. section 1.901-2(c)(1) to avoid violating the realization test. He would have to argue that since a similar adjustment would have been effected under section 482 of the Code, such an adjustment should not affect the foreign tax's qualification as an income tax.

Although the proposed regulations seem to offer little real change of direction with respect to the realization requirement, they do expand conceptually the scope of this requirement as set forth in Revenue Ruling 78-61. They treat the realization requirement with more flexibility when the only difference between the foreign tax and the United States income tax is the timing of the tax on the gain. They allow this requirement to be satisfied if the tax is levied on an event which occurs after realization under the Code and on a taxable event occurring before realization where the event is the export of inventory-type assets under certain circumstances.

Since the draftsmen of the proposed regulations have broken the conceptual barrier of allowing foreign taxes to qualify as an "income tax" that are levied on an event other than realization as understood under the Code, it is difficult to understand why the proposed regulations limit qualifying taxes on prerealization events to the narrowly defined export tax situation. They may want to be certain that the gain taxed upon export would be realized and that the estimated receipts

²⁷⁶ *Id.*

²⁷⁷ Treas. Reg. § 1.482-1(d)(4). See note 49 *supra* for further discussion.

would be as close as possible to actual receipts. There is, however, no guarantee that this result will occur under the proposed regulations.

It is, therefore, hoped that the proposed regulations are revised to provide that a foreign tax that is levied on an event which occurs before realization under the Code should satisfy the realization of income requirement in Prop. Reg. section 1.901-2(b)(3), so long as it can be reasonably expected that the gain taxed will be realized within a reasonable period thereafter, and that the tax is computed on the basis of fair market value or government controlled prices at the date of taxation.²⁷⁸ With such a rule, the flexibility inherent in the definition of an income tax, and expressed in the case authority would be preserved. Reasonable methods of computing fair market value on the export date should be included, allowing an average of market prices over a reasonable period of time. While there may be more interpretative problems under such an expanded test the problems do not appear to be insoluble.

Net Income Requirement

The proposed regulations adopt a net income test for an income tax that is very similar to the net gain test in Revenue Ruling 78-61. Prop. Reg. section 1.901-2(b)(4)(i) provides that a tax is computed on the basis of net income only if the tax is computed in a manner which allows a reasonable opportunity to recover the significant expenses and capital expenditures incurred in deriving gross receipts.²⁷⁹

Proposed Reg. section 1.901-2(b)(4)(ii) provides that in determining whether an expense or capital expenditure is significant, the principal considerations are: (1) whether disallowance of the recovery of the expense or expenditure would generally increase significantly the amount of taxable income, in the U.S. sense, of taxpayers subject to the foreign tax, and (2) whether the disallowed expense or capital expenditures are generally otherwise significant with respect to the type of ac-

²⁷⁸ Although some scholars do not consider that conformity with United States realization provisions of the Code is a necessary requirement for a creditable tax, they point out that in analyzing realization, care must be taken to distinguish cases in which there is never any income in the U.S. Code sense and in those cases in which there is a discrepancy between the timing of the imposition of the foreign tax and a realization that conforms to the U.S. rules. Thus, if there were a realization requirement, an otherwise qualifying foreign tax imposed on the manufacture of products or upon their export would have sufficient similarity to the U.S. concept of realization to qualify as a foreign tax because there is an overwhelming likelihood that the products manufactured or exported will be sold or exchanged for value. Ad Hoc Comm. on the Foreign Tax Credit, *supra* note 49, at 58-59.

²⁷⁹ 44 Fed. Reg. at 36073.

tivities from which income is derived.²⁸⁰ It does provide that the recovery of capital expenditures and expenses may be subject to reasonable limitations, but that a limitation is not reasonable if it effectively negates the recovery of a significant expense or capital expenditure.²⁸¹ Expenses and capital expenditures incurred in deriving interest or dividend income not derived from the conduct of a trade or business in any country and such expenditures by an employee in deriving income from personal services are presumed not to be significant. Accordingly, it provides that taxes on the gross amount of those items of income satisfy the net income requirement.²⁸²

The use of the term "recovery" in the proposed regulations for both expenses and capital expenditures, rather than "deduction" as used in Revenue Ruling 78-61, and the acceptance of "reasonable limitations" may indicate an intention to allow this requirement to be satisfied under a variety of recovery methods and over various time periods.²⁸³ In addition to the deductibility of current expenses, it appears to recognize, for example, capital recovery which may differ from the methods of depreciation and amortization under the Code.

The basic net income test of the proposed regulations, however, differs little from the net gain test in Revenue Ruling 78-61 and the other 1978 rulings. As discussed earlier,²⁸⁴ in order for a tax to satisfy the net gain requirement under Revenue Ruling 78-61, it had to be almost certain of not reaching taxable income when the taxpayer has no gain, or suffers a loss "in the United States sense." According to the ruling, this rule is satisfied in the case of a tax on business profits when the tax permits the deduction of all generally significant expenses incurred in earning gross income.

Proposed Reg. section 1.901-2(b)(4)(ii) reaches the same result, albeit through a different approach. Under the proposed regulations a tax must allow a reasonable opportunity to provide recovery for significant expenses and capital expenditures. In determining whether an expense or capital expenditure is significant, the proposed regulation provides that one of the two principal considerations is whether disallowance of the recovery of the expenditure would generally increase

²⁸⁰ *Id.* at 36073-74.

²⁸¹ *Id.* The net income test, as in Revenue Ruling 78-61, is defined in terms of the general class of taxpayers and not with respect to a particular taxpayer or taxable year.

²⁸² *Id.*

²⁸³ *Id.* at 36073. The proposed regulations seem to follow the standard for the recovery of capital expenditures in Rev. Rul. 78-222, discussed in note 186 *supra*.

²⁸⁴ See text accompanying notes 53-93 *supra*.

significantly "the amount of taxable income (in the U.S. sense) of taxpayers subject to the foreign tax."²⁸⁵ Thus, like the net gain test in Revenue Ruling 78-61, the net income test in the proposed regulations requires a comparison of the foreign tax base with "taxable income in the U.S. sense."

Proposed Reg. section 1.901-2(b)(4)(ii) does not, however, describe what is meant by expenses or expenditures that generally increase significantly taxable income in the U.S. sense. To define a significant expense as an expense that significantly decreases taxable income in the U.S. sense seems simply to state that an expense is significant because it is significant. Unfortunately, the examples in the proposed regulation are similarly unenlightening.

Example (5) of Prop. Reg. section 1.901-2(d) describes a tax imposed on business income that is computed by deducting actual expenses from realized income.²⁸⁶ The tax law, however, limits the amount of deductible expenses to eighty percent of gross receipts. The example concludes, therefore, that this limitation does not allow a reasonable opportunity to recover significant expenses or capital expenditures.²⁸⁷ There is nothing in the examples, however, which offers any insight into the kinds of expenses that would, if disallowed, "generally significantly increase the amount of taxable income in the U.S. sense," nor what is "taxable income in the U.S. sense."²⁸⁸

²⁸⁵ 44 Fed. Reg. at 36073-74.

²⁸⁶ *Id.* at 36074-75.

²⁸⁷ If adopted in the final regulations, example (5) will revoke Rev. Rul. 72-346, 1972-2 C.B. 436. This Ruling held that a Botswana tax, modified by agreement between the government and the taxpayer, relating to the taxpayer's income from mining operations, was found to qualify as a creditable income tax, where under the tax law as modified, the taxpayer's mining capital expenditure deductions in any one year were limited to 75% of its net income (before such deduction). See Rev. Rul. 76-215, 1976-1 C.B. 194; I.R. 1638, note 11 *supra*. See also Lipson, *supra* note 268, at 994 n.87. As was pointed out in the discussion of the revocation of Rev. Rul. 59-120 and Rev. Rul. 56-658 by Rev. Rul. 78-62, see notes 134-38 *supra*, the treatment of all tax systems which provide a standard percentage deduction from gross income as failing to satisfy the net income or net gain requirement may be too strict. It ignores cases in which it can be shown that over a reasonably long time taxpayers' actual expenses will not exceed their gross income or receipts.

²⁸⁸ Example (6) of Prop. Reg. § 1.901-2(d), although illustrating the special separate charge rule under Prop. Treas. Reg. § 1.901-2(c)(2)(iii), makes it clear that the proposed regulations will follow the position in Rev. Rul. 76-215, 1976-1 CB 194, IR 1638, note 11 *supra*, and Rev. Rul. 78-424, 1978-2 CB 197, that in order to provide a reasonable opportunity for the recovery of significant expenses and capital expenditures, a qualifying foreign income tax on mineral extraction income must be applied against income of the taxpayer's entire mining operations in the country. In the example itself, it is stated that an otherwise qualifying general income tax did not allow such recovery (although it permitted the carryover of losses to other periods), where under local law an oil company's drilling operations in respect to each well must be conducted by a separate company, and where the filing of consolidated returns is not permitted. Although this example

Without such guidance, the inference is that the Service will administer the net income test under the proposed regulations as was done in Revenue Ruling 78-61. If this is the case, it will compare generally the foreign tax base with taxable income under the United States Internal Revenue Code, and the deductions allowable under the foreign tax law with the deductions provided under the Code.²⁸⁹ As pointed out in the discussion of Revenue Ruling 78-61 in this article, such a rule is not supported by either case or previous ruling authority. Consequently, it is hoped that further clarification of the net income test under Prop. Reg. section 1.901-2(b)(4) will be forthcoming in the final regulations—clarification which provides that substantial identity between the foreign tax base and taxable income under the Code is not required to satisfy the net income test.

Another "principal" consideration is provided in the proposed regulations for determining whether the disallowance of the recovery of an expense or capital expenditure is "significant." It is "whether the disallowed expenses or capital expenditures are generally otherwise significant [other than by significantly increasing taxable income in the U.S. sense if they were disallowed] with respect to the types of activities from which the income is derived."²⁹⁰

It is difficult to understand what is meant by this "consideration." The proposed regulations already provide that significance is connected to the effect of the expense on the tax base.²⁹¹ This other test apparently is a qualitative test based on the types of activities from which the income subject to tax is derived. If this is the case, it is difficult to understand how this consideration affects the question whether the foreign tax is levied against net income.

It may be an attempt to focus on a certain class of taxpayers or activities within the application of a general income tax. The income

seems unrealistic in assuming that an oil company would be required to incorporate each well it has drilled in a foreign country (vis à vis each oil field), it apparently is intended to show that the Service's consolidated mining operations rule in the previous rulings cannot be circumvented by the foreign country's requirement that separate companies operate each well or field.

In example (7) of Prop. Reg. § 1.901-2(d), a country requires that a person engaged in unrelated lines of business conduct each line of business through a separate corporation. Even though the country does not permit the filing of consolidated returns, the net income requirement is held to be satisfied because the carryover of losses to other periods is considered to provide reasonable opportunity for recovery of significant expenditures.

²⁸⁹ As indicated earlier, the comparison under the proposed regulations is a general one as to the recovery or nonrecovery of the expenses or capital expenditures and does not require substantial identity in the taxable income of the two taxes in any taxable year.

²⁹⁰ Prop. Reg. § 1.901-2(b)(4)(ii).

²⁹¹ *Id.* at § 1.901-2(b)(1).

derived therefrom would be subject to the net income tax. Under this interpretation, an otherwise qualifying general income tax may not necessarily satisfy the net income test as it applies to a particular industry. This would occur if the unrecoverable expenses or expenditures, although not significant with respect to taxable income of a general income tax under the first test of Prop. Reg. section 1.901-2(b)(4)(ii), are significant if viewed only with respect to the income derived from that industry. This has the effect of negating the "predominant character doctrine" and is contrary to the position of Revenue Ruling 78-61 that a foreign tax qualifies as an income tax by reference to the entire class of taxpayers. In addition, it seems to accomplish the same result as Prop. Reg. section 1.901-2(c)(2)(iii) which dictates when a general income tax with respect to its application to certain industries is a separate charge. Since it is doubtful that the Service intended to reach the same result under both provisions, such an interpretation of Prop. Reg. section 1.901-2(b)(4)(ii) presumably was not intended. Hopefully, in the final regulations the Service will delete this second "principal" consideration for determining significance.

Proposed Reg. section 1.901-2(b)(4)(ii) also provides that expenses and capital expenditures incurred by a person in deriving dividend and interest income, not derived from the conduct of a trade or business in any country or by an employee deriving income from personal services, are presumed to be insignificant.²⁹² Accordingly, foreign taxes, which levy on the gross amount of such items of income, will satisfy the net income requirement under the proposed regulations. This is presumably based on the rationale articulated by the Court of Claims in *Bank of America*²⁹³ and the Service in Revenue Ruling 78-61²⁹⁴ that the expenses and capital expenditures incurred in earning this income will always be less than the gross amount of the income.

Withholding Taxes

Proposed Reg. section 1.901-2(b)(4)(iii) deals with gross taxes on fixed or determinable income—*i.e.*, withholding taxes. This section first provides that a foreign tax need not satisfy the net income requirement if it is imposed on fixed or determinable income of the type subject to withholding tax under the Code.²⁹⁵ This is the case provided the

²⁹² 44 Fed. Reg. at 36073-74.

²⁹³ *Bank of America Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 515 (Ct. Cl.), *cert. denied*, 409 U.S. 949 (1972).

²⁹⁴ 1978-1 C.B. at 224.

²⁹⁵ 44 Fed. Reg. at 36074.

income is derived by a nonresident of the foreign country or a foreign (to the host country) corporation or other entity, and provided the income is not derived from the conduct of commerce within the foreign country imposing the tax.²⁹⁶ Thus, the proposed regulations generally require that creditable foreign withholding taxes parallel U.S. withholding taxes.

One slight deviation from the Code is provided in the proposed regulations. Rather than using the term "engaged in the conduct of a trade or business," as found in section 864, the regulation uses the term "the conduct of commerce."²⁹⁷ This is defined to mean a level of activities in a foreign country which is not materially greater than the minimum level necessary for the person to be considered to be engaged in a trade or business under U.S. principles.²⁹⁸ Whether this is intended as a concession to use of the international "permanent establishment" concept remains to be seen. The difficulty, of course, lies in the definition of what level of activity is considered "materially greater" than the minimum level for engaging in a trade or business.²⁹⁹

The proposed regulations further provide that a person shall not be considered to be engaged in the conduct of commerce within a foreign country solely because of the presence of an individual or individuals in the foreign country for a period of 183 days or less in a taxable

²⁹⁶ *Id.*

²⁹⁷ *Id.*

²⁹⁸ *Id.*

²⁹⁹ The Service recently applied this test in three private letter rulings. LTR8010025 (December 11, 1979), LTR8010040 (December 11, 1979), and LTR8010093 (December 14, 1979). The rulings involved the question whether the 21% Mexican federal gross tax on interest paid by Mexican residents to foreign financial institutions registered with the Mexican Ministry of Finance and Public Credit is an income tax under § 901 of the Code. Under the effective Mexican banking law, a foreign entity or foreign-controlled Mexican entity can not engage in normal banking operations, including banking and savings deposit operations, credit operations, and trust operations. A foreign financial institution is, however, permitted to maintain representative offices in Mexico. The activities of such representative offices are limited under law to the identification of prospective borrowers, the facilitation of communication with borrowers, the collection and transmission of information about specific borrowers, and the collection and transmission of information of a more general nature. The U.S. taxpayer had such an office in Mexico. It represented that office was typical of such offices in Mexico. The Mexican office could not bind its home office or commit it to a loan. The loan was granted to the Mexican borrower by the home office, all remittances of principal and interest were made outside of Mexico, and "troubled loans" were administered by the home office. Although the Service concluded that the activities of the taxpayer's representative office in Mexico met the minimum level necessary for a person to be considered to be engaged in the conduct of a trade or business, under U.S. principles, it ruled that based on the taxpayers representations of Mexican law and the manner in which representative offices in Mexico operate, the activities were not materially more than the minimum level within the meaning of Prop. Reg. § 1.901-2(b)(4)(iii). Therefore, the Mexican tax was a creditable income tax within the meaning of § 901.

year.³⁰⁰ It is difficult to determine exactly what is meant by this apparent "safe haven." It may mean that a foreign withholding tax on personal service income of nonresidents, such as the Tanzanian tax in Revenue Ruling 78-234, will be a creditable income tax, if under the foreign law the presence of individuals during the 183-day tax period will not trigger the tax, or will not subject the taxpayer to local net income taxation.

It may, on the other hand, mean that the foreign withholding tax will be a creditable income tax with respect to those taxpayers who do not exceed their stay in the taxing country beyond the 183-day period. This interpretation, however, is contrary to the Service's position in prior rulings and in the proposed regulations that a separate charge is to be considered for creditability purposes in its entirety for all persons subject to the charge.³⁰¹

The proposed regulations seem to import into the determination of creditability the effectively-connected income rules of section 864(c)(2) of the Code.³⁰² Under these proposed regulations, income is not considered derived from—effectively connected with—the conduct of commerce in the foreign country unless it is generated by assets used in or held for use in the conduct of commerce in the foreign country or unless activities of commerce in the foreign country are a material factor in the realization of the income.

The proposed regulations also provide that "income will not be considered not derived from the conduct of commerce within a foreign country solely because that country prohibits the performance of incidental activities (*e.g.*, the maintenance of books and records or the final execution of documents) within that country."³⁰³ It is not clear why this rule was adopted. It may be, in part, an attempt to prevent an argument on the basis of section 864(c)(2) that there can be no conduct of commerce in a country where books and records cannot be maintained. Section 864(c)(2) provides that in determining whether income meets the asset-use test or the material-factor test, the accounting treat-

³⁰⁰ 44 Fed. Reg. at 36074.

³⁰¹ See Prop. Reg. §§ 1.901-2(c)(2)(i), 44 Fed. Reg. at 36074. One author recognized that it is unclear whether to apply the conduct of commerce test on a taxpayer-by-taxpayer basis or on a broader class such as the class of taxpayers subject to the charge. He suggests, however, that example (8) of Prop. Reg. § 1.901-2(d) (stating that a separate tax on all gross interest paid by residents of a foreign country to lenders whether or not operating in the country is a separate charge) might indicate that the test is applied to the general class of taxpayers subject to the charge. Lipson, *supra* note 268, at 997.

³⁰² 44 Fed. Reg. at 36074.

³⁰³ *Id.*

ment of the asset or income shall be considered.³⁰⁴

The adoption of a rule similar to the effectively-connected test in section 864(c) for purposes of determining the creditability of gross taxes on fixed or determinable income represents an extension of the rationale of the 1978 rulings. Otherwise the proposed regulations continue to hold to the position, with few exceptions, that taxes levied on gross business income are not creditable—a stance that is in conflict with the *Bank of America* decisions and unsupported by prior case and ruling authority. They also generally continue to rely on section 864 in determining whether foreign withholding taxes on business income qualify as an income tax under section 901, notwithstanding its conflict with the substantial equivalence test of a qualifying income tax developed by the courts.

Rules of Application—Substantial Equivalence

Proposed Reg. section 1.901-2(c) sets forth rules of application to be used when applying the tests for determining whether a foreign tax is a creditable income tax.³⁰⁵ The first of these rules may represent a response to criticism of the 1978 rulings that they require a foreign tax to be the mirror image or near image of the U.S. income tax. Proposed Reg. section 1.901-2(c)(1) states that the requirement of Prop Reg. section 1.901-2(b)(1) that a foreign tax must be computed on the basis of “realized net income,” as amplified in succeeding portions of the regulation, need be met only to a degree which is substantially equivalent to a degree to which the U.S. income tax satisfies those requirements.³⁰⁶ This rule was analyzed in detail in the discussion of the realization test in Prop. Reg. section 1.901-2(b)(2).³⁰⁷

Separate Charges

Proposed Reg. 1.901-2(c)(2) sets forth rules for determining whether a tax will be considered a separate charge so that its creditability will be determined separately from the creditability of other charges imposed by the foreign country.³⁰⁸ Although the proposed regulation does not directly concern the definition of income tax, its impact on the determination of whether a foreign tax qualifies is critical. In deter-

³⁰⁴ The premise of the argument is that the income cannot be connected with the conduct of commerce because the accounting must occur outside the foreign country.

³⁰⁵ 44 Fed. Reg. at 36074.

³⁰⁶ *Id.*

³⁰⁷ See text accompanying notes 227-31 *supra*.

³⁰⁸ 44 Fed. Reg. at 36074.

mining whether a charge is an income tax, the requirements of a tax under Prop. Reg. section 1.901-2(a) and of an income tax under Prop. Reg. section 1.901-2(b) will be applied independently to each separate charge.

The proposed regulations adopt the position in Revenue Ruling 78-61 that the tax will be analyzed with respect to a general class of taxpayers rather than on a taxpayer-by-taxpayer or transaction-by-transaction basis. It provides that "each separate charge will be considered in its entirety for all persons subject to the charge."³⁰⁹ The proposed regulations, however, include a number of exceptions to the "separate tax base-separate computation rule" of *Lanman & Kemp-Barclay & Co. of Colombia*³¹⁰ followed by Revenue Ruling 78-61.

The proposed regulations provide that if under foreign law there are "separate bases," foreign law is considered to impose a separate charge on each base.³¹¹ The foregoing statement is the standard, provided that a separate rate of charge is to be applied to each base or a flat rate is to be applied to bases that are combined.³¹² This approach follows that taken in Revenue Ruling 78-234 in which the charge imposed by the Tanzanian government was considered separately as it applied to each of the types of income covered.³¹³

A "separate base" is defined in Prop. Reg. section 1.901-2(c)(2)(ii).³¹⁴ Generally, a "separate base" may consist of a particularly identified type of income such as interest income, income derived by a particular class of persons, or an identified amount which is not income such as wages paid. Two identified types of income constitute one base if expenses of one may reduce income of the other. If such offset is not possible, however, they comprise two separate bases.

It is not certain what is meant by "particularly identified type of income." Since foreign laws may define income very generally or with great precision, the final regulations hopefully will provide further guidance.

A distinction is made between the application of a flat rate and a progressive rate on the sum of the separate bases. Where a flat rate applies, the tax on each base is treated as a separate tax or charge.³¹⁵ In

³⁰⁹ *Id.*

³¹⁰ 26 T.C. 582 (1956).

³¹¹ 44 Fed. Reg. at 36074.

³¹² *Id.*

³¹³ 1978-1 C.B. 237.

³¹⁴ 44 Fed. Reg. at 36074.

³¹⁵ *Id.*

the case of a progressive rate, though, the foreign law is considered to impose a separate charge on the aggregate of the bases. It is difficult to understand the basis for such a distinction and the reason for this rule's deviation from *Lanman*.

Proposed Reg. section 1.901-2(c)(2)(i) also provides that a foreign law is considered to impose separate charges if the law specifies a class of persons with respect to which a separate rate of charge is provided.³¹⁶ This rule differs from the one in *Lanman*. Under *Lanman*, the foreign tax would be treated as imposing a single tax if the tax base for all classes of persons was the same and the tax was computed in the same manner in respect to all such classes.³¹⁷ It is unclear why the proposed regulations have incorporated these exceptions to the general *Lanman* rule. There appears to be no authority for their inclusion. They will only restrict further tax qualifications of legitimate foreign income taxes as income tax under section 901.

Paragraph (iii) of Prop. Reg. section 1.901-2(c)(2) also provides a rule which generally will have the effect of restricting the creditability of foreign taxes as they apply to a particular industry. Under that paragraph, a charge is to be considered a separate charge under certain conditions. If the foreign law under which a charge is imposed contains a provision which materially affects the liability of persons engaged in a particular industry, and if imposition of the provision would result in the charge not being an income tax if those persons engaged in the industry were the only persons subject to the charge, the charge is to be considered a separate one.³¹⁸ For example, a tax law such as the U.S. tax law, which provides a special method of taxing particular industries, such as the insurance industry, will be viewed first as a whole and then as it applies to the insurance industry. If the tax as it applies to the insurance industry does not constitute an income tax under the proposed regulations, persons engaged in that industry will not be permitted to credit the foreign tax. On the other hand persons not engaged in that industry will be permitted to credit taxes imposed by the same law if, viewed as a whole, the foreign law imposes an income tax.

There is absolutely no authority for this rule. It effectively reads the predominant character doctrine out of income tax determinations of general income taxes. While the proposed regulations drop the limited taxpayer-tax base aberration rule of Revenue Ruling 78-61, they

³¹⁶ *Id.*

³¹⁷ 26 T.C. at 587-88.

³¹⁸ 44 Fed. Reg. at 36074. Example (6) of Prop. Reg. § 1.901-2(d) illustrates the application of this rule. See discussion of this example in note 288 *supra*.

have included in section 1.901-2(c)(2)(iii) an "aberrational rule" of much greater magnitude.³¹⁹

This provision also raises difficult interpretative and administrative problems for the taxpayer. When does a foreign law contain provisions which "naturally affect the liability only of persons engaged with particular industry?" What does "naturally affect the liability" mean? How can one determine when these provisions apply? How is the tax as it applies to a particular industry segregated to determine if its imposition would result in a charge not being an income tax if persons in such industry were the only taxpayers?

CONCLUSION

Nearly sixty years after the enactment of the predecessor of section 901, the Internal Revenue Service and Treasury have embarked on a new course in defining a qualifying income tax under that section—a course that can be summarized as significantly narrowing the scope of this definition. As a result, U.S. taxpayers are and will be faced with fewer foreign taxes qualifying for the foreign tax credit and greater tax costs in doing business overseas. Furthermore, and perhaps more importantly, it is highly questionable whether the Treasury has the authority to change the rules developed by the courts and itself after almost sixty years of congressional acceptance.

Although purporting to be based on case and ruling precedent, the 1978 revenue rulings effectively conditioned qualification to an unprecedented degree on a foreign tax's substantial identity with a "pure," not wholly accurate, model of the United States federal income tax law. Little attention was given to the more flexible approach evidenced in the case law and previous rulings. The proposed regulations under section 901, although tempering to some degree the treatment accorded the income tax definition by the 1978 rulings, still embody to a large degree the rulings' adherence to a United States income tax model.

While this article has been concerned with the legal and technical basis of the proposed regulations and the 1978 rulings, the policy ramifications of these developments should not be ignored. At a time when United States business is finding the international market place increasingly competitive, the Treasury's constriction of the income tax definition will act to increase the costs of doing business overseas and ultimately decrease the United States competitiveness in world markets.

³¹⁹ 44 Fed. Reg. at 36074.

While one can theorize about the meaning of double taxation and what Congress intended to prevent in enacting the predecessor of section 901, it is clear that its purpose was to stimulate United States business abroad by eliminating the heavy tax cost under previous law. Therefore, it must be argued that a restrictive and narrow approach to the income tax definition conflicts with the spirit of this section.