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Some UnConventional Thinking About Foreign Tax Credits and the Advance Corporation Tax

H. David Rosenbloom*
Christine W. Booth**

The purpose of this article is to revive a debate, or perhaps more accurately to initiate a debate that should have taken place but never did, on a complex but important question of international tax law. The question is whether the United Kingdom’s Advance Corporation Tax (ACT) is a creditable income tax under section 901 of the Internal Revenue Code and the Treasury Regulations that interpret section 901.1 The debate never took place because the Income Tax Convention between the United States and the United Kingdom effectively preempted it, by providing rules for applying the U.S. foreign tax credit system to the ACT.2 Those rules do not, however, address the status of the ACT under the Code, an independent issue with important practical implications.

To appreciate the scope of that issue, it is necessary to traverse some familiar ground: relief from international double taxation, the nature of the ACT, the history of the Convention, and various interpretations of the Convention. We will keep this necessary contextual material to a minimum.

1 The Advance Corporation Tax was originally enacted as part of the U.K. Finance Act of 1972, principally sections 84-92 and schedule 12. The current provisions are contained in the U.K. Income and Corporation Tax Act of 1988 (hereinafter ICTA). The U.S. foreign tax credit provisions are generally in sections 901-908 of the Internal Revenue Code. The Treasury Regulations relevant to this discussion are in sections 1.901-1 through 1.901-2A.

I. RELIEF FROM INTERNATIONAL DOUBLE TAXATION

The United States taxes its residents, including domestic corporations, on worldwide income.\(^3\) Taxation of the same income by two or more distinct taxing jurisdictions (double taxation) is subject to mitigation under provisions of U.S. domestic tax law and, independently, under bilateral income tax treaties to which the United States is a party.\(^4\) In the absence of a treaty, U.S. residents who pay income taxes, or taxes in lieu of income taxes, to foreign jurisdictions may either deduct those taxes pursuant to Code section 164(a) or claim credits against their U.S. income tax under the provisions of Code sections 901-908.\(^5\) The foreign tax credit provisions relevant to the discussion here are sections 901 (the direct foreign tax credit), for foreign taxes paid by the taxpayer, and section 902 (the deemed paid foreign tax credit), for foreign taxes paid by a foreign corporation but deemed, under specified circumstances, to have been paid by a U.S. corporate shareholder.

The foreign tax credit provisions of the Code represent a unilateral effort by the United States to mitigate international double taxation. The U.S. tax treaty network, on the other hand, constitutes an attempt, through bilateral negotiation, to refine the domestic legal system so that it will operate effectively country by country.

United States tax treaties prohibit the use of a treaty to restrict benefits otherwise available under local law.\(^6\) This means that a taxpayer covered by a treaty provision may choose between its benefits and those available under the Code.\(^7\)

The Convention contains a provision to this effect in Article 27(2):

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\(^4\) This is the function of all U.S. income tax treaties.

\(^5\) Foreign tax credits are also available in limited circumstances to foreign persons. See I.R.C. § 906 (1992).


\(^7\) A limited exception to this ability to choose the more advantageous provision was suggested when the Service denied a taxpayer's request to invoke a provision of the United States - Poland treaty with respect to the treatment of business income while continuing to treat business losses under the provisions of the Code. Rev. Rul. 84-17, 1984-1 C.B. 308. U.S. courts have never addressed whether such "cherry picking" is permissible. See Harvey P. Dale, "Cherry Picking" - Treaty or Code, Not Both, 13 Tax Mgmt. Int’l J. 181 (1984) (stating that "bilateral income tax treaties can only help, not hurt, the taxpayer").
This Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of the Contracting State.

This language makes clear that if double taxation relief is available under the Code, the Convention does not and cannot withdraw such relief. The problem at hand, however, is that a fair reading of the Convention suggests that its negotiators believed ACT payments were not creditable under the Code. This (largely unexamined) assumption has forestalled virtually all discussion of the Code issue.

In fact, the Code provisions governing the foreign tax credit, the Treasury Regulations interpreting those provisions, and the evolution and nature of the ACT all support the position that the ACT is a creditable income tax under the Internal Revenue Code. If that conclusion is correct, taxpayers need not invoke the Convention in order to qualify ACT payments for the credit; and the extensive rules regarding creditability in the Convention and the various Treasury and IRS interpretations of the Convention must be viewed as nonexclusive alternatives to the Code rules governing creditability, rather than the Hobson's choice that those interpretations purport to be.

II. THE ADVANCE CORPORATION TAX

The ACT is an integral part of a system intended to alleviate double taxation of corporate earnings, a subject that is distinct from (but necessarily related to) the international double taxation that occurs when different taxing jurisdictions tax the same income. Double taxation of corporate earnings occurs under a so-called "classical" system of corporate taxation, or any system that retains classical elements. In a classical system (such as the one currently in force in the United States), a corporation pays tax on its income, and shareholders pay additional tax on amounts received as distributions out of after-tax corporate earnings. Systems designed to eliminate or ameliorate this double taxation through "integration" of the corporate and individual taxes have been implement-
ed in many other countries and considered repeatedly in the United States, but never enacted.11

One form of integration involves "imputation" of the corporate tax payment to the shareholder. Under this approach a shareholder who receives a cash dividend from a corporation may claim a credit for the portion of the corporate tax attributable to the dividend received. The shareholder reports as income both the cash dividend and the amount of corporate tax attributable to the dividend and claims a credit against his own income tax liability for the "imputed" corporate tax. Under this system there is only one tax on corporate earnings instead of two, and that one tax is collected from the corporation, subject to final application based on the personal situation and status of the shareholder.

Such a system has been in place in the United Kingdom for most of that country's income tax history, with the exception of the period from 1965 to 1972, when a classical system prevailed.12 The problem that triggered adoption of a classical system in the United Kingdom was that, under certain circumstances, the imputation system permitted a recipient of a dividend to claim a credit for corporate tax when no corporate tax was actually collected.13

When, in conformity with the rules promulgated by the EEC,14 the United Kingdom returned to an imputation system in 1972, it sought to avoid the leakage that was possible under its earlier system. The mechanism chosen to achieve the desired result — the ACT — is unique among countries employing imputation systems.15 The ACT is a pay-


13 For a more complete discussion of the difficulties with the prior U.K. imputation system, see Holdstock, supra note 12, at 2.


15 For general descriptions of the mechanics of the ACT, see Holdstock, supra note 12; Marianne Burge, The New Revamped U.K. Corporate Tax System: How It Will Operate, 37 J.
FOREIGN TAX CREDITS AND THE A.C.T.

ment to the U.K. Treasury from a U.K. corporation upon a qualifying distribution to shareholders. It is distinct from the normal U.K. corporation tax (the "mainstream tax"), which is assessed annually on taxable corporate earnings. It is also distinct from the U.K. tax on individuals. However, payment of the ACT triggers two credits, one for the corporation against its mainstream tax and one for the corporation’s shareholders against their tax.

The ACT credit available to offset a corporation’s mainstream tax is subject to a limitation to ensure that mainstream tax liability cannot be fully expunged by the ACT. The ACT credits that cannot be used because of this limitation may be carried back six years and forward indefinitely. Unused ACT may also be surrendered to designated affiliates. However, with minor exceptions, the ACT is not refundable to the distributing corporation.

As in any imputation system, the shareholder adds his proportionate share of the ACT payment to the cash dividend received and reports the sum of the two as taxable income. The shareholder then claims a credit for his share of the ACT paid by the distributing corporation. Because the ACT is payable by the corporation and only retrievable by that corporation as an offset against mainstream tax, the risk of shareholder credits in the absence of corporate tax payments is eliminated.

The ACT rate is set so that, when applied to the cash dividend plus the amount of the credit (the grossed-up dividend), it will equal the basic rate of individual U.K. income tax. That rate, for the year ending March 31, 1991, was 25 percent and the ACT rate for that period

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16 The ACT provisions define "qualifying distributions" by reference to the definition in section 209 of the ICTA. That definition encompasses dividends and other distributions "except so much of the distribution, if any, as represents repayment of capital on the shares . . . ." ICTA § 209(2)(b). The authors do not claim knowledge of the subtleties of U.K. tax or corporate law, but U.K. statutes are drafted in English and it would appear that this provision is intended to preclude application of the ACT with respect to at least some corporate distributions.

17 ICTA § 6.

18 ICTA § 239 (set-off against corporate tax liability); ICTA § 231 (credit for recipient of qualifying distribution).

19 ICTA § 239(2).

20 ICTA § 239(3). As originally enacted, the carryback period was two years. The Finance Act of 1972, Ch. 41 § 85(3) and (4) (Eng.).

21 ICTA § 240(1)(a)-(b). Permissible surrenderees must be U.K. resident corporations and must be at least 51% owned by the surrendering corporation. Id. at § 240(10).

22 This is a limited right to a refund in situations involving "franked investment income." See infra notes 26, 27, and 46.

23 ICTA § 14.
was therefore 25/75ths of the cash dividend amount. Assuming a U.K. corporation subject to a 35 percent tax rate pays out all its after-tax income as dividends, the ACT would operate in the following manner:

**Corporate taxes**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax income</td>
<td>100.00</td>
</tr>
<tr>
<td>Income taxes:</td>
<td></td>
</tr>
<tr>
<td>ACT (25/75 x dividend amount of 65)</td>
<td>21.67</td>
</tr>
<tr>
<td>U.K. corporation tax at 35%</td>
<td>35.00</td>
</tr>
<tr>
<td>less: ACT credit (25/75 x 65)</td>
<td>(21.67)</td>
</tr>
<tr>
<td>Net mainstream tax</td>
<td>13.33</td>
</tr>
<tr>
<td>Total income tax paid</td>
<td>(35.00)</td>
</tr>
<tr>
<td>After tax profit and dividend paid to shareholder</td>
<td>65.00</td>
</tr>
</tbody>
</table>

**Shareholder taxes**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend received</td>
<td>65.00</td>
</tr>
<tr>
<td>add: ACT credit</td>
<td>21.67</td>
</tr>
<tr>
<td>Shareholder taxable income</td>
<td>86.67</td>
</tr>
<tr>
<td>U.K. individual tax at 25%</td>
<td>21.67</td>
</tr>
<tr>
<td>less: ACT credit</td>
<td>(21.67)</td>
</tr>
<tr>
<td>Shareholder tax due</td>
<td>0</td>
</tr>
</tbody>
</table>

A U.K. shareholder who is not subject to full tax because of losses, other relief, or charitable status, will receive the ACT credit as a refund.24 Under U.K. tax law a corporate shareholder is not normally subject to U.K. income tax on dividend income.25 Unlike individual shareholders, however, corporate shareholders are not entitled to ACT refunds.26 Rather, dividends with accompanying ACT credits received by corporate shareholders ("franked investment income") may be distributed by those corporate shareholders without further ACT payments to the United Kingdom.27

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24 ICTA § 231(3).
25 ICTA § 208.
26 ICTA does not state that corporate shareholders are not entitled to refunds, however, it does provide alternative treatment (franked investment income) for such shareholders.
27 If no distributions are made during the taxable year in which franked investment income
As a matter of U.K. domestic law, there are no ACT credits or refunds for foreign shareholders, individual or corporate. Thus, in the absence of a tax treaty, the ACT is payable by a U.K. corporation with respect to distributions to foreign shareholders, but is not available as a credit to such shareholders. Such distributions are not, however, subject to a separate tax at source under U.K. domestic law.

III. THE CONVENTION

Although the primary purpose of bilateral income tax treaties is to eliminate double taxation of income subject to the taxing jurisdiction of both treaty partners, it is not surprising that, following the adoption of the ACT system in the United Kingdom, the Convention would address the extent to which an otherwise purely domestic tax benefit would be made available to foreigners.\(^2\) After all, the ACT has an impact upon cross-border investment and, from the U.S. point of view, arguably discriminates against U.S. ownership of U.K. corporations. What is most noteworthy for present purposes, however, is that the Convention, augmented by subsequent interpretations, provides in detail the manner in which the ACT is to be treated for purposes of the U.S. foreign tax credit.\(^2\) This aspect of the Convention suggests an assumption by the drafters that, absent the Convention, the ACT would not be a creditable tax under U.S. domestic foreign tax credit rules. If the drafters had believed that the ACT was fully creditable under U.S. principles, Convention foreign tax credit rules would have been unnecessary.

In fact, the Convention addresses both the obligations of the United Kingdom with respect to ACT paid by U.S.-owned U.K. companies and the U.S. foreign tax credit implications of such payments.\(^3\) With respect to the availability of ACT benefits to U.S. shareholders, Article 10

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\(^{2}\) See infra part IV.

\(^{3}\) Convention, *supra* note 2, arts. 10, 23.
provides that when dividends are paid to a U.S. corporate shareholder under specified conditions, the shareholder shall be entitled to a payment from the United Kingdom equal to one-half of the ACT credit available to an individual U.K. shareholder, subject to a “deduction withheld” not to exceed 5 percent of the aggregate of the cash dividend plus the one-half credit.\textsuperscript{31} The conditions under which this treatment is applicable are that the U.S. corporation, either alone or together with one or more associated corporations, controls, directly or indirectly, at least 10 percent of the U.K. corporation paying the dividend.\textsuperscript{32} Such shareholders will be referred to hereafter as “qualifying shareholders.”\textsuperscript{33}

Using the earlier example, a qualifying shareholder entitled to a cash dividend of 65 would receive $65 + 10.84$ (½ the ACT paid) or 75.84, less a 5 percent (3.79) deduction from that total amount for a net cash receipt of $72.05$ $(75.84 - 3.79)$. Of this amount, 65 would come directly from the U.K. corporation and 7.05 would come via the U.K. Treasury as a refund of ACT paid by the U.K. corporation.\textsuperscript{34} In other words, ignoring the “deduction,” this provision places a qualifying shareholder in the same position as a U.K. individual shareholder who is unable to make use of one-half of an ACT credit, i.e., the qualifying shareholder becomes entitled to an ACT refund.

The interaction between the ACT and the U.S. foreign tax credit is addressed in two separate articles of the Convention. Article 10 provides that the aggregate of the cash dividend received by a U.S. shareholder (either a qualifying shareholder or otherwise) plus the amount of the ACT credit received, less the applicable “deduction,” shall be treated as


\textsuperscript{32} Convention, \textit{supra} note 2, art. 10.

\textsuperscript{33} The Convention also provides that other U.S. shareholders (including individuals and nonqualifying corporate shareholders) shall be entitled to payment from the United Kingdom of the entire ACT credit available to individual U.K. shareholders, subject to a “deduction” not to exceed 15 percent of the aggregate of the dividend plus the credit. Convention, \textit{supra} note 2, art. 10(2)(a)(ii). This distinction between shareholders who receive one-half the ACT refund and those who receive the full ACT refund generally reflects the distinction between “direct” investors (those eligible for the deemed paid foreign tax credit of Code section 902) and portfolio investors.

\textsuperscript{34} See Finance Act, 1989, § 115 (Eng.). That section was enacted to clarify that the 5 percent deduction is to be based on the gross amount of the dividend plus the one-half ACT credit. A 1988 U.K. case interpreting the Convention had upheld a taxpayer’s contention that the 5 percent deduction should be based on the amount of the tax credit actually paid rather than on the sum of the dividend plus one-half of the ACT credit. See Union Texas Int’l Corp. v. Critchley, [1990] S.T.C. 305 (Feb. 27, 1990) (affirming the High Court’s decision). Section 115 effectively restricts the holding in \textit{Union Texas} to the taxpayer in that case.
a dividend "for United States tax credit purposes." Article 23 provides that the amounts "withheld" (deducted) from amounts paid to U.S. shareholders are to be treated for U.S. foreign tax credit purposes as an income tax imposed on the recipient of the dividend. In addition, in cases involving distributions to qualifying shareholders, Article 23 provides that the one-half of the ACT credit not paid to such shareholders shall be treated as an income tax imposed on the U.K. corporation paying the dividend.

Absent subsequent interpretations, these Article 23 provisions appear to be relatively simple statements of creditability under the foreign tax credit provisions of Code section 901 (the direct foreign tax credit) for payments treated as having been made by the shareholder, and section 902 (the deemed paid foreign tax credit) for payments treated as having been made by the corporation distributing the cash dividend. Their principal aim, it appears, is to identify the proper taxpayer and, in the case of the ACT and the amounts "withheld" from recipients, to assure that a credit is available for the amount the United Kingdom is not required, under the Convention, to refund.

IV. INTERPRETATIONS OF THE CONVENTION

The U.S. Treasury Department issued a Technical Explanation of the proposed Convention on March 9, 1977 four months in advance of

35 Convention, supra note 2, art. 10.
36 Id., art. 23.
37 Id.
39 I.R.C. § 902 (1992). See infra Part V. Because the United Kingdom does not impose a separate tax at source on amounts paid as dividends by U.K. corporations to foreign shareholders, it is likely that amounts treated as payments by a shareholder solely by reason of the Convention would not otherwise qualify for a credit in the United States. See Treas. Reg. § 1.901-2(f); see infra note 40.
40 Identifying the particular taxpayer entitled to the foreign tax credit has been a dilemma throughout the history of the credit. See, e.g., Biddle v. Commissioner, 302 U.S. 573 (1938) (under the former U.K. imputation system, tax paid by a U.K. corporation upon a distribution to shareholders is, for U.S. foreign tax credit purposes, tax on the corporation and not on the shareholders). Biddle followed what has been termed a "technical taxpayer" or "legal liability" analysis, focusing on the identity of the entity or individual legally liable for the tax in the foreign jurisdiction. More recent cases (at least in the context of taxes withheld at source) appear to have shifted the focus to a test that seeks to identify the party whose income is being taxed rather than the party who bears liability for the tax payment. See, e.g., Nissho Iwai American Corp. v. Commissioner, 89 T.C. 765 (1987); First Chicago Corp. v. Commissioner, 61 T.C.M. (CCH) 1774 (1991); Gleason Works v. Commissioner, 58 T.C. 464 (1972); Continental Ill. Corp. v. Commissioner, 55 T.C.M. (CCH) 1325 (1988), aff'd sub nom., Citizens & Southern Corp. v. Commissioner, 900 F.2d 266 (11th Cir. 1990); Norwest Corp. v. Commissioner, 63 T.C.M. (CCH) 3023 (1992).
hearings before the Senate Foreign Relations Committee and a full three years before instruments of ratification were exchanged and the Convention was brought into force.\textsuperscript{41} On the day the Convention was brought into force the Internal Revenue Service issued a Revenue Procedure interpreting it.\textsuperscript{42} Thus, at the moment the Convention took effect, it was already subject to two substantial exegeses.

The Convention treats the ACT not refunded to qualifying shareholders as a tax paid by the distributing U.K. corporation.\textsuperscript{43} If the ACT was creditable under the U.S. foreign tax credit system, it would be allowable as a credit in the year of the distribution, when the liability to make the tax payment to the U.K. Treasury became fixed.\textsuperscript{44} The Technical Explanation and the Revenue Procedure, however, ultimately treat unrefunded ACT as a tax paid by the distributing corporation (or, alternatively, as a tax paid by a surrenderee corporation if the unused ACT is surrendered) in the year in which the corporation's mainstream tax is reduced by an ACT credit.\textsuperscript{45} In other words, the documents that officially interpret the Convention treat the ACT in a manner different from that contemplated by the U.S. statutory foreign tax credit provisions.

The Technical Explanation supports its interpretation of the Convention in the following terms:

In the United Kingdom tax system, ACT serves a dual function. To the extent that it offsets the United Kingdom corporate income tax imposed without regard to distributions (hereinafter referred to as the "mainstream tax"), it is analogous to a payment of regular corporate income tax. To the extent that it does not offset mainstream tax, it is more analogous to a tax imposed on distributions which are income to the shareholders.
To reflect this hybrid nature of ACT, ACT which offsets mainstream tax will be attributed to the earnings of the year in which it offsets such tax and treated as if it were regular corporate tax. ACT which does not offset mainstream tax will generally be attributed to the accumulated profits of the year of distribution. This describes the approach taken in the Technical Explanation, but says little about rationale. U.K. law leaves no doubt that the ACT must be paid upon every qualifying distribution. The fact that a credit against other U.K. taxes may be available is entirely independent of the fact of the ACT payment. Under the ACT provisions of U.K. law, once ACT has been paid to the U.K. Treasury, it cannot be refunded to the corporation that has paid it. Clearly, the approach taken in the Technical Explanation reflects someone’s judgment that an ACT payment, by itself, has no legal effect under the U.S. foreign tax credit system.

The Revenue Procedure relies on the authority of the Technical Explanation to conclude that, where ACT credits are surrendered by a distributing U.K. corporation, only the surrenderee affiliate is deemed to have paid a tax for U.S. purposes, and the ACT refunded pursuant to the Convention will not be considered a distribution from the subsidiary surrenderee in the absence of certain specific actions by the surrenderee and its parent company. The Revenue Procedure recites that computation of the U.S. foreign tax credit must be made “pursuant to the rules and examples set forth in the Treasury Explanation,” even though a surrender situation is not discussed in the Technical Explanation.

The interpretations contained in the Technical Explanation and the Revenue Procedure were echoed by a 1986 Competent Authority Agreement addressing creditability of the ACT under the Convention. All three of these interpretive documents were considered by the United

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47 A minor exception exists where a corporation receives “franked investment income” later in a taxable year in which a qualifying distribution has been made. Because distributions made out of “franked investment income” are not subject to the ACT, amounts paid as ACT during a taxable year prior to receipt of such “franked” income may be refunded to the corporation. ICTA, ch. 1, sched. 13, ¶ 4(2) (Eng.).
49 The Convention contains a “Mutual Agreement Procedure” under which the parties to the Convention agree that the “competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.” Convention, supra note 2, art. 25. The 1986 Competent Authority Agreement was entered into (in the form of an exchange of letters) pursuant to this provision. These letters are reproduced in full in Xerox v. United States, 14 Cl. Ct. 455, 464-66 (1988).
States Claims Court in *Xerox v. United States,*\(^50\) a case involving an ACT credit surrendered to a U.K. subsidiary corporation. Relying primarily on the Revenue Procedure, the Court held that where the U.K. corporation paying the dividend had surrendered its ACT credit, the U.S. shareholder was not entitled to a foreign tax credit under Article 23 for the one-half of the ACT not refunded. The court deferred in large measure to the Treasury Department and Internal Revenue Service interpretations of the Convention.\(^51\) This deference was accorded despite the following language in the Senate Foreign Relations Committee Report recommending ratification of the Convention: "[I]n recommending ratification of the treaty, the Committee does not intend to adopt or reject the amplifications of the foreign tax credit rules contained in the Treasury technical explanation."\(^52\) The *Xerox* opinion is, however, limited by its terms to "the treaty issue."\(^53\) The argument that foreign tax credit relief is available under U.S. domestic law, without regard to the Convention, was not considered by the court.

In a more recent case, *Snap-On Tools, Inc. v. United States,* the Claims Court approached the Technical Explanation with less deference.\(^54\) As in *Xerox,* the taxpayer in *Snap-On Tools* claimed a credit under the Convention for unfunded ACT. In this case, in computing the credit, the taxpayer took the position that both dividends received during 1978 and dividends received during the first 60 days of 1979 should be treated as having been made out of accumulated profits of 1978. The taxpayer relied on the 60-day rule of Code section 902 to support its position.\(^55\) The Revenue Service disallowed a portion of the credit attributable to the dividends paid during the 60-day period on the authority of the Technical Explanation, which explicitly rejected the 60-day rule.\(^56\) Noting that the Convention itself does not address the 60-day rule, the Court rejected the argument that the Technical Explanation was controlling. It relied on the language of Article 27 of the Convention (regarding the primacy of domestic law) to conclude that "resort

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\(^{50}\) 14 Cl. Ct. 455 (1988).

\(^{51}\) *Id.* at 462-63.


\(^{53}\) Xerox, 14 Cl. Ct. at 455.


\(^{55}\) Section 902, as in effect for the years in question in *Snap-On Tools,* limited the deemed paid foreign tax credit to the amount of tax attributable to dividends paid out of the accumulated profits of a taxable year of a foreign corporation. The 60-day rule permitted a dividend paid within 60 days of the close of a taxable year to be treated, for section 902 purposes, as if it were paid out of the profits of the prior taxable year.

\(^{56}\) See 1980-1 C.B. at 473.
to preparatory materials" was not necessary. As a result, the court granted summary judgment in favor of the taxpayer.

As in Xerox, the Snap-On Tools court did not address whether the ACT is creditable under the Code in the absence of the Convention. The court never reached that question, emphasizing instead the literal language of the Convention as opposed to the interpretation placed upon the Convention by later Treasury and Revenue Service pronouncements. However, the court's refusal to defer to the Technical Explanation is also consistent with the position that creditability under the Code remains an open question. Moreover, the result reached by the Claims Court is harder to defend if creditability of the foreign levy depends exclusively upon the Convention. For if it does, it would seemingly have been appropriate for the Court to have deferred to the Technical Explanation. In other words, the court's willingness to eschew Convention interpretations may reflect an underlying doubt about whether creditability of the ACT is solely a function of the Convention.

Even if the official interpretations of the Convention are accorded the same weight as the Convention itself, however, a taxpayer who seeks relief from double taxation without invoking the Convention cannot be bound by such interpretations.

V. CREDITABILITY OF THE ACT UNDER THE CODE

Analysis of U.S. domestic law must begin with the fact that, notwithstanding the history of the ACT under the Convention, no official U.S. pronouncement has ever stated that the ACT fails to qualify as a creditable tax under the Internal Revenue Code. The closest any public statement has ever come to such a position is the following excerpt from the Report of the Senate Foreign Relations Committee on the Convention:

It is open to question whether, in the absence of the proposed treaty, the unfunded ACT would be treated as a creditable income tax for U.S. foreign tax credit purposes. On the one hand, although the unfunded ACT may be viewed economically as a foreign tax with respect to income of the U.S. shareholders because it is imposed with respect to dividend income paid to them, it is imposed on the paying U.K. corporation rather than the U.S. shareholder receiving the distribution and thus probably would not be allowed as a direct income tax credit to the U.S. shareholder.

On the other hand, although it is a tax imposed on the paying

57 Snap-On Tools, 26 Cl. Ct. at 1073.
U.K. corporation, it is not imposed with respect to income of the paying corporation, but rather on all distributions made by the U.K. corporation, whether out of taxable income, out of untaxed earnings, or out of capital. Under present IRS ruling policy, in order for a foreign tax to qualify for the U.S. foreign tax credit, it must be imposed on the net gain of the taxpayer (determined by allowing the deduction of the generally significant expenses incurred in the production of that income), it must be imposed only on income that is realized, and it must be imposed on the receipt of income rather than some other transaction. It would appear that, at least in form, the ACT would not satisfy these criteria. There is, therefore, a reasonable possibility that the ACT would not be viewed by the IRS as a creditable tax in the absence of the proposed treaty.  

This, of course, is neither a position of the Internal Revenue Service nor a firm conclusion of the Committee. Moreover, the description of the ACT in the Senate Report does not appear to be correct. ACT is not imposed on “all distributions” by a U.K. corporation. It is not imposed, in particular, on distributions that represent “repayment of capital on the shares.” Moreover, its place and purpose in the overall U.K. imputation system make it clear that the ACT was intended to fall mainly if not solely, on earnings, including earnings from prior years. ACT may reach earnings not reached by U.K. mainstream tax, and it may reach some earnings that, under U.S. principles, would be viewed as a return of capital; but the aim of the ACT and its principal target in fact is normal corporate earnings.

Finally, neither the thought processes nor the beliefs of the individuals involved in negotiation of the Convention is relevant to the issue at hand. Regardless of whether they assumed that the ACT was not otherwise creditable or simply side-stepped the question in favor of a treaty resolution, it is evident that creditability analysis under the Code can and must proceed on a clean slate.

A. Development of U.S. Creditability Standards

The sole statutory standard for determining which foreign levies are creditable as income taxes is section 901(b)(1), which provides a credit for “the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country . . . .”  

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59 See supra note 10.
60 Section 903 provides a credit for taxes “in lieu” of income taxes. I.R.C. § 903 (1992).
The term "income taxes" is not defined in the Code, and its meaning was thus left to the courts. In 1938, the Supreme Court in *Biddle v. Commissioner* set forth a principle that, in expanded form, has been employed in all subsequent interpretations of the foreign tax credit provisions. The principle is that a foreign levy, in order to be creditable, must be substantially equivalent to an income tax in the U.S. sense.

This principle was refined in a 1943 Third Circuit case, *Keasbey & Mattison Co. v. Rothensies*, in which a U.S. taxpayer had been denied a foreign tax credit for a Quebec Mining Tax triggered by consumption or shipment of ore. The court upheld the denial of the credit, enunciating two conditions for creditability: (1) that a tax must be levied on net gain or income in the U.S. sense, and (2) that the income subject to the tax must have been realized. These principles remained in place, subject to further judicial gloss, and by the mid-1970s had been crystallized by the standards set forth in the Court of Claims and Tax Court decisions in *Bank of America National Trust & Savings Assoc. v. Commissioner*.

The foreign taxes at issue in *Bank of America* were gross income taxes levied on banking revenues. The principles that emerge from the cases are: (1) that a gross tax is generally not an income tax; (2) that only foreign taxes "very highly likely" or "reasonably intended" to reach net gain are income taxes; (3) that a foreign tax must allow for deductions in order to be a creditable income tax; (4) that creditability must be tested for the classes of taxpayers subject to the tax and not on the basis of individual taxpayers; and (5) that creditable foreign taxes must be imposed on realized net income. Thus, as of the early 1970s, the statutory provision addressing foreign tax credits had not been changed for more than fifty years and the evolution of creditability standards had proceeded in a more or less orderly fashion in the courts. It was therefore not surprising that a spate of Revenue Rulings in the latter half of the 1970s denying creditability for various foreign taxes gave rise to controversy.

The Rulings came in the wake of considerable pressure on and close scrutiny of the foreign tax credit rules of the United States in the

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That provision is not relevant here, as the ACT is not "in lieu of" an income tax.

61 302 U.S. 573.
mid-1970's as a result of the run-up in oil prices and heavy foreign taxation of oil extraction income, following the OPEC-induced oil price shock of 1972-73. In May 1976, the Revenue Service published Revenue Ruling 76-215, dealing with the creditability of Indonesian "production sharing" payments. This was followed by a July 14, 1976 News Release dealing with the standards for crediting foreign taxes incurred by taxpayers engaged in extracting mineral resources owned by foreign governments. A host of further rulings were published in 1978, including a significant one, Revenue Ruling 78-63, dealing with Saudi-Arabian and Libyan oil taxes.

Shortly thereafter, the Treasury Department announced that it was opening a regulation project on the creditability of foreign taxes. This project led to proposed regulations in June 1979 and the adoption of proposed and temporary regulations in November 1980. These regulations were substantially amended, and issued in final form, in 1983, and they continue to form the basis for determining creditability of foreign taxes to this day.

B. Current Standards

The final foreign tax credit regulations simplified the task of analyzing a foreign levy to test whether it meets U.S. standards for creditability. To be creditable under section 901, the levy must: (1) be a "tax," and (2) have a "predominant character" of an income tax in the U.S. sense. Of course these questions imply that the foreign payment

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65 Id.
69 The regulation project was opened on June 1, 1978. See T.D. 7918 (October 6, 1983), reprinted in 1983-2 C.B. 113, 114.
73 Treas. Reg. § 1.901-2(a).
be isolated as a “separate levy.” The ACT meets all of these require-
ments.

1. Separate Levy

The regulations provide that the benchmark for determining whether a payment is a “separate levy” is U.S. principles, and that where the base of a levy differs “in kind” and not merely “in degree” from the base of other levies, it will be a separate levy for foreign tax credit purposes. A clear example of a separate levy would be a levy by a lesser political subdivision, such as a state, or municipality. Similarly, the regulations use the separate U.S. taxes on corporations, personal holding companies, foreign corporations, and FICA taxes as examples of separate levies.

Although the determination of “separateness” can be difficult, ACT appears to qualify as a separate levy under the foregoing provisions. It is based on the amount of a qualifying distribution, while U.K. mainstream tax is based on all corporate earnings, whether or not distributed. As the Claims Court noted in Xerox, a distributing corporation must pay the ACT “whether or not it has any U.K. corporation tax liability.” The ACT is not refundable and therefore is not an estimated tax, and it is independent of the U.K. corporation mainstream tax. The fact that the ACT may be credited against mainstream tax liability is not relevant. The foreign tax credit regulations provide rules for “multiple levies,” making clear that the possibility of crediting one levy against another has nothing to do with “separate levy” analysis. Moreover, when one levy is credited against another, it is the former levy that is considered paid. On this analysis it would be the ACT, not mainstream tax, that would qualify for the credit.

2. Tax

The regulations provide that a separate levy is a “tax” if it is “a compulsory payment pursuant to the authority of a foreign country to levy taxes,” and not compensation for “a specific economic benefit.” Payments to foreign governments in the nature of penalties, fines, and customs duties are not “taxes” within the meaning of this provision.

74 Treas. Reg. §§ 1.901-2(a) and 1.901-2(d)(1).
75 Treas. Reg. § 1.901-2(d)(1).
76 Xerox, 14 Cl. Ct. at 458.
77 Treas. Reg. § 1.901-2(e)(4).
78 Treas. Reg. § 1.901-2(a)(2).
A prime example of, and the principal reason for, the "specific economic benefit" language is a payment made in return for the right to extract government-owned petroleum and other minerals. The purpose of the "tax" requirement is to deny foreign tax credits for such quid pro quo payments to foreign governments masquerading as taxes.

The ACT is clearly a "tax" within the meaning of this provision because it is "a compulsory payment pursuant to the authority of a foreign country to levy taxes." There is no possible argument that an ACT payment is really a disguised transfer in exchange for a government benefit "specific" to a particular taxpayer. All distributions (with the exception of those out of "franked investment income") are subject to the ACT and the only benefit arising from payment of the ACT is a credit that is not limited to specified taxpayers but available, under varying conditions, to all.

3. Predominant Character

Having cleared the "separate levy" and "tax" hurdles, the analysis passes to whether the predominant character of the ACT is an income tax in the U.S. sense. This provision of the regulations essentially incorporates the elements developed by the courts as discussed above. In other words, it requires an analysis of the realization, gross receipts, and net income tests. The rules do not, however, require exact conformity to the legal standards developed by the courts. Instead, they call for a judgment about the "predominant character" of the levy being analyzed. In this regard the regulations can be viewed as a relaxation of the judicially created standards.

(a) Realization

A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed "subsequent to the occurrence of events that would result in the realization of income under

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79 See supra text accompanying notes 66-72. See also Lieberman, supra note 72, at 99.

80 Technically, the regulations provide that the "predominant character" test will be satisfied if (1) the tax is likely to reach net gain in normal circumstances and (2) the tax is not dependent upon the availability of a credit in another foreign country. Treas. Reg. § 1.901-2(a)(3). The first of these requirements — the net gain requirement — is merely shorthand for the realization, gross receipts, and net income tests. The second requirement, the so-called "soak-up" tax provision, is designed to deny foreign tax credits for foreign taxes that are imposed solely because a credit from another country is available. This second requirement is irrelevant in the case of the ACT. Thus, the "predominant character" test resolves itself into an inquiry into the "net gain" requirements.
the income tax provisions of the Internal Revenue Code." Corporate distributions are events that occur subsequent to the realization of corporate earnings. Therefore, the ACT meets the realization test because it is a tax imposed on corporate distributions.

An example in the Treasury Regulations holds that a branch profits tax imposed when realized net income is remitted or deemed to be remitted satisfies the realization test. This is because a levy subsequent to the occurrence of events that would result in realization under U.S. principles is not objectionable from a U.S. foreign tax credit standpoint. There is no meaningful distinction between this example and the ACT insofar as the realization test is concerned.

(b) Gross Receipts

A foreign tax satisfies the gross receipts requirement if, based on its predominant character, it is imposed on the basis of net income attributable to actual gross receipts. The purpose of this provision is to deny a foreign tax credit for a tax levied on nonincome items or on a "formulary" basis, where the tax base might yield a foreign tax higher than one based on transactions at fair market value.

There is nothing to suggest that the ACT applies to artificial gross receipts or to gross receipts determined on a formulary basis. ACT is imposed on qualifying distributions, which are generally made out of actual gross corporate receipts less the expenses necessary to generate those receipts. Therefore, the ACT satisfies the gross receipts test.

In fact, there are only two possible sources of funds for corporate distributions: earnings and capital. Contrary to the assertion in the Senate Report, the ACT cannot be imposed on distributions out of capital for two distinct reasons. First, U.K. company law prohibits distributions out of capital. Second, under U.K. tax law the ACT applies only to qualifying distributions, and distributions are defined for that purpose so as to exclude distributions out of capital. Therefore, under U.K. law, the base upon which ACT is imposed is predominantly comprised of income.

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82 Treas. Reg. § 1.901-2(b)(2)(iv), example (3).
85 ICTA §§ 14(12) & 209(2)(b).
Finally, a foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts to permit recovery of significant costs and expenses. Alternatively, the requirement is satisfied if the tax base is computed under a method likely to produce an amount that approximates or exceeds recovery of significant costs and expenses. The thrust of this test, like the others, is to restrict creditability to foreign taxes that are essentially equivalent to U.S. income taxes. The second part of the test is designed to permit a tax credit for foreign taxes imposed under a system that does not permit recovery of certain costs and expenses recoverable under U.S. law, provided that the system includes allowances that effectively compensate taxpayers for such nonrecovery.

The ACT applies to qualifying distributions which, as noted above, must generally be made out of the profits of the distributing corporation. There is no hint in U.K. law that those profits are derived under a system that fails to allow for recovery of significant costs and expenses. Those same corporate profits form the base for U.K. mainstream corporation tax, which is doubtless itself a creditable income tax. Of course, neither the mainstream tax nor the ACT has a base that is identical to the one used under the income tax provisions of the Code, but such identity is not required. Therefore, the ACT satisfies the net income test.

In sum, the ACT meets all of the tests designed to determine whether its predominant character is that of an income tax in the U.S. sense. Having satisfied those tests as well as the "separate levy" and "tax" requirements, the ACT must be fully creditable as and when paid.

This conclusion is buttressed by evidence that, at one point, the Internal Revenue Service itself suggested that the ACT was a creditable tax under the Code. By Memorandum to the Assistant Secretary of the Treasury dated May 7, 1980, concerning an earlier proposed version of the regulations that had attempted to address (at least in part) the creditability of the ACT, the Commissioner stated: "An issue not resolved
in these regulations is whether the advance corporation tax is a separate charge. *If it is a separate charge, it is probably an income tax because it is imposed almost exclusively on distributions of realized net income.*

The rules regarding "separate charges" that appeared in the earlier version of the regulations were completely rewritten, and replaced in 1983 by the "separate levy" rules discussed previously. However, the provisions of the earlier regulations addressing "realized net income" reflected the development of early case law in approximately the same manner as the current regulations. Thus, the Commissioner's assertion that the ACT is imposed on "distributions of realized net income" is as valid under the current regulations as it was earlier.

**CONCLUSION**

It is probably not possible to determine with certainty whether negotiation of the Convention proceeded upon an assumption that the ACT was not a creditable tax under then prevailing U.S. standards of creditability. What is clear, however, is that inquiry into the creditability of the ACT outside the terms of the Convention all but ceased when the Convention was brought into force. As a result, limitations on the creditability of the ACT imposed by interpretations of the Convention have been challenged (as in *Xerox* and *Snap-On Tools*) only by reference to the language of the Convention itself. No one has suggested laying the Convention aside and considering the proper result under the Code.

This article has attempted to do precisely that. It has maintained, notwithstanding the views of Convention interpreters and the doubts surrounding creditability of foreign taxes during the 1970s, that the ACT is a fully creditable tax under current U.S. foreign tax credit rules.

The implication is that the Convention's treatment of the ACT

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in the taxable year for which it is imposed and the advance amount is not paid or accrued to the extent such amount reduces the corporate income tax. The amount of corporate income tax paid or accrued is reduced to the extent the advance amount is paid or credited to shareholders of the distributing corporation.

This provision, which essentially treats the "advance amount" as an estimated tax payment was found applicable to the ACT in Priv. Ltr. Rul. 83-39-060 (June 28, 1983) and Priv. Ltr. Rul. 8409002 (Sept. 23, 1983). However, it was deleted when the final 1983 regulations were issued, and the subject of "integrated tax systems" was reserved. Treas. Reg. § 1.901-2(e)(4)(ii). The rationale for the deletion was not fully explained. It may be that, like the *Xerox* court, the draftsmen found the conceptual basis for this rule to be untenable.

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represents an alternative, as opposed to an exclusive, path through the U.S. foreign tax credit system. The impact of such a conclusion on the economic and political validity of the bargain struck between the United States and the United Kingdom in the Convention is, as they say, beyond the scope of this article.