The Mexican Railroad Cases: A Study of Qualification and Allocation Under the United States Foreign Tax Credit

The Mexican railroad cases are several decisions involving the qualification of the Mexican *per diem* railroad tax for the United States foreign tax credit. These cases are of direct concern to those engaged in foreign rolling stock activities, including railroads and leasing companies. They also provide an interesting general analysis of the eligibility of foreign taxes for the United State foreign tax credit.

I. The Mexican *Per Diem* Railroad Tax

The Mexican railroad cases involved two basic factual patterns dealing with the eligibility of certain Mexican taxes for the United States foreign tax credit. The early cases concerned the straightforward *per diem* tax which was in effect prior to the Mexican income tax changes of 1954. The later cases dealt with the new income tax law and certain agreements thereunder.

Prior to 1954, the Mexican income tax was imposed on the rental of railroad cars to Mexican railroads on the basis of a *per diem* rate. The taxes were imposed pursuant to a dual schedule; Schedule 1 imposed a general income tax and Schedule 2 imposed a tax on specific types of income including income from railroad rolling stock.[1]

On January 1, 1954, a new Mexican income tax law provided for a tax on rentals less certain deductions.[2] This statute allowed a taxpayer to enter into an agreement with the Mexican government for the determination of the tax base where ordinary procedures could not ascertain the taxable income.[3] One year later the Mexican government, certain government-owned railroads of Mexico, and the Association of American Railroads (representing United States and Canadian railroads) entered into an agreement which provided that Mexican railroads renting rolling stock would withhold from the rentals payable to the United States and Canadian railroads an amount which would be paid to the Mexican government. This amount would equal the difference between the basic *per diem* rate (for practical purposes, the United States rate) and the Mexican *per diem* rate for renting rolling stock. The amount withheld would be considered as complete satisfaction of each of the railroad's income tax liabilities under the new Mexican income tax law.[4]

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[1] Mexican Income Tax Law of March 18, 1925, Schedules 1, 2.

[2] New Mexican Income Tax Law (published Dec. 31, 1953, effective Jan. 1, 1954).

[3] *Id.* schedule 1, art. 28 (Commerce).

[4] Agreement between the Republic of Mexico, government-owned railroads and the Association of American Railroads, Dec. 31, 1954.

II. Eligibility of Foreign Tax Credit

In order to qualify as a tax eligible for the foreign tax credit an amount paid must either:

(1) be considered an income, war profits or excess profits tax paid to a foreign country or United States possession,[5]
or
(2) be considered a tax paid in lieu of one of the above taxes, and hence included as such a tax.[6]

Whether a tax is considered a creditable tax eligible for the foreign tax credit is determined by using United States standards for that type of tax. It has been held that taxes assessed on gross income without deductions were not income taxes.[7] The term "income tax" covers foreign taxes designed to fall on some "net gain or profit." It includes a gross income tax if, but only if, that impost is very likely to reach some net gain, that is, costs or expenses will not be so high as to offset net profit.

It is not completely clear what elements go into the determination of the net gain, but certainly some relationship to United States taxable income would be acceptable. A net gain measurement short of taxable income would be less secure. This determination is a factual inquiry which, ideally, examines the type of tax as envisioned by its draftsmen and the practical effect of the tax.[8]

The alternative tactic is to qualify as an "in lieu of" tax.[9] The Treasury Regulations delineate the Internal Revenue Service's (IRS) interpretation of this provision by specifying three necessary criteria:[10]

(1) The country or possession has in force a general income tax law.
(2) The taxpayer claiming the credit would, in the absence of a specific provision applicable to him, be subject to the general income tax.
(3) The general income tax is not imposed upon the taxpayer subject to the substituted tax.

In a letter to the Secretary of the Treasury discussing the substantially identical precursor to these Treasury Regulations under the United States Internal Revenue Code of 1939, Senator George (Chairman of the Senate Finance Committee in 1942) criticized this formulation as more restrictive than Congress intended.[11] Senator George interpreted the "in lieu of" language to encompass the situation where a clearly creditable tax is subsequently replaced by another sort of tax. And although authority can be found supporting the position that an "in lieu of" tax must be designed to reach net

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[5]I.R.C. § 901(b)(1).
[6]I.R.C. § 903.
[7]Bank of Am. Nat'l Trust and Sav. Ass'n v. United States, 459 F.2d 513 (Ct. Cl. 1972).
[8]Rev. Rul. 73-117, 1973-1 C.B. 344; Rev. Rul. 78-61, 1978-1 C.B. 221; Rev. Rul. 78-233, 1978-1 C.B. 236; and Rev. Rul. 78-235, 1978-1 C.B. 238.
[9]I.R.C. § 903.
[10]Treas. Regs. § 1.903-1. *See also* Prop. Treas. Regs. 1. 903-1 (a).
[11]Henkel, *Foreign Tax Credits*, 17 N.Y.U. INST. FED. TAX. 391 (1959)

income, the history of the provision suggests that it was specifically enacted to get around a narrow interpretation of the term "income tax."[12]

III. The Mexican Railroad Cases

A taxpayer wishing to establish the creditability of the Mexican *per diem* tax could propose three lines of argument:

1. the Mexican *per diem* tax is a tax on income;
2. it is in lieu of such a tax and meets the requirements of the Treasury Regulations;
3. even if the requirements of the Treasury Regulations are not met, the tax is still in lieu of a creditable tax since the Regulations are unduly restrictive and the Mexican *per diem* tax followed the enactment of a previous income tax law.

In order to assess the viability of these arguments, it is necessary to examine what courts have done with variations on these themes.

There are two cases applying the 1939 Code which held that a graduated tax on gross freight rentals was in lieu of the Mexican income tax law then in effect. The first case involved the Missouri Pacific Railroad Company and held that it was unnecessary to determine whether the tax on gross receipts was an income tax creditable under the 1939 Code since it was clearly a substitute for a general income tax and not merely an additional or unrelated tax.[13] The court in that case applied the provisions of a Regulation substantially similar to the present "in lieu of" Treasury Regulations.[14] The second case merely cited the *Missouri Pacific* case and stated a similar conclusion.[15]

In the late 1960s three cases dealt with the same question in light of the new Mexican income tax law. A case involving the Missouri-Illinois Railroad Company held that the 1957 *per diem* tax paid to Mexico was "either an income tax or a tax in lieu of a tax upon income, and therefore creditable."[16] The court did not cite the relevant Treasury Regulations, but its discussion paralleled the requirements in the Regulations.[17] It appears the court was

[12]Northwestern Mut. Fire Assoc. v. Comm'r., 181 F.2d 133 (9th Cir. 1950); Metropolitan Life Ins. Co. v. United States, 375 F.2d 835 (Ct. Cl. 1967); Missouri Pac. R.R. v. United States, 392 F.2d 592 (Ct. Cl. 1968). Cf., Comm'r. v. American Metal Co., 221 F.2d 134 (2d Cir. 1955); United States v. Waterman S.S. Corp., 330 F.2d 128 (5th Cir. 1964).

[13]Missouri Pac. R.R. v. United States, 392 F.2d 592 (Ct. Cl. 1968).

[14]Treas. Regs. § 1.903-1.

[15]Chicago, Mil., St. P. & Pac. R.R. v. United States, 404 F.2d 960 (Ct. Cl. 1968).

[16]Missouri-Illinois R.R. v. United States, 381 F.2d 1004 (Ct. Cl. 1967).

[17]Treas. Regs. § 1.903-1.

convinced that the tax was in lieu of a creditable tax, and, like the courts in the 1939 Code cases, probably deferred on the question of whether the tax was itself an income tax.

The same railroad sued alternatively in a district court for the recovery of 1958 taxes, but lost when the court found no proof that the tax had ever been withheld and actually paid. The Mexican tax return was not sufficient evidence of itself and tax receipts or similar documentation were not produced. The claim was disallowed without discussion of the legal issues and without citation.[18]

Another significant decision concerning the 1954 Code involved the Missouri Pacific Railroad Company.[19] Taxes for the years 1955 and 1956 were at issue. After reviewing the facts in great detail, the court then concluded, without analysis, that "the laws of Mexico in force during 1955 and 1956 imposed an income tax upon the taxpayer recognizable as a credit against the U.S. income tax."[20] This conclusion is ambiguous; it is not clear whether the *per diem* tax is of itself a creditable income tax, or whether it is an income tax solely because of the "in lieu of" provisions.

The government did appeal from this decision, but limited its appeal solely to the question of whether the per-country limitation on usable tax credits, a provision which will be discussed below, had been correctly applied. Consequently, it may be inferred that in 1968 the IRS saw little chance for a reversal of the court's finding that the Mexican tax qualified as an income tax and was therefore creditable.

However, in two fairly recent Court of Claims cases, where the facts were substantially identical to those of the Missouri Pacific case, the IRS did raise this issue. In the first case, involving the Chicago, Burlington and Quincy Railroad Company, the court seemed almost impatient with the government's attempt to place this issue in question.[21] The court concluded, without extensive analysis, that the tax payments were payments of a "foreign income tax within the meaning of the Internal Revenue Code of the United States."[22] Again, it is not clear whether the tax was considered an income tax or an "in lieu of" tax. The court's survey of the facts highlighted considerations of the type outlined in the Treasury Regulations, but the Regulations were not cited.

The most recent case again involved the Missouri Pacific Railroad Company.[23] This case cited the *Chicago Burlington* case as applicable and re-

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[18]Missouri-Illinois R.R. v. United States, 268 F. Supp. 214 (E.D. Mo. 1967).

[19]Missouri Pac. R.R. v. United States, 301 F. Supp. 839 (E.D. Mo. 1967) *aff'd in part, rev'd in part and remanded*, 411 F.2d 327 (8th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970).

[20]301 F. Supp. at 845.

[21]Chicago, B. & Q. R.R. v. United States, 455 F.2d 993 (Ct. Cl. 1972), *rev'd on other issues*, 412 U.S. 401 (1973).

[22]455 F.2d at 1019.

[23]Missouri Pac. R.R. v. United States, 497 F.2d 1386 (Ct. Cl. 1974).

sponded to the government's argument that the method of implementing this tax resulted in an abdication of the Mexican government's taxing authority to the American Association of Railroads by noting that nothing in the record demonstrated that this tax system was anything other than a withholding system and an appropriate exercise of government authority. The case cited and followed previous decisions without extensive elaboration.

Recently, the IRS indicated its disagreement with the Mexican railroad cases to the extent that the cases could be cited for the proposition that the payment of a governmental subsidy to the one paying the tax does not bear upon the issue of the tax's creditability. The IRS has neither agreed nor disagreed with an interpretation of the holding of the cases that the tax was an "in lieu of" tax.[24]

IV. Summary of Potential Taxpayer Positions

A taxpayer may contend that a tax qualifies for the foreign tax credit either as an income, war profits or excess profits tax, or as a tax paid in lieu of such taxes. Two cases applying the 1939 Code held that a tax arrangement similar to the one in question was "in lieu of" the creditable tax and hence qualified for the credit.[25] The cases applying the 1954 Code have held that the Mexican *per diem* tax is either an income tax or "in lieu of" such tax.[26] However, the courts have been somewhat ambiguous, and it is not clear whether their conclusions were based upon the direct tax or "in lieu of" provisions.

The validity of a creditable tax argument for the Mexican *per diem* tax depends in part upon how clearly the tax in question is related to "net gain," a concept similar to taxable income. Perhaps the more convincing argument is based on the "in lieu of" provisions. The tax appears to meet the requirements of the Treasury Regulations, which themselves might be more restrictive than those which would be imposed by a court.[27]

V. The Foreign Tax Credit Limitations

While several of the Mexican railroad cases did allow the tax credit, the amount of that credit was limited on the basis of either a per-country limitation or an elective, overall limitation (all foreign countries). For tax years beginning after 1975, however, the per-country limitation has been eliminated so that only the overall limitation may be used.[28]

During the tax years involved in the cases discussed above, the per-country limitation was predominantly used. The amount of the credit could not exceed that proportion of the tax against which the credit was taken which the

[24]Rev. Rul. 78-258, 1978-1 C.B. 239.

[25]Sections 901 & 903.

[26]Missouri Pacific R.R. v. The United States 392 F.2d 592 (Ct. Cl. 1968) and Chicago Mil. St. P. & Pac. R.R. v. United States 404 F.2d 960 (Ct. Cl. 1969).

[27]Treas. Reg. § 1.903.

[28]I.R.C. § 904.

taxpayer's taxable income from sources within the specific foreign country (but not to exceed the taxpayer's entire taxable income) bore to his entire taxable income for the same taxable year.

Thus, the crucial determination in the per-country limitation was the "taxable income from Mexico." In computing taxable income, foreign income must be reduced by identifiable expenses, losses or other deductions and a ratable proportion of unallocable expenses. The taxpayer would wish to maximize taxable income from Mexico for purposes of the computation and would allocate as many deduction items as possible to United States income. This same analysis would apply to the overall limitation, except that a taxpayer would wish to maximize taxable income from all foreign sources by similarly allocating deduction items to United States income. These allocations are the subject of complex rules contained in the Internal Revenue Code, Treasury Regulations and related case law.[29]

The *Missouri Pacific* case under the 1939 Code made an extensive inquiry into the appropriate allocation of deductions.[30] Interest attributable to car financing, state property taxes, major and running repairs, indirect maintenance, depreciation and amortization were generally allocated on the basis of car-days. User repairs for damages caused by improper usage and inspection expenses were allocated to United States income. The other 1939 Code case similarly allocated running repairs on the basis of car-days and allocated interest on indebtedness only to the extent it was attributable to railroad cars.[31] The court in that case found that there was no evidence to support the proposition that expenses in general were less in Mexico because of that country's less intense use.

In the first *Missouri Pacific* case under the 1954 Code, the circuit court disagreed with the district court's conclusion that the evidence showed less intense use in Mexico (so as to allocate running repairs on a where-paid basis), and therefore allocated running repairs on a per car-days basis. However, the circuit court agreed with the district court with respect to state property taxes and allocated them entirely to United States income.[32] The circuit court decision was lenient in accepting much of the taxpayer's computation of Mexican taxable income. It determined that maintenance of freight traffic offices, employees' accrued vacation pay, and interest on debt did not have a sufficient relationship to Mexican earnings to be attributable to Mexican taxable income, and consequently allocated the items in their entirety to United States income.[33]

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[29]I.R.C. §§ 861-863 and Treasury Regulations thereunder. *See also* Feinschreiber, *Analysis of the Allocation and Apportionment Cases: 1934 to Present*, 4 INT'L TAX J. 769 (1978).

[30]Missouri Pac. R.R. v. United States, 392 F.2d 592 (Ct. Cl. 1968).

[31]Chicago, Mil., St. P. & Pac. R.R. v. United States, 404 F.2d 960 (Ct. Cl. 1969).

[32]Missouri Pac. R.R. v. U.S., 301 F. Supp. 839 (E.D. Mo. 1967) *aff'd in part, rev'd in part and remanded*, 411 F.2d 327 (8th Cir. 1969), *cert. denied*, 396 U.S. 1037 (1970).

[33]Missouri Pac. R.R. v. United States, 497 F.2d 1386 (Ct. Cl. 1974).

In summary, if the taxpayer can factually demonstrate a definite relationship to either United States source income or Mexican source income a deduction item will be allocated to that income. Other items will be allocated on a ratable basis, probably predicated on car-days. Interest will be allocated to Mexico only to the extent it is attributable to funds used to obtain railroad cars operated in that country.

Allocation of Expenses Under the Mexican Railroad Cases

Type of Expense	*Allocation*
1. Property taxes (assessed by states)	car-days
Missouri Pacific R.R. v. United States, 392 F.2d. 592 (Ct. Cl. 1968) "overall ownership expenses"	
Missouri Pacific R.R. v. United States, 411 F.2d. 327 (8th Cir. 1969) affirming district court	United States only
2. Interest	
Attributable to general railroad business	United States only
Attributable to cars	car-days
3. Classified repairs	car-days
Made in major repair shops, generally body work costing more than $50.	
4. Running repairs	car-days
Made in trainyards or tracks, generally minor	
5. User repairs	United States only
Caused by improper usage, generally assumed by user railroad	
6. Inspection	United States only
Attributed primarily to user safety rather than maintenance	
7. Indirect freight car maintenance	car-days
Exclude user repairs, inspection expenses attributable to foreign cars.	
Include miscellaneous maintenance or equipment overhead, maintenance and depreciation of equipment repair	

Allocation of Expenses Under the Mexican Railroad Cases (continued)

Type of Expense	Allocation
facilities, state property taxes attributed to equipment repair facilities, general and administrative expenses attributable to car repairs, deadline haul cost of car repair material (transportation).	
Also include payroll taxes pursuant to the following formula:	
$\frac{\text{annual payroll taxes}}{\text{annual compensation}} \times$ total estimated labor portion of all freight car maintenance expenses	
8. Depreciation and amortization	car-days
9. Switching expense in connection with freight car repairs	car-days
10. Maintenance of freight traffic offices	United States only
11. Employees' accrued vacation pay	United States only

Car-day computation per Missouri Pac. RR. v. United States, 392 F.2d. 592 (Ct. Cl. 1968) and Missouri Pac. R.R. v. United States 411 F.2d. 327 (8th Cir. 1969).

Average number of freight train cars × 365 = total available system car-days per year or total car-days unadjusted.

Subtract: (1) bad order car-days—days during which cars cannot be used because they are under repair.

(2) surplus car-days—days during which cars are not in use because of no available load within 24 hours

= total active car-days.

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