The Foreign Tax Credit Limitation: An Analysis of the President’s Tax Proposals

I. Introduction

The principal mechanism provided by the U.S. Internal Revenue Code for minimizing international double taxation of income earned by U.S. taxpayers from sources outside the United States is the foreign tax credit. Under the credit mechanism, U.S. taxpayers may reduce their U.S. income tax dollar-for-dollar by the amount of foreign taxes they pay on foreign-source income. A limitation on the foreign tax credit prevents taxpayers from using foreign taxes to reduce U.S. tax on U.S.-source income. No aspect of our tax system has a greater impact on the total U.S. and foreign tax burden on income generated by foreign business operations of U.S. taxpayers than the limitation on the foreign tax credit.

As a part of the President’s Tax Proposals to the Congress for Fairness, Growth and Simplicity (Proposals), the Administration has proposed extensive changes to the rules governing the limitation on the foreign tax credit. The potential major effects these changes would have on the after-tax profitability and competitive position of U.S. business abroad render them a matter of high priority for U.S. businesses with foreign operations.
This article will summarize and attempt a preliminary evaluation of the Administration's principal proposals affecting the foreign tax credit limitation.

A. CURRENT LAW

In broad outline, under present law U.S. taxpayers are allowed a credit against their U.S. tax liability for income taxes paid directly by the taxpayer to foreign countries and United States possessions. In addition, a U.S. corporate taxpayer is allowed an "indirect" credit for foreign income taxes paid by a foreign corporation in which it owns at least ten percent of the voting stock (as well as for taxes paid by certain of that corporation's lower-tier foreign affiliates) when the U.S. corporate shareholder receives an actual dividend distribution or is treated as receiving a constructive dividend distribution of profits from a "controlled foreign corporation" under the anti tax-haven rules of the Internal Revenue Code. However, the total amount of direct and indirect credits for foreign taxes available to any taxpayer to offset U.S. income tax liability in any taxable year is subject to a limitation contained in section 904 of the Internal Revenue Code that is designed to ensure that the credit does not exceed the U.S. tax that otherwise would be imposed on all income of the taxpayer derived from foreign sources in that year.

B. PROPOSED CHANGES TO THE FOREIGN TAX CREDIT LIMITATION

The Proposals would replace this "overall" foreign tax credit limitation, which is calculated on the basis of income earned from all foreign sources and applied to taxes paid to all foreign countries, with a "per-country" limitation, which would be calculated and applied on a country-by-country basis.4 The Proposals would also expand the scope of the separate foreign tax credit limitation that is applied under existing law to certain types of interest income to encompass other forms of passive, and typically low-taxed, foreign income to prevent taxpayers from using this income to increase the general foreign tax credit limitation (applicable to operating income) in order to increase available foreign tax credits.5 In addition, the Proposals would change existing rules concerning the source of certain types of income and the allocation of expenses against foreign-source income in a manner that would tend to reduce the amount of net taxable foreign-source income for U.S. taxpayers earning such income and thereby to lower the foreign tax credit limitation and the amount of usable foreign tax credits for

4. Proposals, at 386–89.
5. Id. at 389.
such taxpayers.\textsuperscript{6} The Administration also proposes new rules for the treatment of foreign losses in calculating the foreign tax credit limitation; these new rules are designed in part to adapt the foreign loss rules of existing law to the per-country limitation, but, unlike present law, would also include provisions intended to prevent a permanent loss of foreign tax credits as a result of U.S. losses.\textsuperscript{7}

Despite a limited number of changes proposed by the Administration that are favorable to taxpayers (such as the U.S. loss rule just mentioned), it seems clear that the net effect of the Administration's foreign tax credit proposals, particularly in combination with the reduction in the maximum corporate tax rate from forty-six to thirty-three percent contemplated by the Proposals, would be significantly to exacerbate problems of excess foreign tax credits already faced by some U.S. corporations, and to create excess foreign tax credit problems for many others. According to the Administration's explanation of the Proposals, however, the goal of these proposed changes is not merely to increase tax revenues, but also, and more fundamentally, to ensure that to the extent possible the foreign tax credit serves the function of preventing international double taxation, without permitting U.S. taxpayers to use the credit mechanism to "average" high foreign taxes with low foreign taxes and, in ways described more fully below, to use high foreign taxes to offset U.S. tax that otherwise would be imposed on low-taxed foreign income.\textsuperscript{8} The Administration concedes that achievement of this goal through enactment of its foreign tax credit proposals would come at a high cost in terms of greatly increased administrative complexity for both taxpayers and the Internal Revenue Service in operating under the new rules.\textsuperscript{9}

Part II of the article summarizes the existing rules relating to the foreign tax credit limitation that would be affected by the proposed changes and some of the opportunities afforded by those rules for maximizing foreign tax credits by averaging high and low foreign taxes. Part III describes the basic changes proposed by the Administration, and part IV provides an analysis and evaluation of these proposed changes.

C. OTHER PROPOSED CHANGES TO THE FOREIGN TAX CREDIT

Beyond the proposals that relate directly to the foreign tax credit limitation, other changes have been proposed in the calculation of indirect foreign tax credits with respect to actual dividend distributions from foreign corporations and constructive dividend distributions under the anti tax-haven
rules of subpart F. These include provisions for changes to the rules for identifying the earnings of a foreign corporation out of which a dividend distribution is considered to have been made and the foreign taxes attributable to those earnings, as well as to the rules for translating those earnings and the related foreign taxes out of the relevant foreign currency into U.S. dollars. These proposed changes to the manner in which the amounts of indirect credits would be determined do not directly involve the section 904 limitation on the foreign tax credit (which is applied after the amount of creditable foreign taxes has been determined), and are therefore beyond the scope of this article, but they would have important effects in reducing the opportunities currently available to taxpayers to manipulate actual and constructive distributions in order to maximize available indirect foreign tax credits.

Thus far the Proposals have taken the form only of a summary description of possible changes to U.S. tax law suggested by the Administration, and no draft of legislation that would implement the Proposals has been made available to the public. As a result, aside from the possibility of significant changes to the Proposals in Congress prior to enactment of any actual legislation, many details concerning the Proposals remain unclear, and any discussion of the Proposals at this time must focus on the general structure of the proposed changes, rather than their specifics. The importance of the proposed changes to the foreign tax credit limitation to U.S. taxpayers engaged in international business, however, makes it appropriate to comment before Congress takes final action on the President’s program.

II. Current Law

A. General

All U.S. domestic taxpayers are subject to U.S. federal income tax on their worldwide income. As a mechanism for dealing with the problem of international double taxation, taxpayers are allowed a dollar-for-dollar credit for foreign income taxes (and certain other foreign taxes) against their U.S. federal income tax liability.

A U.S. taxpayer earning foreign income directly (for example, through a

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10. See id. at 385–86, 388–89, 393–94.
12. The foreign tax credit provisions of the Proposals are analyzed in STAFF OF JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., TAX REFORM PROPOSALS: TAXATION OF FOREIGN INCOME AND FOREIGN TAXPAYERS 22–83 (Comm. Print 1985).
13. The credit is allowed for “income, war profits, and excess profits taxes” paid to foreign countries and possessions of the United States, as well as taxes paid “in lieu of” any such income, war profits or excess profits tax. See §§ 901, 903; Treas. Reg. §§ 1.901-1, T.D. 7961.
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foreign branch, rather than a subsidiary) is entitled to a “direct” foreign tax credit for the foreign income taxes that it actually pays (or that are withheld on its behalf, as in the case of withholding taxes on such income as dividends, interest and royalties). Most U.S. corporations, however, conduct their foreign operations primarily through foreign subsidiaries. In order to place income earned through a foreign subsidiary on roughly the same footing as income earned directly through a foreign branch, a U.S. corporate shareholder is entitled to claim an “indirect” foreign tax credit for foreign taxes paid by a foreign corporation in which the U.S. corporation owns at least a ten percent voting stock interest. A U.S. corporation may claim this indirect foreign tax credit in respect of foreign income taxes paid by such an affiliate at the time that the U.S. shareholder either receives an actual dividend distribution out of the after-tax profits of that foreign affiliate, or is treated under the rules of subpart F of the Code as receiving a constructive dividend distribution from a “controlled foreign corporation.”


15. §§ 902; 960. The indirect credit is also allowed for taxes paid by second- and third-tier foreign affiliates of a U.S. corporation upon the receipt by a U.S. corporation of dividends or subpart F distributions attributable to income earned by such lower-tier corporations, as long as the tiers are connected by at least 10 percent voting stock ownership and the cumulative ownership interest of the U.S. corporation in the second- or third-tier foreign corporation equals at least five percent. §§ 902(b); 960(a)(1). No credit is allowed to a U.S. corporation for foreign taxes paid by any foreign affiliate below the third tier.

16. Subpart F of the Code, §§ 951-964, requires “United States shareholders” in a “controlled foreign corporation” to include in U.S. taxable income, as a constructive dividend, their pro rata share of certain defined categories of income earned by the controlled foreign corporation that are included in the definition of “subpart F income” set forth in § 952, as well as of any increase during the shareholder’s taxable year in earnings of the controlled foreign corporation that are “invested in United States property” (such as tangible property in the United States or a loan to a United States shareholder), as defined in § 956. Similarly, under certain circumstances § 1248 treats gain realized by a U.S. person from the sale or exchange of stock in a foreign corporation (or a distribution from the corporation treated as gain from a sale or exchange) as a dividend, taxable as ordinary income (to the extent of the controlled foreign corporation’s accumulated earnings) if the U.S. person owned (directly, indirectly or by attribution) ten percent or more of the voting power of the corporation at any time during a five-year period during which the corporation was a controlled foreign corporation. Otherwise, this gain would be treated as a capital gain. The indirect foreign tax credit rules applicable to actual dividends also apply to deemed dividends under § 1248. Treas. Reg. § 1.1248-1(d), T.D. 7961, 1984-2 C.B. 130, 151; T.D. 6779, 1965-1 C.B. 383, 388. See also infra note 17.

17. § 960. A “controlled foreign corporation” is a foreign corporation more than 50 percent of the total combined voting power of which is owned, directly, indirectly or by attribution, by
B. FOREIGN TAX CREDIT LIMITATION

In order to prevent taxes in foreign jurisdictions with higher (effective) tax rates than U.S. rates from offsetting U.S. tax on income from U.S. sources, the United States limits the availability of the foreign tax credit to an amount equal, in effect, to the amount of U.S. tax that would be imposed on a U.S. taxpayer's foreign-source income (determined under U.S. tax-accounting and source-of-income rules). This limitation is computed as follows: \[ \text{Foreign tax credit limitation} = \frac{\text{Foreign-source taxable income}^{19}}{\text{Worldwide taxable income}^{19}} \times \text{U.S. tax on worldwide taxable income (before foreign tax credit)} \]

The limitation fraction is calculated on an "overall" (i.e., a worldwide) rather than a country-by-country basis, and applies to the aggregate of a taxpayer's direct and indirect credits for taxes paid to all foreign countries (and U.S. possessions) for a given taxable year. Thus, income from high-tax jurisdictions is grouped together with income from low-tax or tax-free jurisdictions in determining the numerator of the limitation fraction. As a result, effective rates of taxes imposed by various jurisdictions are averaged, and foreign taxes in the aggregate are fully creditable so long as the overall effective rate of foreign taxes on foreign-source taxable income (determined under U.S. rules) does not exceed the effective U.S. tax rate on worldwide (i.e., U.S.- and foreign-source) income.

Credits in excess of the limitation for any taxable year may be carried back to the previous two taxable years and carried forward five years.\[20\] Since the carryforward and carryback are of little or no benefit to taxpayers that are in a chronic excess credit position, many taxpayers have used the averaging mechanism of the overall foreign tax credit limitation to improve their foreign tax credit position by structuring international transactions and investments in a way that generates foreign-source income that is subject to little or no foreign tax. Inclusion of this low-taxed or tax-free foreign income in the numerator of the limitation fraction increases the taxpayer's overall foreign tax credit limitation with little or no increase in foreign tax, so that, ...
in effect, otherwise excess credits for foreign taxes imposed on other foreign-source income may be used to offset U.S. tax liability on the low-taxed or tax-free foreign income.\(^\text{21}\)

1. **Separate Limitation Rules**

Over a period of years some opportunities for using the averaging mechanism of the overall foreign tax credit limitation to achieve foreign tax credit benefits have been foreclosed through legislation. For example, in order to prevent taxpayers from artificially increasing the overall limitation by earning certain kinds of low-taxed or tax-free foreign-source income that otherwise would be includible in the numerator of the limitation fraction, current law requires that a separate foreign tax credit limitation be calculated for specified categories (referred to in the Proposals as "separate baskets") of income and applied only to taxes imposed on such income.\(^\text{22}\) As a result, such income and taxes are disregarded entirely in calculating and applying the overall foreign tax credit limitation.

For example, in recognition of the fact that U.S. taxpayers may readily shift investments in debt obligations or interest-bearing bank accounts to jurisdictions in which little or no tax will be imposed on interest earned from such investments, thereby generating low-taxed foreign-source income that would be includible in the numerator of the general limitation fraction, certain categories of interest income are subject to a separate basket limitation applicable only to such income and taxes imposed on such income.\(^\text{23}\) In addition, to prevent taxpayers from converting interest income that would fall into this separate basket limitation into foreign-source dividends that would be included in the numerator of the general limitation fraction merely by having a controlled foreign corporation hold portfolio debt and pay dividends to its U.S. shareholders out of the interest it earns on the debt, "look-through" rules introduced by the Tax Reform Act of 1984 (1984 Act) require that such dividends retain the character of the underlying interest...

\(^{21}\) This may be illustrated by the following simple example: Assuming an effective U.S. tax rate of forty percent, a U.S. taxpayer with U.S.-source income of $100, income from Country A of $100 (with an effective tax rate of sixty percent and thus taxes of $60) and income from Country B of $100 (with an effective tax rate of twenty percent and thus taxes of $20) is entitled, under the overall foreign tax credit limitation, to a foreign tax credit of $80 (i.e., $200/$300 x pre-credit U.S. tax liability of $120). By comparison, if the taxpayer had foreign operations only in Country B, the taxpayer would have had a foreign tax credit of $20, and additional U.S. tax of $20 would have been imposed on the income from Country B. Thus, through the averaging mechanism of the overall limitation, the taxpayer in effect uses otherwise excess credits from Country A (i.e., the excess of Country A taxes of $60 over the foreign tax credit limitation of $100/$200 x $80 = $40 that would have applied absent Country B operations) to offset the remaining U.S. tax of $20 on income from Country B.

\(^{22}\) § 904(d).

\(^{23}\) § 904(d)(2).
income to which they are attributable. Comparable look-through rules also apply to prevent the conversion of U.S.-source income into foreign-source income includible in the numerator of the general limitation fraction by routing the U.S.-source income through a foreign corporation.

Opportunities remain, however, for taxpayers to arrange their operations so as to alleviate actual or potential excess foreign tax credit problems. The most obvious possibility not addressed by the separate basket limitations for a taxpayer with excess credits from operations in high-tax countries is simply to establish or expand business operations in a low-tax jurisdiction. As a result of the averaging of foreign taxes under the overall limitation, taxes from the high-tax jurisdiction may be used to offset U.S. tax on income from the low-tax jurisdiction.

2. Source-of-Income Rules

Additional opportunities for maximizing foreign tax credits arise under the U.S. source-of-income rules, which in some cases permit U.S. taxpayers to generate income that is treated as foreign-source income under U.S. law, but not subject to foreign tax under foreign law. For example, existing U.S. law treats the source of income from the purchase and sale of personal property as the place where the sale occurs, normally where title to the property passes to the buyer. The placed at which title passes can be fixed by agreement between buyer and seller and is normally a matter of indifference to the buyer. Since the mere passage of title in a foreign country generally does not give rise to foreign tax, U.S. sellers often agree with foreign buyers to structure export sales of inventory to such buyers (in some cases their own foreign sales subsidiaries) to provide for passage of title outside the United States, thus generating untaxed foreign-source income that can be included in the numerator of the general limitation fraction.

24. Specifically, under these provisions, dividend distributions made by fifty percent or greater U.S.-owned foreign corporations (including deemed distributions under subpart F), by foreign corporations in which a U.S. person owns a ten percent voting interest and by regulated investment companies are recharacterized as interest that is subject to the separate basket limitation, to the extent that the distributions are attributable to such interest. § 904(d)(3).

25. Dividends and interest received from fifty percent U.S.-owned foreign corporations (which otherwise would be foreign-source income) are treated as U.S.-source income for purposes of the foreign tax credit limitation, to the extent that the dividends or interest reflect underlying U.S.-source income of the payors. § 904(g).

26. See note 21, supra, and accompanying text.

27. § 861(a)(6); Treas. Reg. § 1.861-7(c) (1957).

28. Under a related rule, income from the manufacture of property in the United States and sale in a foreign country is, in effect, usually treated as one-half from U.S. sources and one-half from foreign sources unless an independent factory price of the manufacturer provides a basis for a different allocation. Treas. Reg. § 1.863-3(b)(2), Example (2) (1957). This rule results in foreign tax credit benefits for many U.S. taxpayers who pass title abroad on sales of goods that they manufacture, again because such export sales result in foreign-source income without an increase in tax in the countries in which they are made.
An additional opportunity for U.S. corporate groups to maximize available foreign tax credits relates to the rules concerning allocation of expenses to U.S.- and foreign-source income. This allocation affects the foreign tax credit limitation, since the limitation depends on the ratio of foreign-source taxable income to worldwide taxable income. Since an allocation of an amount of expense to U.S. sources has the same effect on the foreign tax credit limitation as an allocation of an equal amount of income to foreign sources, the limitation generally increases (or reductions in the limitation are avoided) to the extent that expenses are allocated against U.S.- rather than against foreign-source income.¹²

One expense allocation rule of existing law that is of particular significance for U.S. corporations filing consolidated returns provides that interest expense of a member of a consolidated group must be allocated to U.S. and foreign sources in accordance with the assets or, alternatively, the gross income, of that member alone, and not on the basis of the assets or income of the group as a whole. Some U.S. consolidated groups have obtained the maximum benefit of this rule by having all borrowing done by members with little or no foreign-source income.³⁰

The result of this approach is to avoid allocations of interest expense incurred in the United States against foreign-source income of other members of the group, thereby maximizing (by avoiding reductions of) foreign-source taxable income of the group as a whole for foreign tax credit purposes and increasing the group's foreign tax credit limitation.

C. TREATMENT OF FOREIGN AND U.S. LOSSES

Under the overall foreign tax credit limitation, a taxpayer first uses a net loss incurred in any foreign country to reduce its income from other foreign countries. If a taxpayer’s net foreign losses exceed its foreign income, the excess ("overall foreign loss") reduces the taxpayer’s U.S. taxable income. Prior to the Tax Reform Act of 1976, if a taxpayer incurred an overall foreign loss in foreign country X in one year and later earned income abroad on which the taxpayer paid foreign tax (for example, because country X did not provide for an operating loss carryover or the income was realized in another foreign country), a foreign tax credit generally was allowed for the full amount of that tax even though the earlier overall foreign loss had

29. The limitation does not increase in the current year as a result of allocation of expenses to U.S.-source income when the taxpayer has an overall U.S. loss (in which case, despite the allocation to U.S. source-income, the expense in effect reduces foreign-source taxable income, i.e., the only net income earned by the taxpayer) or when, despite the allocation, the taxpayer has an overall foreign loss (in which case the limitation is zero). For a discussion of U.S. and foreign losses, see notes 31 to 32, infra, and accompanying text.

reduced the taxpayer's U.S. taxable income and its U.S. tax. To eliminate this double tax benefit, Congress enacted the overall foreign loss recapture rule of section 904(f) in the Tax Reform Act of 1976.

Under section 904(f), a taxpayer with an overall foreign loss in one year must "recapture" that loss in subsequent years by treating at least 50 percent of subsequent foreign-source income each year as U.S.-source income (which is excluded from the numerator of the limitation fraction) until the re-sourced income equals the total loss. The result is to reduce the foreign tax credit limitation and thus (to the extent creditable foreign taxes exceed the limitation after the application of section 904(f)) credits for foreign taxes imposed in subsequent years that otherwise would offset U.S. tax.

Under present law, if U.S.-source expenses exceed U.S.-source gross income, resulting in an overall U.S. loss, the excess expenses are applied to reduce a taxpayer's foreign income. An overall U.S. loss may be carried back to reduce taxable income in an earlier year or carried forward to reduce taxable income in a later year only to the extent that the loss exceeds the taxpayer's foreign income in the year incurred, thereby generating a net operating loss carryover for that year in the amount of the excess. Because an overall U.S. loss first reduces same-year foreign income before generating a loss carryover and therefore reduces the foreign tax credit limitation, such a loss may generate excess foreign tax credits in the year it is incurred.

Under present law, U.S. income earned after an overall U.S. loss year does not restore any of the foreign income previously offset by the U.S. loss, i.e., there is no "overall U.S. loss" recapture rule comparable to the overall foreign loss recapture rule of section 904(f). Thus, the foreign tax credit limitation is not increased in years following an overall U.S. loss year to permit the utilization of excess credits carried forward from the loss year and thereby to compensate for the decrease in the amount of usable credits in the loss year. As a result, two U.S. taxpayers with the same total U.S. source taxable income, foreign-source taxable income and foreign taxes over a two-year period, one of which has an overall U.S. loss in one year and one of which does not, may pay different amounts of U.S. tax and may utilize different amounts of foreign tax credits over the two-year period.

31. § 904(f).
32. The problem discussed in the text may be illustrated by a U.S. taxpayer with a U.S. loss of one hundred dollars, foreign-source taxable income (prior to giving effect to the U.S. loss) of one hundred dollars and foreign taxes of forty dollars in year 1, and U.S. taxable income of $100, foreign-source taxable income of one hundred dollars and foreign taxes of forty dollars in year 2. Assuming an effective U.S. tax rate of forty percent, the foreign tax credit in year 1 would be $0 (i.e., $0/$0 × $0), and in year 2 would be forty dollars (i.e., $100/$200 × $80). Thus, while foreign taxes of eighty dollars would have been incurred, and the entire two hundred dollars of income for the two years would be attributable to foreign-source income, only forty dollars of credits would be available. By comparison, if the same taxpayer had simply
III. Description of the Proposals

A. Per-Country Limitation

The Proposals would replace the current overall foreign tax credit limitation with a rule requiring computation of the limitation on a country-by-country basis. Thus, the foreign tax credit limitation for taxes paid to any particular country (Country A) would be computed as follows:

\[
\text{Maximum available foreign tax credit} = \frac{\text{Country A source taxable income}}{\text{Worldwide taxable income}} \times \text{U.S. tax on worldwide taxable income (before foreign tax credits)}
\]

Under this “per-country” limitation, credits would be available for taxes imposed by a particular country only to the extent that the effective U.S. tax rate did not exceed the effective rate of taxes imposed by that country on taxable income (calculated under U.S. tax-accounting rules) treated as earned within that country (under U.S. source-of-income rules). The per-country limitation would thus eliminate the mixing of income and averaging of tax burdens of all foreign countries that occur under existing law and would end the use of otherwise excess credits from high-tax jurisdictions to offset U.S. tax on income from low-tax jurisdictions.

B. Separate Basket Rules

The Proposals would retain the existing separate basket limitation for certain interest, but would apply it on a per-country basis. As a result, income subject to the separate basket limitation could not be used to make credits available for taxes imposed either on operating income, wherever earned, or on passive income earned in other countries. The Proposals would also expand the separate interest basket limitation to include (i) dividends received from corporations in which the recipient owned less than a ten percent interest and (ii) gains from the sale of assets generating passive income, such as stocks and debt securities, unless trading in such assets were integrally related with the seller's trade or business. Interest and dividends from corporations in which the recipient owned at least ten percent of the

had U.S. taxable income of zero in both years, the credit in both years would have been forty dollars (i.e., \$100/\$100 \times \$40), resulting in a total credit of eighty dollars for the two years. As long as the taxpayer in the first situation (involving an overall U.S. loss) does not earn low-taxed foreign income that will generate “excess limitation” in years following the loss year (or cannot carry back the excess credits to prior years) no credits will ever be available for the foreign taxes incurred by the taxpayer in year 1.

33. Proposals, at 389.
34. Id. at 389, 392.
voting stock would be excluded from the separate passive income basket, presumably because they represent a return on a direct investment and should therefore be assimilated to operating income. The Proposals do not include any rents or royalties in the passive income basket, but they state that “[t]he Administration will continue to consider whether other types of easily movable income that are generally taxed abroad on a gross withholding basis should also be included in the passive income basket.”

The proposals would also retain the other separate basket limitations for domestic international sales corporation (DISC) dividends and items related to a foreign sales corporation (FSC). The separate limitation for foreign oil and gas extraction income would be retained, but would be applied on a per-country basis.

C. Changes to the Generally Applicable Source-of-Income Rules

The Proposals would substantially amend the general source-of-income rules of current law that determine where a particular item of income is deemed for U.S. tax purposes to have been earned. These changes are intended to curtail the ability enjoyed by U.S. taxpayers under current law to structure foreign business operations in a way that will generate foreign-source income that is subject to little or no tax abroad, which can be included in the numerator of foreign tax credit limitation fraction and thereby permit the taxpayer to use foreign tax credits that would otherwise exceed the limitation.

1. Sales Income

Under the most important proposed change, income from sales of inventory goods not manufactured by the seller would generally be sourced in the country of residence of the seller, rather than (as under current law) at the place where title passes from the seller to the buyer. As an exception to this general rule, the source of income from sales out of inventory made through a fixed place of business outside the country of the seller would be the country where the fixed place of business is located, if the fixed place of business “participated materially” in the sale. However, this exception would not apply to sales to affiliates, i.e., the income from such sales would be sourced to the seller’s home country under the general rule. Thus, all income on export sales by U.S. taxpayers to controlled sales corporations

35. Id. at 389.
36. Id. See § 904(d)(1)(B), (C), (D).
38. Proposals at 402.
established in the foreign country in which customers are located would be treated as U.S.-source income. This change would convert a large volume of export sales income to U.S.-source income.

Similar changes are proposed in the rules for determining the source of income from the manufacture and sale of inventory property. The existing rules under which fifty percent of the income is usually treated as attributable to sales activity and fifty percent to manufacturing would be continued (although the Administration is also considering a reduction in the percentage allocation to sales activity), but the sales-related portion of the income would be sourced on the basis of the rules summarized in the previous paragraph applicable to pure sales income. For U.S. manufacturers selling out of U.S. rather than foreign sales offices, this change would also result in a significant reduction in foreign-source income.

Income from sales of passive investment assets, such as stock, securities and commodities futures contracts, would also be sourced in the country of the seller's residence, while the source of income from the sale of trade or business assets (other than inventory property) would be the place where the property is used by the seller. The Administration also proposes that the source of income from the sale of intangible property (such as patents, know-how and trademarks) be the country in which the property will be used.

The principal purpose of these proposed changes in the source-of-income rules is to eliminate the possibility of using the passage of title abroad on export sales (whether of goods, securities or intangibles) to a buyer in a high-tax jurisdiction to generate tax-free income sourced in that country in order to "free up" credits for otherwise uncreditable taxes imposed on income earned by the U.S. seller by that same country.

39. Id. at 402-03.

40. Id. at 403. The proposed rule concerning the source of income from sales of passive investment assets is similar to the rule of existing law treating capital gains from the sale or exchange of personal property as U.S.-source income, subject to certain exceptions, for purposes of computing the foreign tax credit limitation of a U.S. seller. See § 904(b)(3)(C). However, the proposed new rule would apply to sales by foreign corporations, so that gain from such sales by foreign affiliates of U.S. corporations would be sourced to the country of residence of the seller for purposes of computing the indirect credit. In addition, it is unclear whether the existing exceptions of § 904(b)(3)(C) (such as the exception providing that a capital gain is not a U.S.-source income if it is subject to foreign tax at a rate of at least ten percent) would continue to apply.

41. Id. Under existing law, royalties from licenses of intangible property (and gain from certain sales of intangible property treated as licenses) are sourced in the countries where the intangible property is used. Treas. Reg. § 1.861-5, T.D. 7378, 1975-2 C.B. 272, 282. The Proposals would retain these rules. Proposals, at 403.
2. Other Proposed Changes

Under existing law dividends and interest paid by a U.S. corporation that earns eighty percent or more of its gross income for a specified period from foreign sources are treated as foreign-source income.\(^42\) Repeal of this rule is also proposed, in part in order to prevent the use of such dividends and interest by U.S. taxpayers to increase their foreign tax credit limitation.\(^43\) Changes are also proposed in the rules relating to the source of transportation income. Whereas under current law transportation income is sourced in proportion to where expenses related to such income are incurred (resulting in treating most income generated in international transportation as foreign-source income because allocable to areas outside U.S. territorial waters), under the proposed new rules the source would reflect the economic activity involved, so that the amount of foreign-source income (usually untaxed abroad) available for inclusion in the numerator of the limitation fraction in many cases would be reduced.\(^44\)

Two important changes are also proposed for the allocation of interest expense against foreign-source income. Interest expense incurred by a corporation joining in the filing of a consolidated return would be required to be allocated to income from various sources on a consolidated group basis; that is, the assets or gross income of all members of the consolidated group would be aggregated for purposes of determining the percentage of interest expense to be allocated against foreign income. In addition, tax-exempt interest income and assets generating tax-exempt interest would no longer be taken into account for purposes of allocating interest expense.\(^45\)

\(^{42}\) §§ 862(a)(1), (2); 861(a)(1)(B), (a)(2)(A).

\(^{43}\) Proposals, at 403–04. The effects of this change on the foreign tax credit position of most U.S. taxpayers should be limited, since for most taxpayers interest (but not dividends) from such so-called “80-20” companies is subject to the separate basket limitation.

\(^{44}\) Id. at 404. Cf. § 863(b); Treas. Reg. § 1.863-4, T.D. 7378, 1975-2 C.B. 272, 282 (current law). The Proposals also would repeal § 861(e), under which, generally, income or gain realized by a lessor with respect to an aircraft, spacecraft or vessel that is eligible for the investment tax credit and is leased to a U.S. person is treated as U.S.-source income, so that tax losses in early years of the lessor in a typical leasing transaction are not allocated to foreign-source income and thus do not reduce the lessor’s foreign tax credit limitation. Under the Proposals, the source of such income or gain would be determined under the general rules governing the source of transportation income discussed in the text. In many leasing transactions this would result in a greater allocation of net deductions in the early years of a lease to foreign-source income, thus reducing the foreign tax credit limitation of the lessor.

\(^{45}\) Proposals, at 404. The Administration proposes this change because the allocation of deductible interest expense to tax-exempt U.S. income or assets increases foreign-source taxable income and thus the foreign tax credit limitation, while the income itself is not subject to U.S. tax. Id. at 401. Under current law this benefit is available primarily to financial institutions, since taxpayers generally are not entitled to deduct interest from loans incurred to carry tax-exempt bonds. See § 265.
D. Look-Through Rules

The Proposals include several look-through provisions which extend the comparable rules introduced by the 1984 Act and which are designed to ensure that the per-country limitation and the separate basket limitation for passive income not be subverted by running operating income from sources in a number of foreign countries with different effective tax rates, passive income and U.S.-source income through a foreign subsidiary that would pay dividends to its U.S. parent. Unless look-through rules were employed, dividends paid by a foreign corporation earning operating income sourced in various foreign countries subject to varying tax rates, passive income of a type includible in a separate basket limitation and U.S.-source income would be treated in the hands of its U.S. parent as operating income sourced in the country of organization of the corporation, which would be subject to a foreign tax rate for indirect foreign tax credit purposes equal to the average of the foreign taxes paid on the various sources and types of underlying income earned by the corporation. The look-through rules ensure that the dividends will retain for foreign tax credit limitation purposes the geographic source and character (and carry the appropriate foreign tax burden) of the underlying earnings of the foreign corporation out of which they are paid.

1. Source of Dividends

Thus, under current law the source of dividends is generally considered to be the country in which the corporation paying the dividends is organized, which permits blending of income from various countries and averaging of the taxes imposed on such income. Under the look-through rules of the Proposals, however, dividends paid by a foreign corporation earning ten percent or more of its income outside its home country would be resourced for purposes of the indirect foreign tax credit to reflect the source of the underlying income of the foreign corporation (including income received from its own lower-tier subsidiaries or affiliates) out of which the dividend is paid. For example, a dividend not subject to the separate basket limitation paid by a corporation organized in Country X that derives twenty percent of its profits from Country Y and eighty percent from Country Z would be sourced twenty and eighty percent in Countries Y and Z, respectively. Withholding taxes imposed on dividends would be treated as paid to the countries to which the dividends were resourced under these rules (or, if not resourced, to the country that imposed the withholding tax). Withholding

46. Proposals, at 391–92.
taxes on nondividend income such as interest, rents and royalties, would be treated as paid to the country that imposes the tax.47

For purposes of the indirect credit, taxes on net income of a foreign affiliate would be treated as taxes of the country to which they are paid, subject to an exception. The exception would permit foreign corporations that are subject to taxation in their home countries on their worldwide income and the dividends of which were resourced under the rules just described to elect also to have a portion of their home country tax treated as paid to the countries from which the income giving rise to the dividends was derived. This proposed election is designed to alleviate problems of mismatching of tax and income that would arise if income subject to home country tax, but not the home country tax itself, of a foreign corporation earning income in countries other than its home country were resourced to those countries.48 But for this election, such mismatching would occur in the example above if the Country X corporation were subject to Country X tax on its Country Y and Country Z income, since under U.S. rules the income earned by the Country X corporation would be treated as entirely Country Y and Country Z source income. Since Country X source income would under U.S. rules be considered to be zero, no credit would be available for Country X taxes.

2. Character of Income

Look-through rules similar to the recharacterization rule of the 1984 Act, but applied on a per-country basis, would also be included for identifying portions of dividends eligible for the indirect credit that would be subject to the separate passive income basket limitation in the hands of a U.S. corporation receiving the dividend.49 Thus, dividends eligible for the indirect credit generally would not only be resourced to the appropriate countries and so be included in the numerator of the general limitation fraction for each of those countries; in addition, under the separate basket look-through rules, the dividends would be treated as separate limitation basket income to the extent attributable to separate limitation income of the distributing corporation.50 In addition, the existing rules of section 904(g), providing for the resourcing as U.S.-source income of dividends and interest paid by

47. Id. at 392–93.
48. Id. at 393.
49. Id. at 392.
50. Under existing law, this look-through designed to maintain the character of interest income is applicable to any foreign corporation of which fifty percent of the voting power or value of the stock is owned by U.S. persons, any foreign corporation of which a U.S. person owns ten percent of the voting power and any regulated investment company. § 904(d)(3)(E).
United States-owned foreign corporations to the extent attributable to U.S.-source income, would be retained.51

3. Lower-Tier Foreign Affiliates

Since the expanded look-through rules would be applied in calculating indirect credits available to U.S. corporations owning at least 10 percent of the voting stock of a foreign corporation, under the Proposals the passive income and per-country look-through rules, and possibly even the U.S.-source income look-through rule of section 904(g), would be applied in the case of all 10 percent-owned foreign corporations and related lower-tier foreign corporations. Since no indirect foreign tax credit is available for foreign taxes paid by foreign corporations below the third tier, it is rather unusual to find more than three tiers of foreign corporations. However, in order to preclude blending of income (and related taxes) belonging in various baskets and from various countries in foreign corporations below the third tier, it would be necessary to apply the look-through rules to foreign corporations below the third tier.52 Moreover, expenses incurred by foreign subsidiaries would have to be allocated among separate baskets of income and individual foreign countries for all foreign corporations down through all tiers.

4. Summary

The Proposals thus would require for the purpose of calculating indirect foreign tax credits (i) identification of both the source and the character of gross income, (ii) allocation of related expenses against income in each basket for each country and (iii) attribution of foreign taxes to the net income allocated to each basket for each country, in each case down through all tiers of foreign subsidiaries, with the intended result that the ultimate U.S. corporation receiving an actual or constructive subpart F dividend would be entitled to foreign tax credits in accordance with general and

51. A United States-owned corporation is defined as a foreign corporation of which at least fifty percent of the voting power or value of the stock is owned by U.S. persons. § 904(g)(6).

52. Consider, for example, a third-tier foreign corporation with a wholly-owned foreign subsidiary organized in another foreign jurisdiction that invested exclusively in Eurocurrency interest-bearing obligations issued by unrelated parties, interest on which was free of withholding tax at the source and subject to a low rate of tax in the fourth-tier corporations' home jurisdiction. Since the fourth-tier foreign subsidiary would pay low taxes on its interest income, the absence of an indirect foreign tax credit with respect to its dividend distributions in some cases could be immaterial. Unless the look-through rule applied to the fourth-tier corporation, its low-taxed passive interest income could be converted into dividend income sourced in its home country that would be excluded from the passive income basket in the hands of its third-tier foreign parent. As a result, the dividends could be used, for example, to increase the per-country general limitation and thus available credits for taxes imposed on operating income earned by the third-tier corporation in the home country of the fourth-tier corporation.
separate basket limitations computed for each country that is the ultimate source of income distributed as dividends. Finally, after computation of the taxpayer’s available credits with respect to income earned directly, actual dividends and constructive subpart F distributions, it would be necessary to provide for carryovers of excess credits for the general and separate basket limitations applicable to each country. The policy underlying this highly complex set of look-through rules is evidently that, to the extent possible, the same foreign tax credit consequences should result if a U.S. corporation conducted its international operations through subsidiaries or affiliates as would result if it conducted those operations directly through foreign branches. The analysis of these rules included in the Proposals concedes, however, that: “these appropriate results will be achieved only through imposition of significant new burdens on both taxpayers and the Internal Revenue Service. Computation of a per country limitation with expanded separate baskets will introduce additional complexity into the already complicated limitation calculation.”

E. TREATMENT OF FOREIGN AND U.S. LOSSES

The Proposals would require that a net loss in a foreign particular country be reallocated to all other countries, including the United States, in proportion to the shares of worldwide taxable income earned in those countries in that year (and as to each such foreign country, the loss would be apportioned between separate basket limitation income and other income). Subsequent income in the loss country would be reallocated to those countries in the same proportions. To the extent that loss allocation, by reducing income from—and thus the foreign tax credit limitation applicable to—a particular foreign country, gave rise to additional excess foreign tax credits, the subsequent treatment of additional income as if it had been earned in that country would increase the amount of the foreign tax limitation, and thus the amount of usable tax credits, from that country later. To the extent that the loss allocation, by reducing U.S. taxable income or income from a particular low-tax foreign country, reduced U.S. tax liability in the loss year, the subsequent treatment of additional income as if it had been earned in the

54. Id., at 390-91. In the event that deductions exceed gross income from active business operations in a particular country, the loss apparently would be allocated pro rata to all other baskets in which there were positive income (including the passive income basket for the country concerned, the passive income and operating income baskets for all other foreign countries and a single basket for the United States).
55. Id. As a step toward simplification, the Administration proposes to repeal the existing rules governing the treatment of foreign oil and gas extraction losses, including the foreign extraction loss recapture rule. Id. at 391. Cf. § 907(c)(4) (current law).
United States or in the low-tax foreign country would result in the recapture of some or all of the U.S. tax revenue lost in the loss year.\footnote{56}

Unlike present law, a U.S. loss would be subject to these same general rules, i.e., the Proposals would require reallocation of the U.S. loss to all foreign countries and baskets, and subsequent reallocation of U.S.-source income in the same proportions.\footnote{57} Thus, an overall U.S. loss would reduce foreign income as it does under present law, except that, for per-country limitation purposes, the U.S. loss would be prorated against income earned by the taxpayer in different foreign countries in proportion to the shares of worldwide taxable income of each of those countries. In addition, however, the Proposals would in effect introduce an overall U.S. loss recapture rule, under which a portion of U.S. income earned after an overall U.S. loss year would be treated as foreign income. The additional foreign income would be allocated among the income accounts of the various foreign countries in which the taxpayer operates in proportion to the previous U.S. loss proration, and thus would increase the relevant general and separate basket limitations of each country by an amount equal to the previous reduction.

As an example of the operation of the proposed rule under a per-country limitation, consider a U.S. corporation with operations in the United States (with an effective tax rate approximately equal to the proposed maximum rate of thirty-three percent), Country X (with an effective tax rate of fifty percent) and Country Y (with an effective tax rate of ten percent), none of whose income constituted separate basket limitation income. If in year 1 this corporation had U.S.-source income of $100, Country X income of $100 and a Country Y loss of $100, $50 of the loss would be allocated to the United States and $50 to Country X. Worldwide taxable income would be $100,

\footnote{56. But for the loss-recapture rule, income from the low-tax country would, in the loss year, be subject to U.S. tax in the amount of the excess of the effective U.S. tax rate over that country's effective tax rate on the taxpayer's income. The allocation of a portion of the loss to that country thus would reduce income otherwise subject to U.S. tax and therefore result in a current reduction in U.S. tax liability. By comparison, no such current tax benefit would result in the allocation of losses to countries with effective rates equal to or higher than U.S. rates, since credits would offset the full amount of U.S. tax on income from such countries even prior to the loss allocation. In the case of allocation to high-tax countries, then, the loss reallocation rule would result in deferral of the U.S. tax benefit of the loss.

The subsequent reallocation to the United States and to low-tax foreign countries of income earned in the country in which losses had previously been incurred would increase U.S. tax liability since no credits would be available either for amounts treated, as a result of the reallocation, as U.S.-source income or as low-tax country income (since income from a low-tax country would generate "excess limitation" and therefore be subject to U.S. tax to the full extent of any excess of the U.S. tax rate over the low-tax country's tax rate). On the other hand, reallocation of income to high-tax countries would result in a reduction in U.S. tax by increasing applicable per-country limitations, thus making it possible to use otherwise excess credits for current-year taxes or credit carryovers from previous years.}

\footnote{57. In applying the loss reallocation rules both to U.S. and foreign losses, however, U.S. income would be treated as in a single basket. See Proposals, at 391.}

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resulting in pre-foreign tax credit U.S. tax liability of $33, against which a credit of $16.50 (i.e., $50/$100 $33) would be available for Country X taxes. Since but for the loss reallocation rule the credit for Country X taxes would have been $33 (i.e., $100/$100 $33), the rule would result in a loss of credits of $16.50.

If in year 2 operating results were the same, except that Country Y operations produced a profit of $100, that Country Y profit of $100 would be treated for U.S. foreign tax credit purposes as derived from the same jurisdictions (i.e., Country X and the United States) in the same proportion as the previous year’s loss had been allocated. Thus, no credit would be available for Country Y taxes, because for U.S. foreign tax credit purposes the corporation would be treated as having no Country Y income in that year. However, through an allocation of $50 of Country Y income to Country X, a credit of $49.50 (i.e., $150/$300 pre-credit U.S. tax liability of $99) would be available for Country X taxes, in effect offsetting the previous reduction in credits for Country X taxes.

F. RULES MITIGATING EFFECT OF MISMATCHING PROBLEMS

For foreign tax credit purposes foreign-source income and expenses are determined in accordance with U.S. tax-accounting rules. Since foreign taxes are, of course, imposed with respect to a tax base determined under foreign rules, significant mismatching of the sourcing and timing of income and tax burdens under the U.S. and foreign tax systems may occur. For example, if a U.S. engineering firm performs engineering services in the United States for a client in Brazil, the fee income will be subject to Brazilian tax as Brazilian-source income, while under U.S. rules it is U.S.-source income and would therefore be excluded from the numerator of the foreign tax credit limitation, under either current law or the Proposals.

While the averaging of effective foreign tax rates under the present overall foreign tax credit limitation and the flexibility of existing sourcing rules often make it possible to alleviate these mismatching concerns, this would no longer be the case under the proposed per-country limitation and new sourcing rules. Thus, if in the example above the U.S. engineering firm earned no income that would be treated under U.S. rules as from Brazilian sources, no credit would be available for Brazilian taxes.

The Proposals include measures intended to provide some relief from the adverse foreign tax credit consequences of such mismatching problems. Thus, the Proposals would extend to ten years the current five-year carry-forward of excess foreign tax credits, but would retain the existing carryback period of two years. The Proposals would also permit taxpayers to elect whether to credit or deduct foreign income taxes on a country-by-country
b) (Current law permits taxpayers to elect to deduct rather than credit foreign taxes, but the election must be made with respect to all taxes that would be creditable or deductible in a given taxable year. 59) Although the deduction does not produce the dollar-for-dollar benefit of a tax credit, foreign taxes may be deducted without limit. The option to deduct may be of benefit, for example, in cases of high effective foreign tax rates relative to the U.S. effective rates so that the foreign taxes are not fully creditable, or, as in the example above, when income taxed abroad is considered as U.S.-source under U.S. rules.

G. Effective Dates

The new foreign tax credit provisions generally would apply for taxable years beginning on or after January 1, 1986, subject to a complex set of transitional rules. Excess foreign tax credits existing on January 1, 1986 could be carried forward five (not ten) years and would be grandfathered from the effects of the per-country limitation for purposes of this carry-forward. Moreover, post-December 31, 1985 excess credits could not be carried back to years prior to January 1, 1986. 60 Other effective-date rules would apply to the provisions governing the "recapture" of foreign and U.S. losses.

IV. Evaluation and Conclusions

A. Overview

The proposals to lower the maximum U.S. corporate rate income tax rate from forty-six to thirty-three percent, to replace the overall with the per-country foreign tax credit limitation, to extend the passive interest basket limitation to apply also to portfolio dividends and gains from the disposition of assets producing passive income, and to revise the income and expense (and related foreign tax) sourcing rules, would, if enacted as a package, result in a striking increase in the number of U.S. taxpayers with multinational operations that would be unable to credit all income taxes paid to all foreign countries from which they receive income. The extent to which this effect will be offset by the proposed reduced rates of U.S. corporate tax will, of course, vary from taxpayer to taxpayer and a reliable prediction as to whether the overall impact would improve or worsen the competitive position in general of U.S. business operating abroad must be left to others.

58. Id. at 390.

59. § 275(a)(4)(A).

60. Proposals, at 394. The changes to the generally applicable source-of-income rules generally would be effective for taxable years beginning on or after January 1, 1986. Id. at 404-05.
The Proposals would end the possibilities available under current law of blending income from some foreign countries subject to high foreign taxes with income from other foreign countries subject to low or no foreign taxes in the numerator of the overall foreign tax credit limitation fraction, with the objective of avoiding a potential loss of credits by keeping the average foreign tax on aggregate foreign-source income below the effective U.S. tax rate. The Proposals would also eliminate many of the opportunities for structuring transactions to generate low-taxed or tax-free foreign-source income that can be included in the numerator of the foreign tax credit limitation fraction and thus increase the amount of limitation. In addition, the proposed requirement that corporations filing consolidated returns allocate interest expense on a consolidated basis for foreign tax credit limitation purposes, and therefore that an appropriate amount of all interest expense be allocated against foreign-source income even if the borrowings were made by a subsidiary having no foreign-source income, would have a substantial impact on the foreign tax credit position of many U.S. corporate groups with multinational operations.

Although most foreign tax credit planning opportunities available under the overall limitation of existing law would be eliminated under the Proposals, planning opportunities would remain in some cases for preventing the loss of credits for foreign income taxes on certain income from a particular foreign country in excess of the U.S. effective corporate rate. For example, certain passive income payments made by a foreign corporation in which the U.S. taxpayer owned a ten percent or greater voting stock interest would not be included in the separate basket limitations for passive dividend and interest income. These payments would include rentals under leases of tangible property, royalties under licenses (and gains from the sale) of marketing and manufacturing intangibles, and interest on loans, which are often subject to low or no tax in the source country and could still be mixed with high-taxed income from that country in the numerator of the applicable per-country limitation.61 Similar planning opportunities may be available with respect to rentals and royalties (but, in general, not interest or dividends) received from independent parties within the country concerned.62

61. This may be illustrated by a U.S. corporation planning a ten percent or greater direct investment in the equity of a corporation organized in a high-tax country, such as France, in which corporate income is taxed at a fifty percent rate and distributed earnings bear an additional five percent withholding tax, resulting in an effective French tax rate of 52.5 percent on earnings distributed as dividends. Under the Proposals, if the U.S. corporation licensed patents and know-how and loaned funds to its French affiliate, the royalties and interest on the loans (which are subject to French withholding taxes of only five percent and ten percent, respectively) could be mixed with the high-taxed dividends in the numerator of the per-country limitation fraction applicable to France. Thus, the French tax imposed on the dividends in excess of the U.S. effective corporate rate would be offset against the U.S. tax otherwise imposed on the royalties and interest from the French affiliate.

62. But see note 35, supra, and note 65, infra, and accompanying texts.
B. Proposals Other than the Per-Country Limitation

A number of the Administration's foreign tax credit proposals would represent constructive steps toward reducing the opportunities available to taxpayers to manipulate to their advantage various rules related to the foreign tax credit limitation and would be worthy of enactment quite apart from whether the Congress eventually adopts a per-country limitation to replace the current overall foreign tax credit limitation. These proposals include the expanded separate basket limitation for passive income, the proposed changes to the source-of-income rules, the look-through rules and the rules relating to foreign and U.S. losses.

1. Expanded Separate Limitation for Passive Income

In recognition of the fact that taxpayers can readily shift deposits of funds and loans to foreign banks or other financing institutions and thereby earn foreign-source interest subject to little or no tax in the source country, and which could as a result be used to absorb excess foreign tax credits on operating income, in 1962 Congress enacted what is now section 904(d)(1)(A), which requires that passive interest, with certain exceptions, be subjected to a separate foreign tax credit limitation applicable only to such interest. The Administration has proposed that this separate basket be expanded to include portfolio dividends (dividends from corporations in which the taxpayer owns less than a ten percent interest) and gains from the disposition of assets producing passive income, which remain to be defined but would not include income from sales of assets integrally related to the taxpayer's business and presumably would not include stock or obligations of a foreign corporation in which the taxpayer owned a ten percent or greater interest (since dividends and interest thereon would not be included in the passive income basket).63

This proposal is premised on the fact that it is relatively easy for a taxpayer to make portfolio investments in foreign corporations and to sell passive income assets, such as stock or securities, outside the United States and in this way generate foreign-source income subject to little or no tax in the foreign source country.64 To the extent that this approach is availed of to

63. This approach would also follow that adopted by current law in § 904(d)(2)(D), under which interest received on obligations acquired as the result of the disposition of stock or obligations of a corporation in which the taxpayer owns a ten percent or greater voting stock interest is not subject to the separate limitation for passive interest income.

64. The proposal to treat gain on sales of passive investment assets as separate limitation income is related to the proposed rule that would treat the source of such gain as the seller's country of residence. See note 40, supra, and accompanying text. Thus, in the case of a U.S. seller, such gain would be treated as U.S.-source income subject to the separate limitation for passive income, and in the case of a foreign subsidiary of a U.S. corporation, such gain would be separate limitation income sourced in the seller's country.
make credits for taxes imposed on other income usable against the U.S. tax on the low-taxed foreign income, as is possible under current law, the credit mechanism is not being used for the purpose of preventing international double taxation of the same income. As noted above, the Administration is considering the extension of this separate limitation to include other types of "easily movable" passive income typically subject to withholding taxes in the foreign source country. Leading possibilities would appear to be rents and royalties. However, rents and royalties from a foreign corporation in which the recipient has a ten percent interest should be treated as operating income, in recognition of the fact that they represent forms of return on a direct investment and payments such as interest, royalties and rents (all of which are usually deductible by the payor) have the effect of reducing foreign taxable income, and therefore creditable foreign taxes, on the total income generated by that investment. A very persuasive case can also be made for excluding rents and royalties received from independent parties that are derived "in the active conduct of a trade or business," a test employed to exclude rents and royalties received by a controlled foreign corporation from foreign base company income that can be taxed as a constructive dividend to ten percent U.S. shareholders under the rules of subpart F.65

Putting the types of income proposed by the Administration (together with rents and royalties from independent parties not derived in the active conduct of a business) in the separate passive income basket would end the opportunity to manipulate the foreign tax credit limitation in this way, and would be a desirable change whether the overall or per-country limitation is chosen.

2. Changes to Source-of-Income Rules

Revising the source-of-income rules to make it impossible for taxpayers to generate foreign-source trading income by the simple expedient of agreeing with the foreign buyer that title pass in the buyer's country would also eliminate a major and widely used means of manipulating the credit by


On the other hand, it would seem appropriate to treat as separate limitation income any income that is eligible for the credit of § 936 for certain income from U.S. possessions, unless, as the Administration has proposed, the § 936 credit is repealed. See Proposals, at 307–13. Under current § 936, a U.S. corporation operating in a U.S. possession may elect to receive a credit that offsets completely the U.S. tax on its foreign-source income from carrying on an active business in the possession or from qualified possession investments. While foreign taxes on such income are not eligible to be used as foreign tax credits, possessions income is includible in the numerator of the general limitation fraction as foreign-source income.
generating foreign-source income that will usually be subject to no foreign tax if the U.S. exporter does not earn the export income through a permanent establishment in the buyer's country. Under the Administration's proposal, income from export transactions would be deemed to have a foreign source only if sales of inventory were involved and the exporter maintained a fixed place of business outside its country of residence that participated materially in the export sale. Current law already provides considerable guidance concerning what constitutes "material participation" in this sense. While application of this rule is certainly more complicated than the passage-of-title test of current law, its added complexity seems a reasonable price to pay for elimination of the manipulation that the passage-of-title test encourages. The changes to the rules governing the source of sales income thus would also be desirable, whatever decision is made on the issue of per-country vs. overall limitation.

3. Look-through Rules

Rules calling for characterizing dividends from a foreign corporation as to source and character by looking through the foreign corporation to the underlying earnings distributed, introduced (in more limited form) by the 1984 Act, are required in order to prevent conversion of U.S.-source income to foreign-source income and averaging of passive low-taxed income with high-taxed income in a foreign corporation that pays actual dividends or earns subpart F income taxed as constructive dividend to its U.S. corporate shareholder. Look-through rules are necessary to serve these objectives under the indirect credit whether an overall or per-country limitation is adopted. Under the per-country limitation, however, look-through rules have the additional function of preventing the blending of low-taxed income from one country with high-taxed income from another for purposes of calculating the foreign tax credit limitation by interposing a foreign corporation to earn income in and pay taxes to both countries.

It must be acknowledged that the complexity of the proposed rules requiring that a U.S. corporation receiving a dividend from a foreign corporation of which it owns as little as ten percent of the voting stock look through the paying corporation and additional lower tiers of its foreign subsidiaries to determine the character and sources of the profits from which the dividend is paid would present serious compliance problems for U.S. corporate taxpayers, and would no doubt discourage the use of foreign holding companies and multitiered foreign affiliate structures. A U.S. cor-

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poration owning at least ten but less than fifty percent of the voting power of a foreign corporation in particular might experience serious practical difficulties in obtaining the detailed information concerning the character and sources of the income and applicable tax burdens of the corporation (and its lower-tier subsidiaries) that would be necessary for the U.S. shareholder to utilize the indirect credit.

While look-through rules for passive income and U.S.-source income are necessary to preserve the integrity of the limitation by preventing inclusion of such income in the numerator of the limitation fraction of either the overall or per-country limitation, the overall limitation has the virtue of avoiding the exponential increase in complexity that results from having to apply the look-through rules to identify on a country-by-country basis source and character of income, related expenses and taxes down through multiple tiers of foreign corporations.

4. Treatment of Losses

There are at least four methods of treating losses for purposes of the foreign tax credit limitation. First, losses could be allowed to offset only subsequent income from the country in which the loss was incurred and thus provide no current U.S. tax benefit at all. This would be consistent with a per-country approach to the limitation, but would lead to harsh results if the loss operation were abandoned before the losses were recouped because no credits would ever be available for foreign taxes imposed on the income offset by the losses. Second, losses could be permitted to offset only income from the United States. This, however, would involve assuming that a foreign loss is more closely associated with U.S. income than foreign income and would shift a substantial part of the risk of a foreign loss to the U.S. Treasury. Third, foreign losses could be offset only against income earned in all foreign countries and thus not against U.S.-source income. There seems no reason, however, to treat a foreign loss incurred in a particular foreign country as more closely related to other foreign-source income than to U.S.-source income.

The fourth approach, and the approach proposed by the Administration, is to require that a loss incurred in any foreign country be spread pro rata against income earned in all other countries, including the United States. The principal objective of this proposal is to eliminate the possibility that U.S. tax would be reduced both in the loss year, by allocating a loss incurred in a particular foreign country against U.S. income, and in a subsequent year, i.e., if the loss is recouped but (because no loss carryover is available in the foreign country) a foreign tax would be imposed that would be creditable against the U.S. tax. Achieving this objective has two aspects. First, by spreading a net loss incurred in any foreign country against income earned in other foreign countries, as well as against income earned in the United
States, the proposal would in some cases reduce available credits for taxes imposed by high-tax countries and would hereby limit the reduction of U.S. tax in the loss year.\textsuperscript{67} Second, by treating some income earned in the loss country in a later year or years as U.S. income (up to the amount of the portion of the previous loss that was allocated to U.S. income), the proposal would reduce the foreign tax credit limitation for the loss country in such later year or years and thus limit the extent to which U.S. tax on the subsequently earned income could be eliminated by foreign tax credits. In addition, the proposed change would produce a benefit to U.S. taxpayers not available under current law by permitting a portion of U.S.-source income earned in a year following an overall U.S. loss year to be treated as foreign income, which would result in an increase in the credit limitation. The proposal would also simplify current law by eliminating the separate treatment of foreign oil and gas extraction losses.

The Administration's proposals would provide workable and consistent rules for the treatment of foreign and U.S. losses in calculating the foreign tax credit limitation, which would be compatible with either the per-country or the overall approach. Accordingly, their enactment would represent a significant improvement, however the per-country vs. overall issue is resolved.

C. OVERALL VS. PER-COUNTRY LIMITATION

The most significant and most controversial feature of the Administration's foreign tax credit proposals is the proposed change from the overall to the per-country limitation. In evaluating the choice between these two approaches to the section 904 limitation, one can perhaps best start by examining the purpose and function of the foreign tax credit mechanism in minimizing international double taxation.

1. \textit{Theoretical Issues}

Among the major trading states, two principal paradigm approaches are used to avoid international double taxation (although in a considerable number of countries a combination of the two approaches is used). The first is the exemption method, under which income that is determined under the applicable source-of-income rules to be foreign-source is exempted from the "home country" income tax. The result is that, from the standpoint of the home country, all income earned by its taxpayers is subject to tax by only

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\textsuperscript{67} When a loss in a particular country in a given year does not exceed income earned in all other foreign countries in that year, the proposed loss recapture rule (which would allocate the loss to U.S. and other foreign sources) would in some cases produce more favorable results than existing law, which allocates the entire amount of the single-country loss against all other foreign-source income.

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one country, *i.e.*, the country in which the income is earned. Thus, if the exemption method is employed, income of a home country taxpayer that is subject to tax by another, high-tax, jurisdiction is subject only to that jurisdiction's high tax rates, and income earned in a low-tax jurisdiction is subject only to that jurisdiction's low tax rates. The total aggregate tax burden on foreign-source income (which represents exclusively foreign taxes) thus necessarily reflects an averaging of the various rates of foreign tax.

The second paradigm approach is the foreign tax credit. Under this approach, the home country claims authority to tax persons subject to its general taxing jurisdiction on a worldwide basis, but it recognizes the primary right of each foreign country to tax income earned (or, more technically, sourced) in that country. After allowance of a credit for taxes paid to the foreign country, the home country retains a residual taxing authority over income earned in the foreign country of source to the extent that taxes it imposes do not exceed the home country tax rate.

The irreducible essence of international double taxation is the subjection of a given item of income to tax in more than one taxing jurisdiction. If the U.S. foreign tax credit mechanism were applied to any given item of income, a foreign country in which an item of income is sourced would have the primary right to tax. However, if the foreign tax were less than the U.S. tax on that income (determined at the U.S. taxpayer's marginal rate), the United States would have the residual right to collect its tax, after granting a dollar-for-dollar credit for the foreign tax. Under the theoretical model of an item-by-item U.S. foreign tax credit limitation, the limitation would be calculated as follows:

\[
\text{Foreign tax credit limitation} = \frac{\text{Item of foreign-source taxable income}}{\text{Worldwide taxable income}} \times \text{U.S. tax on worldwide taxable income (before foreign tax credit)}
\]

Any given item of foreign-source income would therefore be subject to a total tax burden equal to the larger of the U.S. or the foreign tax, which is precisely the result sought under a "pure" foreign tax credit approach to preventing international double taxation.

While theoretically sound, an item-by-item approach to calculating foreign tax credits would involve such a staggering level of administrative complexity as to be totally impractical. As a minimum, the steps required would include identifying the gross income from, and allocating the appropriate deductions to, each transaction and then determining the amount of foreign tax applicable thereto under a foreign tax system that
would not in fact (as none in fact do) impose its income tax on a transaction-by-transaction basis.

Any step beyond an item-by-item approach in the direction of aggregating items of income from multiple transactions that are subject to varying levels of foreign tax is likely to involve some averaging of foreign taxes above the level of U.S. taxes with foreign taxes below that level, with the higher foreign taxes in effect offsetting the U.S. tax that would otherwise be imposed on the income subject to the lower foreign tax. The policy objection to this averaging is therefore that it involves some surrender of U.S. residual tax on foreign-source income that is taxed by foreign countries at rates below the U.S. rates and is therefore inconsistent with the fundamental premise of the foreign tax credit.

2. Arguments for and against the Per-Country Limitation

a. Surrender of U.S. Residual Tax

In the view of the Administration, the overall limitation of existing law involves an excessive surrender of the residual right of the United States to tax foreign income subject to foreign taxes imposed at lower rates than U.S. tax rates. Furthermore, the overall limitation, in the eyes of the Administration, creates an incentive to U.S. taxpayers with excess foreign tax credits from operations in high-tax countries to place new investments not in the United States, but in low-tax foreign countries, since such taxpayers can use their excess foreign tax credits to reduce or eliminate the U.S. tax that would otherwise be imposed on income from investments in low-tax countries and thus earn a higher after-tax rate of return than if the investments were made in the United States. This incentive would be increased if, as the Administration has proposed, U.S. tax rates are reduced, since more taxpayers will be in an excess foreign tax credit position. The Administration has thus proposed a shift to the per-country limitation in order to mitigate these effects of the overall limitation and to move closer to the theoretical model of an item-by-item credit at the cost of what it regards as a manageable level of increased administrative and compliance burdens.

b. Purpose and History of the Foreign Tax Credit Limitation

Both those supporting the per-country and those supporting the overall limitation attempt to invoke logic in support of their positions. Adherents of the per-country limitation contend that the overall limitation is flawed because it involves surrender of the U.S. residual right to tax low-taxed foreign income, while proponents of the overall limitation argue that the purpose of the foreign tax credit limitation is to prevent foreign taxes from being used to offset the U.S. tax on U.S.-source income, a purpose that is
not undermined by the overall limitation. In addition, the history of the foreign tax credit limitations in the United States sheds little, if any, light on the merits of the debate between the proponents of the overall and the per-country limitations. From 1921 until 1932, the foreign tax credit was subject to an overall limitation. From 1932 until 1954, foreign tax credits were subject to the lesser of an overall or a per-country limitation. As first enacted in 1954, the present Internal Revenue Code called exclusively for a per-country limitation. From 1960 to 1975, taxpayers were permitted to choose between the overall and the per-country limitation, and since 1976 the overall limitation has been required.

c. Investment Incentives

The principal battleground is the anticipated practical consequences of the two alternatives, but neither side has been able to land a conclusive blow. Supporters of the overall limitation contend that the incentive it provides to make new investments in low-tax countries rather than in the United States is relatively insignificant, because overseas investments decisions are normally influenced by a broad range of factors, of which the tax burden is only one. In addition, it is argued, the barriers, or disincentives, to making investments to earn operating income abroad subject to low foreign taxes are much higher than those to which passive investments generating interest or dividends are subject, so that the opportunities for abuse are much greater in the latter than in the former case. Proponents of the Administration view counter by arguing that under traditional microeconomic analysis, tax incentives are significant "at the margin" when other political, economic and business factors are in relative equipoise and that the proposed repeal of the investment tax credit and ACRS, which under current law favor U.S. over foreign investment, will make it even more likely that the averaging permitted under the overall limitation will result in a significant increase in foreign investment in low-tax countries abroad rather than in the United States.

d. Competitive Disadvantage for U.S. Companies

Somewhat more persuasive than the foregoing positions taken on each side is the position of the supporters of the overall limitation that under the tax laws of all major trading countries, including both those using an exemption system and those using a per-country foreign tax credit system, averaging of foreign taxes paid to different foreign countries is permitted. Averaging is an inevitable aspect of an exemption system, and in the case of each country now using a per-country limitation averaging is permitted through the use of foreign holding companies in which income from various other foreign countries subject to varying tax rates can be blended—that is,

68. See Proposals, at 132-63.
other countries employing a per-country limitation have not adopted look-through rules under which the source and tax burden of the holding company's income would be traced to the country in which it was generated. Thus, the argument goes, adoption of the per-country limitation as proposed by the Administration would place U.S. business operating abroad at a competitive disadvantage vis-à-vis its trading competitors in other countries. Although more a riposte than an answer, a counter suggested to this point is that the United States has on a number of occasions pioneered in adopting anti-tax-abuse rules, such as the anti tax-haven rules of subpart F and the section 482 intercompany pricing regulations, and, in time, many of the major trading states have followed suit. This point may be of limited solace to the U.S. business that suffers a competitive disadvantage in the meantime.

e. Assessment

As the vigor of the debate suggests, there seems no clear answer on the basis of logic or experience. The Administration seems to hold the higher conceptual ground in arguing that the per-country limitation is preferable because it more closely approximates the theoretically sound item-by-item approach and that it does so with a minimum loss of U.S. residual taxing power through averaging. In terms of economic consequences the balance is closer. The adverse effect on the competitive position of U.S. business operating abroad of a per-country limitation by itself is a persuasive consideration, but the extent to which it would be offset by the benefits of the reduced marginal tax rates proposed by the Administration is uncertain. In any event, it seems by no means clear how the scale should tilt when the incentive to investment in low-tax countries created by the overall limitation is weighed against the possible adverse impact of the proposed changes affecting the foreign tax credit limitation on the competitive position of U.S. business abroad.

In the final analysis, the most telling argument against the per-country limitation, when combined with the look-through rules and the separate basket limitations, is the inordinate amount of difficulty that taxpayers will experience in attempting to comply with and that the Service will experience in attempting to audit compliance with the rules. Enactment of the per-country limitation, requiring allocation of income, expenses and losses received or incurred by the taxpayer directly or indirectly through tiers of subsidiaries to every country in which every U.S. taxpayer does business directly or through various tiers of foreign subsidiaries and to each of the separate basket limitations for each of those countries, would add a very heavy burden of additional complications to foreign tax credit calculations, which are already freighted with considerable complexity. In combination with the revised income sourcing rules, which at least so far as export sales of inventory are concerned, are considerably more complicated than the rules.
they would replace, the complexity of the entire package would put a heavy strain on the foreign tax credit mechanism. The Proposals acknowledge that "[t]he question therefore becomes how much tax rate averaging to permit in the system and at what cost in terms of the complexities of compliance and enforcement." 69

3. Possible Alternative Proposals

In view of these complexities, it may be significant that the Proposals also state that "[a]t a minimum, passive and active income should be separated for credit purposes in order to prevent averaging of easily movable types of income . . ." (emphasis added). 70 This comment may presage a willingness of the Administration to accept an overall foreign tax credit limitation in the interest of administrative workability if opposition to the per-country approach is forceful enough to produce a compromise.

a. Expanded Separate Basket Limitation

One possible compromise would be to abandon the per-country limitation in favor of the overall limitation for most foreign-source income with separate basket limitations for passive income that can readily be shifted to low- or no-tax jurisdictions, buttressed by the Administration's proposed "look-through" provisions for the indirect credit and its proposed new source-of-income rules that would be less susceptible to manipulation by taxpayers seeking to maximize the foreign tax credit limitation. This would result in a foreign tax credit considerably more complicated than the existing credit but one subject to much less averaging and manipulation than exists under current law. We would be left, however, with the basic incentive under an overall limitation for U.S. taxpayers with excess foreign tax credits to invest in low-tax countries abroad rather than in the United States.

b. Per-Country Limitation for Operating Income Only

Another possible compromise that would substantially eliminate the incentive for taxpayers in an excess foreign tax credit position to invest in low-tax countries abroad rather than the United States would be to adopt a per-country limitation for all foreign-source income except income covered by the passive income basket limitation, which would be computed on an overall basis. Since the potential for averaging low-taxed passive income against high-taxed operating income would be virtually eliminated by isolating the passive income in a separate overall basket, there seems little justification for the additional complexity that would be caused by requiring a per-country approach to passive income. This otherwise appealing compromise, however, has the basic defect of a per-country approach across the

69. Id. at 388.
70. Id.
board. Most of the complexity of the per-country limitation (buttressed by the look-through rules) arises not in connection with passive income but in connection with operating income. The source of passive income is usually quite easy to identify, as are directly related deductions, if any, and the applicable foreign taxes. The problems of identifying the source and amount of operating income, such as income from manufacturing and sales and income from services, and making appropriate allocations of expense and foreign tax to such income, down through multiple tiers of foreign corporations is a daunting undertaking—so much so that eliminating the per-country approach for passive income would not bring the burdens of compliance by taxpayers and audit by the Service down to manageable levels. As with the use of the per-country limitation for both operating and passive income, the administrative burdens of this approach seem well out of proportion to the targeted abuses.

c. Separate Limitation for Low-Taxed Income

If, notwithstanding the significant reduction in opportunities for manipulating the foreign tax credit that would result from adoption of the proposed expanded separate basket limitation for passive income, new source-of-income rules and expanded look-through rules, it were concluded that the incentives for excess foreign tax credit taxpayers to make investments in low-tax foreign countries nevertheless remained too great under an overall limitation, one possible change would be to include within a separate limitation basket any foreign-source income subject to no foreign tax or a foreign tax of less than some specified percentage. The less-than-ten-percent level used in the provision of existing law for resourcing to the United States for foreign tax credit limitation purposes certain capital gains realized abroad might be used for this purpose.71

It may be argued persuasively that low-taxed or tax-exempt foreign-source dividends, royalties, interest and rents from foreign corporations in which the corporate recipient owns a ten-percent or greater voting interest should, for the reasons suggested above, be assimilated to operating income from a direct investment and not be included in a separate limitation basket.72 However, so long as such income from direct investment in low-tax or no-tax countries can be averaged with high foreign taxes under the overall limitation, the tax incentive to invest abroad in such countries rather than in the United States will remain. This dilemma might best be resolved by identifying foreign income that would be included in the separate basket because it bore a foreign tax burden below the chosen threshold level (e.g., ten percent) by lumping together all dividends, royalties, rents and interest received from each ten-percent-owned foreign corporation. If this income in

71. See § 904(b)(3)(C). See also note 40, supra.
72. See text accompanying note 65, supra.
the aggregate bore a total foreign tax in excess of the threshold, it would be included in the overall limitation. Income (whether dividends, interest, rents or royalties) received from a ten-percent-owned corporation in a low-tax or tax holiday country would, on the other hand, be included in a separate basket limitation rather than the overall limitation, so that the foreign tax credit incentive under current law to investment in such a country would be eliminated.

Including tax-exempt or low-taxed income in a separate basket limitation under specified circumstances would involve some administrative complexity arising from the difficulty in some cases of identifying the item or category of income enjoying the exemption or the low rate of tax. However, the additional administrative burdens imposed by this approach should be markedly lower than those involved in implementing a per-country limitation applicable to operating income. In addition, the separate limitation for tax-exempt or low-taxed income would be tailored to serve the purpose of preventing averaging of low and high foreign tax rates, and thus would not need to be utilized with respect to income from operations subject to foreign tax at rates higher than the foreign tax rate (e.g., ten percent) selected as the threshold. By comparison, a generally applicable per-country limitation would apply without regard to the effective tax rates of the countries from which any particular taxpayer derived income, and thus in some cases would generate administrative complexity serving no purpose other than that of reducing foreign tax credit incentives to investing in low-tax jurisdictions, an objective achieved with much less complexity by including low-taxed income in a separate limitation basket.

d. Summary

Thus, it appears that enactment of a package that would include retention of the overall limitation and adoption of the other changes proposed by the Administration to reduce manipulation and increase the integrity of the foreign tax credit limitation would strike about the right balance between theoretical perfection and the practical demands that will be made on any proposal ultimately adopted. Adoption of the expanded passive income basket limitation, the new source-of-income rules, the expanded look-through rules, and the rules for handling U.S. and foreign losses as proposed by the Administration, and of a separate basket limitation for tax-exempt and low-taxed foreign income, would eliminate most of the opportunities available under current law to manipulate the limitation by averaging of foreign tax rates. The cost in additional complexity of this approach would be substantial, but far less than would be involved if all of the proposed changes were implemented under a per-country approach. This package would seem a balanced and sensible compromise for the Congress to adopt.