

1996

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Recommended Citation

Ronald A. Worley, *The Indirect Foreign Tax Credit: A Policy Analysis of Section 902*, 13 INT'L TAX & BUS. LAW. 176 (1996).
Available at: <http://scholarship.law.berkeley.edu/bjil/vol13/iss2/3>

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The Indirect Foreign Tax Credit: A Policy Analysis of Section 902

Ronald A. Worley†

The United States currently attempts to address the problems arising from the double taxation of foreign income through a system of tax credits and deductions. The author identifies several shortcomings of the current foreign tax credit system, focusing on the inadequacies of the indirect foreign tax credit. After analyzing the 1986 amendments to the indirect foreign tax credit, the author proposes reforming the indirect foreign tax credit through use of the "throwback method" of taxing foreign income.

I.

INTRODUCTION

Unlike most countries, the United States asserts jurisdiction to tax income based upon the citizenship or residence of a taxpayer, rather than upon a territorial connection to the income being taxed. This means that U.S. citizens, regardless of their place of residence, residents of the United States,¹ regardless of their citizenship, and domestic corporations² are subject to U.S. taxation on their worldwide income.³ However, when some or all of such income is derived from sources outside the United States it is usually subject to taxation by the country

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1. With respect to the determination of residence status, see I.R.C. § 7701(b) (1994); Treas. Reg. § 301.7701(b) (1992). In general, an alien individual is treated as a resident of the United States if such person is a "lawful permanent resident" under § 7701(b)(6) and regulation § 301.7701(b)-1(b) or satisfies the "substantial presence test" under § 7701(b)(3) and regulation § 301.7701(b)-1(c).

2. I.R.C. § 7701(a)(4) (1994) provides that "the term 'domestic' when applied to a corporation or partnership means [a corporation or partnership which is] created or organized in the United States or under the law of the United States or of any State." I.R.C. § 7701(a)(5) (1994) provides that "the term 'foreign' when applied to a corporation or partnership means a corporation or partnership which is not domestic." United States citizens, residents and domestic corporations are herein-after referred to collectively as "U.S. taxpayers."

3. The sixteenth amendment to the United States Constitution provides, in part, that "Congress shall have power to lay and collect taxes on incomes, from whatever source derived, . . ." U.S. CONST. amend. XVI (emphasis added). Similarly, I.R.C. § 61(a) provides, in part, that "gross income means all income from whatever source derived, . . ." I.R.C. § 61(a) (1994). (emphasis added). In *Cook v. Tait*, 265 U.S. 47 (1924), the Supreme Court held that the taxation of the worldwide income of a U.S. citizen, who was a resident of Mexico, was constitutional and did not violate international law. The one exception from the worldwide taxation of U.S. citizens is the foreign earned income exclusion allowed by § 911, under which a taxpayer may exclude up to \$70,000 of income derived from the performance of services in a foreign country. I.R.C. § 911

from which it is received.⁴ These overlapping bases of tax jurisdiction invariably lead to international double taxation.⁵

To deal with the problem of international double taxation, most countries only assert tax jurisdiction over income which is derived from within that country.⁶ Therefore, a taxpayer's income is relieved from international double taxation since it is only taxed by its source country.⁷ The United States, however, taxes its citizens and residents on their worldwide income and then attempts to alleviate international double taxation by granting either a tax credit or a deduction for foreign taxes paid.⁸

Under the foreign tax credit provisions, U.S. taxpayers must make an election each year to take a deduction or to claim a tax credit for foreign taxes paid.⁹

(1994). See generally, BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 65.1 (1991); KUNTZ & PERONI, U.S. INTERNATIONAL TAXATION, ¶ B1.03 (1994).

4. Most countries assert tax jurisdiction on the basis of a territorial connection to the income being taxed; that is, they assert taxing authority over income which has its source within that country. See BISCHEL & FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION 5-8 (2d ed. 1985).

5. A fundamental principle of international taxation is that, in the event of overlapping bases of tax jurisdiction, primary taxing authority is granted to the country from which the income is derived and secondary or residual taxing authority to the country of citizenship or residence. BISCHEL & FEINSCHREIBER, *supra* note 4, at 6-7; ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME ¶ 1.10 (1990).

6. In general, most countries assert full tax jurisdiction with respect to income derived from the operation of a trade or business within that country. A variety of approaches are taken, however, with respect to the "investment" income of foreign investors. The most common treatment for the investment income of a nonresident alien is the "flat tax" approach, under which foreign investors are taxed at a flat rate on the gross amount of such income. See I.R.C. § 871(a) (1994). In addition, the source country's flat tax on the investment income of foreign investors is frequently reduced or eliminated through bilateral tax treaties with the country of such taxpayer's citizenship or residence. Investment income, in general, includes interest, dividends, rents, royalties and other types of passive returns. See I.R.C. § 871(a)(1)(A) (1994), which refers to such items generally as "fixed or determinable annual or periodical gains, profits, and income."

7. The exemption approach to alleviating international double taxation has the virtue of providing complete relief from double taxation. The exemption method, however, can have the effect of favoring foreign investment over domestic investment in violation of the principle of "capital export neutrality." Capital export neutrality, as a principle of international taxation, provides, in general, that a taxpayer's overall tax liability should not be affected by the country in which the taxpayer chooses to make an investment. That is, a country's tax system should not provide tax incentives for investing either at home or abroad. See ISENBERGH, *supra* note 5, ¶ 16.3; BISCHEL & FEINSCHREIBER, *supra* note 4, at 1-10. To the extent that income earned in a foreign country is taxed at a lower rate than that of the country of citizenship or residence, the exemption approach to alleviating international double taxation has the effect of favoring foreign investment.

8. I.R.C. §§ 901-908 (1994). The tax credit approach to alleviating international double taxation has the virtue of not violating the principle of capital export neutrality by favoring foreign investment over domestic investment, but it can have the effect of not providing complete relief from double taxation. That is, while it is foreign law that determines the amount of foreign income taxes that must be paid, it is U.S. tax law that determines what constitutes a creditable foreign tax and the limitations on the amount of credit that may be claimed. See I.R.C. §§ 901(b)(1), 902(a), 902(c)(4)(A), 903, 904(a) (1994); Treas. Reg. §§ 1.901-2 (as amended in 1991), 1.903-1 (1983). To the extent that a foreign tax is not fully creditable against U.S. tax liability there continues to be international double taxation.

9. I.R.C. § 901(a) (1994). If a taxpayer claims a tax credit with respect to any foreign taxes, then no deduction is allowed with respect to any foreign taxes paid. I.R.C. § 275(a)(4) (1994). If a foreign tax is not creditable against U.S. tax liability or a taxpayer does not claim the foreign tax

A tax credit is a dollar for dollar reduction to taxes owed and, therefore, the foreign tax credit generally has the effect of treating foreign taxes (on foreign source income) as a "down payment" on the taxpayers' U.S. tax liability.¹⁰ On the other hand, a deduction merely reduces the amount of income subject to taxation. Therefore, it is generally more beneficial to claim the credit than to take the deduction.¹¹

The foreign tax credit, however, does not alleviate international double taxation for corporations that conduct their offshore operations through separately incorporated foreign subsidiaries. This is because the foreign tax credit is only available for foreign taxes paid or accrued by a U.S. taxpayer.¹² Since a foreign subsidiary is a separate taxable entity, the U.S. parent corporation that owns a foreign subsidiary is not considered to have paid the foreign taxes. Therefore, corporations that conduct their offshore operations through branch offices receive the foreign tax credit, while corporations that conduct their offshore operations through foreign subsidiaries do not.¹³

In 1918, Congress attempted to remedy the problem of unequal tax treatment between foreign branches and foreign subsidiaries by creating the "indirect" (or "deemed paid") foreign tax credit.¹⁴ Under the indirect foreign tax credit, a domestic corporation can claim a tax credit for the taxes paid by a foreign subsidiary at the time the subsidiary distributes a dividend to the U.S. corporation,¹⁵ thereby eliminating international double taxation.¹⁶

credit, foreign taxes generally may be deducted in the computation of taxable income. I.R.C. § 164 (1994).

10. See BITTKER AND EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 15.21 (6th ed. 1994).

11. Practically speaking, the only time the deduction will be more attractive than the tax credit is when the foreign taxes do not qualify as creditable taxes. The deduction may be more valuable, however, if a taxpayer has foreign income from one country that is offset by foreign losses from another country. In this situation, the taxpayer's overall foreign source income is zero and the foreign tax credit is disallowed. See I.R.C. § 904 (1994).

12. I.R.C. § 901(b)(1) (1994). Treas. Reg. § 1.901-2(f)(1) (as amended in 1991), provides that "the person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax . . ."

13. Even though the U.S. corporation was not considered to have paid the foreign taxes paid by the subsidiary, the U.S. corporation was allowed an "indirect deduction" for such taxes. This is because the foreign taxes paid by the subsidiary reduced the amount available for distribution to the U.S. corporation. Taxing the U.S. corporation on the net amount after payment of foreign taxes was the equivalent of granting the U.S. corporation a deduction for the foreign taxes paid by the subsidiary. H.R. REP. NO. 1447, 87th Cong., 2d Sess. 454 (1963).

14. I.R.C. § 902 (1994). See *infra* text accompanying notes 64-113.

15. With certain exceptions, the earnings of a foreign subsidiary are not currently taxable to the domestic parent corporation. When the subsidiary distributes a dividend to the U.S. corporation, however, the parent is subject to U.S. taxation because distributions from foreign corporations, in general, do not qualify for the dividends received deduction. I.R.C. §§ 243(a), 243(e), 245 (1994). In certain situations, however, a domestic corporation is currently taxable on the undistributed earnings of a controlled foreign corporation. See I.R.C. §§ 951-964 (1994). These provisions constitute subpart F of part III of subchapter N of the Code and are hereinafter referred to as "subpart F." For a discussion of the relationship between subpart F and the foreign tax credit, see *infra* text accompanying notes 134-47.

The indirect foreign tax credit¹⁷ reflects the long-standing congressional policy that tax considerations should play only a limited role with respect to what type of structural form a corporation chooses when conducting its foreign operations.¹⁸ However, the indirect foreign tax credit is burdened with two fatal flaws that prevent it from achieving its intended objective.

The first flaw in the indirect foreign tax credit arises from the interaction of U.S. and foreign tax law. Foreign law determines the amount of foreign taxes that must be paid,¹⁹ while U.S. law defines the foreign subsidiary's earnings and profits from which the credit can be computed.²⁰ This interlacing of foreign and domestic tax principles creates an inconsistency between the foreign tax credits available to corporations that operate through foreign branches and those that operate through foreign subsidiaries.²¹ This inconsistency can result in the permanent loss of a portion of the foreign tax credit for corporations that operate through foreign subsidiaries. Thus, the indirect foreign tax credit fails to provide complete relief from international double taxation.

The second flaw in the indirect foreign tax credit is that the utilization of foreign subsidiaries affords U.S. corporations the opportunity to delay U.S. taxation of income earned in foreign countries.²² This is because the earnings of a foreign subsidiary are only subject to U.S. taxation at the time they are distrib-

16. In fact, the 1918 legislation overcompensated since it had the effect of granting the U.S. corporation both a deduction and a credit for the taxes paid by the foreign subsidiary. See *infra* text accompanying notes 77-79.

17. See *ISENBERGH, supra* note 5, ¶ 23.6; *OWENS & BALL, THE INDIRECT CREDIT* § 1/2 (1975); *JOINT COMMITTEE ON TAXATION, 99TH CONG., 2ND SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986*, at 860 (Comm. Print 1987) [hereinafter the 1986 BLUEBOOK].

18. The 1986 BLUEBOOK states that it is the policy of the United States "to limit the role that tax considerations play in the structuring of U.S. persons' operations and investments." *Supra* note 17, at 964.

19. When a corporation conducts its offshore operations through a branch, the critical items for purposes of the foreign tax credit are the net amount of income generated by the foreign branch and the amount of foreign taxes paid with respect to the foreign operation. The net income from the foreign branch is includible in the U.S. tax base of the corporation, and the foreign taxes paid will be allowable as a credit against its U.S. tax liability with respect to its foreign source income.

20. I.R.C. § 902(a) (1994). The creditable portion of the foreign taxes paid by a foreign subsidiary is the part of the taxes paid that is proportional to the dividend distributed to the domestic corporation relative to the subsidiary's accumulated earnings and profits. I.R.C. § 902(a) (1994). See *infra* text accompanying notes 89-113. Thus, it is the subsidiary's net earnings, as determined by foreign law, which determines the amount of foreign taxes that must be paid, but it is the subsidiary's earnings and profits, as determined under U.S. law, that determines the amount of the foreign taxes paid that may be claimed as a credit.

21. The inconsistencies between corporations with foreign branches and those that operate through foreign subsidiaries include differences in both the timing and the amount of the foreign tax credit that is available. See *infra* text accompanying notes 151-62. The timing differences for the foreign tax credit can be justified on the basis of the difference in the timing of the recognition, for U.S. tax purposes, of the foreign source income. There is no theoretical justification, however, for the differences in the amount of the foreign tax credit that is available for offshore operations conducted through foreign branches rather than through foreign subsidiaries.

22. 1986 BLUEBOOK, *supra* note 17, at 869. Despite a certain degree of quantitative similarity of tax treatment that is achieved by the indirect foreign tax credit, there is still the substantial benefit of tax deferral that can be obtained by the use of foreign subsidiaries with the resulting temporal dislocation of income that is earned in foreign countries.

uted to the domestic corporation.²³ Therefore, contrary to congressional intent, tax considerations continue to play a substantial role in the decision regarding which structural form a corporation should take on in order to conduct its foreign operations.

Recent legislation through which Congress sought to implement the indirect foreign tax credit did not correct the flaws in the foreign tax credit.²⁴ Specifically, Congress was overly wedded to the U.S. model of corporate taxation and the earnings and profits mechanism inherent in the U.S. approach to the taxation of corporate distributions.²⁵ As a result, Congress overlooked an alternative statutory scheme that would have been better suited to achieve the express congressional intent with respect to the indirect foreign tax credit.²⁶

Recently, the Treasury Department and the Internal Revenue Service (IRS) have indicated that Congress will need to reconsider the operation of the foreign tax credit provisions.²⁷ This paper will explore the background and underlying policies of the indirect foreign tax credit, analyze the policy implications of the 1986 amendments to the indirect foreign tax credit, and suggest a legislative solution that would achieve all of the stated Congressional objectives in this area.

II. THE FOREIGN TAX CREDIT PROVISIONS

The most pertinent provisions of the Internal Revenue Code (the Code) with respect to U.S. taxation of foreign source income are sections 901 through

23. 1986 BLUEBOOK, *supra* note 17, at 857. See *supra* note 15 with respect to the possible application of the provisions of subpart F.

24. H.R. 3838, 99th Cong., 2d Sess., §§ 1201-1205, amending §§ 864, 901, 902, 904, 954, 960, and 6038 of the Code (1986) [hereinafter the 1986 Tax Act]. The specific objectives of the foreign tax credit are to alleviate international double taxation and to achieve similarity of tax treatment between foreign branches and foreign subsidiaries. 1986 BLUEBOOK, *supra* note 17, at 861, 869. Although the indirect foreign tax credit attempts to alleviate international double taxation, it does not address the principal dissimilarity between foreign branches and foreign subsidiaries. See *infra* text accompanying notes 200-228.

25. Since the U.S. taxation of distributions from foreign subsidiaries involves corporations, Congress' reflex reaction was to invoke the U.S. model of corporate taxation. See 1986 BLUEBOOK, *supra* note 17, at 857. Congress does not seem to have even considered any "non-corporate" solutions to the problem of how to equalize the tax treatment between foreign branches and foreign subsidiaries.

26. Although Congress wanted to create a similarity of tax treatment between foreign branches and foreign subsidiaries, it failed to examine the manner in which foreign branches are taxed, and to thereafter devise (or borrow) a statutory mechanism that would tax foreign subsidiaries in a similar manner. Such a statutory mechanism is available in the form of the throwback rules under subchapter J for the taxation of accumulation distributions from trusts. See I.R.C. §§ 665-668 (1994). These provisions constitute subpart D of part I of subchapter J of the Code and are hereinafter referred to as "throwback rules."

27. See Note, 62 TAX NOTES 137 (1994), indicating that while legislation with respect to the international tax provisions of the Code is not on the horizon for 1994, some statutory changes to the foreign tax credit provisions may soon be necessary.

908, which deal with the foreign tax credit.²⁸ The foreign tax credit, in general, is a unilateral attempt on the part of the United States to alleviate international double taxation.²⁹ The provisions of the direct foreign tax credit are contained mainly in section 901,³⁰ while the provisions of the indirect foreign tax credit are set forth primarily in section 902.³¹ Both of these schemes are subject to the limitation provisions contained in section 904.³²

A. Double Taxation and the Foreign Tax Credit

Due to the worldwide reach of U.S. taxation, U.S. taxpayers who receive foreign source income face the unpleasant prospect of multiple layers of income taxation. In general, the foreign tax credit strives to eliminate the international double taxation of foreign source income of U.S. taxpayers by allowing them to take a credit for taxes paid to a foreign country against their U.S. tax liability.³³ Through the foreign tax credit, the U.S. attempts to approximate the tax treatment of countries whose tax systems are based on territorial tax jurisdiction.³⁴ This is necessary because the United States claims tax jurisdiction over all U.S. source income and foreign source income of U.S. taxpayers,³⁵ thus overlapping the tax jurisdiction of many foreign countries.

Section 901 provides, in general, that taxpayers may elect to claim a tax credit for the amount of foreign taxes paid on their foreign source income against their U.S. tax liability with respect to such income.³⁶ The fundamental policy of the foreign tax credit is to alleviate the international double taxation

28. This is not to discount in any way the highly complex provisions of subpart F, concerning controlled foreign corporations. The foreign tax credit provisions, however, are of greater general applicability. For a discussion of the interrelationship between subpart F and the foreign tax credit, see *infra* text accompanying notes 134-47.

29. BITTKER & LOKKEN, *supra* note 3, ¶ 69.1.1; KUNTZ & PERONI, *supra* note 3, ¶ B4.01; ISENBERGH, *supra* note 5, ¶ 16.1; 1986 BLUEBOOK, *supra* note 17, at 861.

30. I.R.C. § 901 (1994). See *infra* text accompanying notes 36-57.

31. I.R.C. § 902 (1994). See *infra* text accompanying notes 58-113.

32. I.R.C. § 904 (1994). See *infra* text accompanying notes 114-33.

33. BITTKER & LOKKEN, *supra* note 3, ¶ 69.1; KUNTZ & PERONI, *supra* note 3, ¶ B4.01.

34. See BISCHER & FEINSCHREIBER, *supra* note 4, at 4-8.

35. That is, the United States retains the authority to tax the foreign source income of U.S. taxpayers whenever the rate of foreign tax on foreign source income is less than the rate of tax imposed by the U.S. on such income. This retention of residual taxing authority over lower-taxed foreign source income creates some thorny problems that have led to the enactment of some particularly complex provisions for the computation of the limitation on the foreign tax credit. See *infra* text accompanying notes 114-33.

36. I.R.C. § 901(a) (1994); Treas. Reg. § 1.901-1(a) (as amended in 1987). I.R.C. § 901(a) provides as follows:

SEC. 901. TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES.

(a) ALLOWANCE OF CREDIT.—If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall

that occurs when income earned in a foreign country is taxed both by the country from which it is derived and by the United States.³⁷

B. Taxpayers Qualifying for the Foreign Tax Credit

In general, U.S. taxpayers may elect to claim a credit for any foreign income taxes imposed on them under foreign law.³⁸ For instance, a direct foreign tax credit is generally available to any U.S. taxpayer who receives foreign source income that is subject to both U.S. and foreign income taxation.³⁹ In contrast, the indirect foreign tax credit is usually available only to domestic corporations that meet a minimum stock ownership requirement in a foreign subsidiary.⁴⁰ With limited exceptions, individual taxpayers may not claim the indirect foreign tax credit for the taxes imposed on foreign corporations in which they own stock.⁴¹

The difference in tax treatment between the individual and corporate shareholders of a foreign corporation is consistent with the double tax scheme of the U.S. model of corporate taxation. When an individual receives a dividend from a domestic corporation, the distribution represents amounts derived from the earnings and profits of the corporation which have already been subject to taxation at the corporate level.⁴² In addition, the dividend is subject to taxation in the hands of the individual shareholder.⁴³ Because an individual is not allowed a tax credit or any other type of relief for the U.S. corporate income tax,⁴⁴

not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

37. BITTKER & LOKKEN, *supra* note 3, ¶ 69.1; KUNTZ & PERONI, *supra* note 3, ¶ B4.01; ISENBERGH, *supra* note 5, ¶ 16.1; 1986 BLUEBOOK, *supra* note 17, at 861.

38. I.R.C. § 901(a), (b) (1994). This is referred to as the "direct" foreign tax credit because it is the credit that is available for foreign income taxes that are imposed directly upon the taxpayer. Treas. Reg. § 1.901-2(f)(1) (as amended in 1991) provides that "the person by whom tax is considered paid for purposes of sections 901 and 903 is the person on whom foreign law imposes legal liability for such tax."

39. I.R.C. § 901 (1994).

40. I.R.C. § 902 (1994). See *infra* text accompanying notes 84-88.

41. I.R.C. § 962 (1994). The only instance in which an individual is eligible to claim the indirect foreign tax credit is when such person is required to include in income a portion of the undistributed earnings of a controlled foreign corporation (CFC) under the provisions of subpart F and makes the election under § 962 to have such income taxed at corporate rates. In such circumstances, the separate corporate existence of the CFC is disregarded and the individual is treated as if he earned the foreign source income and paid the foreign taxes directly. See *infra* text accompanying notes 134-147.

42. See I.R.C. § 316(a) (1994). See generally, BITTKER & EUSTICE, *supra* note 10, ¶ 8.02.

43. I.R.C. §§ 61(a)(7), 301(c)(1) (1994). U.S. corporate shareholders of domestic corporations, however, are allowed a dividends received deduction of 70, 80 or 100 percent of any dividends received, depending upon the corporate shareholder's ownership interest in the subsidiary making the distribution. I.R.C. § 243 (1994). The dividends received deduction is designed to prevent the normal double tax scheme of corporate taxation from turning into a triple or more tax system through the use of multiple tiers of subsidiaries. The dividends received deduction is generally not available, however, to U.S. corporate shareholders of foreign corporations. I.R.C. §§ 243(a), 245 (1994).

44. Although there have been numerous proposals to "integrate" the individual and corporate tax systems in the United States to eliminate the double taxation of business income, such proposals

neither equity nor the policy of equalizing the tax treatment of foreign and domestic corporate investments require that individual shareholders be given any credit for foreign corporate income taxes.⁴⁵

The U.S. model of corporate taxation is not a double tax scheme, however, with respect to intercorporate distributions. When a corporate shareholder receives a dividend from a domestic corporation, it is allowed a deduction of 70, 80 or 100 percent of the dividend received depending upon the corporate shareholder's ownership interest in the corporation making the distribution.⁴⁶ The dividends received deduction is designed to remove additional layers of taxation at the corporate level in order to prevent the normal scheme of double taxation from becoming a scheme of triple or more taxation because of multiple levels of corporate subsidiaries.⁴⁷ The dividends received deduction, however, is generally not available to U.S. corporate shareholders of foreign corporations.⁴⁸

C. Creditable Foreign Taxes

The foreign tax credit may only be claimed for taxes on income, war profits and excess profits which are paid to a foreign country or to a possession of the United States.⁴⁹ Any other type of levy imposed by a foreign government may only be taken as a deduction in the computation of taxable income.⁵⁰

have yet to get beyond the study stage. See, e.g., U.S. DEPARTMENT OF THE TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992).

45. The denial of tax credits or other relief to the individual U.S. shareholders of foreign corporations is consistent with the principle of capital export neutrality. In fact, the granting of such relief for investments through foreign corporations when it is denied for domestic corporate investments would provide a tax incentive for foreign corporate investments in violation of the principle of capital export neutrality. See *supra* note 7.

46. I.R.C. § 243 (1994). There are, however, a number of exceptions to the availability of the dividends received deduction depending on the type of corporation making the distribution, the length of time the corporate shareholder has owned the stock of the corporation making the distribution, and whether the stock of the corporation making the distribution is "debt financed portfolio stock" in the hands of the corporate shareholder. See I.R.C. §§ 246(a), 246(c), 246A (1994).

47. To the extent that the dividends received deduction is less than 100%, however, there is some degree of multiple corporate level taxation even for intercorporate distributions.

48. I.R.C. § 243(a) (1994). A domestic corporation is allowed a dividends received deduction for distributions from a 10% owned foreign corporation, however, to the extent that the dividend is derived from the earnings and profits attributable to the conduct of a trade or business within the United States by the foreign corporation. I.R.C. § 245 (1994).

49. I.R.C. § 901(b) (1994). In addition, the foreign tax credit may be claimed for taxes that are paid "in lieu of" a tax on income, war profits or excess profits. I.R.C. § 903 (1994). Under the regulations, a foreign levy is a tax "in lieu of" an income tax if, and only if, it constitutes a true tax, and "in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed." Treas. Reg. § 1.903-1 (1983).

50. I.R.C. § 164(a) (1994). *But cf.* I.R.C. § 275(a) (1994) (disallowing any deduction for certain taxes including any foreign income, war profits and excess profits taxes if "the taxpayer chooses to take to any extent the benefits of section 901"). Thus, the foreign tax credit is an "all or nothing" proposition. A taxpayer may not claim the foreign tax credit with respect to certain foreign income taxes and attempt to deduct other foreign income taxes.

The regulations provide detailed rules for determining whether a foreign levy will be creditable against U.S. tax liability.⁵¹ In general, a foreign assessment is creditable only if it is a tax, and its "predominant character" is that of an income tax, in the U.S. sense.⁵² A foreign assessment is considered to be a "tax" if it is a compulsory payment pursuant to the authority of a foreign country to levy taxes⁵³ and is not direct or indirect compensation for a specific economic benefit provided by the foreign country.⁵⁴ The predominant character of a foreign levy is that of an income tax in the U.S. sense if it is "likely to reach net gain in the normal circumstances in which it applies,"⁵⁵ and is not dependent on the availability of a credit against income tax liability to another country.⁵⁶ In

51. See generally Treas. Reg. §§ 1.901-2 (as amended in 1991), 1.901-2A (1983), 1.901-3 (as amended in 1977), 1.903-1 (1983).

52. Treas. Reg. § 1.901-2(a)(1) (as amended in 1991). See *Biddle v. Commissioner*, 302 U.S. 573 (1938) (holding that to be creditable, a foreign assessment must be "the substantial equivalent to an income tax in the U.S. sense of the tax as those terms are used in our own statute," regardless of the label placed on it by the foreign government).

53. Treas. Reg. § 1.901-2(a)(2) (as amended in 1991). The regulations provide by way of example that "a penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax." *Id.* In an unusual interlacing of foreign and domestic tax laws, the regulations also provide that "whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country." *Id.*

54. Treas. Reg. § 1.901-2(a)(2)(i) (as amended in 1991). A specific economic benefit is "an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country." Treas. Reg. § 1.901-2(a)(2)(ii)(B) (as amended in 1991). A specific economic benefit includes "a concession to extract government-owned petroleum," but "does not include the right or privilege merely to engage in business generally or to engage in business in a particular form." *Id.* The underlying premise for this provision is that to the extent that a foreign levy constitutes payment for a specific economic benefit, it should be allowable only as a deductible expense and not as a creditable foreign tax.

55. Treas. Reg. § 1.901-2(a)(3) (as amended in 1991). The regulations provide that a foreign tax is "likely to reach net gain" if and only if the tax satisfies a realization requirement, a gross receipts requirement and a net income requirement. Treas. Reg. § 1.901-2(b)(1) (as amended in 1991). These requirements are intended to ensure that the foreign levy is "substantially equivalent" to the U.S. income tax. For example, a foreign tax is considered to meet the "net income" requirement only if "the base of the tax is computed by reducing gross receipts . . . to permit . . . recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts . . ." Treas. Reg. § 1.901-2(b)(4)(i) (as amended in 1991). See, e.g., *Inland Steel Company v. United States*, 677 F.2d 72 (Ct. Cl. 1982) (holding an Ontario mining tax to be noncreditable because of the substantial discrepancies between the items that were allowed to be considered as deductible expenses in computing net income). The *Inland Steel* court concluded that the "tax does not seek to reach . . . any concept of net gain from the mining business which would be recognized as such in this country." *Id.* at 85.

56. Treas. Reg. § 1.901-2(a)(3)(ii) (as amended in 1991). A foreign tax that is dependent on the availability of a tax credit in another country is referred to as a "soak-up" tax. While not permissible for purposes of the foreign tax credit, soak-up taxes are common in the context of estate and inheritance taxes that are imposed by the states up to the amount of the credit against federal estate taxes. See I.R.C. § 2010 (1994). A foreign tax credit is not allowable for soak-up taxes, because to allow such a credit would effectively cede the taxing authority of the United States to foreign countries.

addition, a tax is not considered to be "paid" to a foreign country to the extent that it is reasonably certain to be refunded, credited, rebated or forgiven.⁵⁷

D. The Indirect Foreign Tax Credit

Section 902 provides, in general, that a domestic corporation will be treated as having paid the foreign taxes actually paid by a foreign corporation if the domestic corporation meets a minimum stock ownership requirement at the time it receives a dividend from the foreign corporation.⁵⁸ The amount of foreign taxes that the domestic corporation is considered to have paid is determined by prorating the foreign taxes among the earnings and profits of the foreign corporation and allocating to the domestic corporation the amount of foreign taxes attributable to the earnings and profits distributed to it as a dividend.⁵⁹

In general, the earnings of a foreign corporation are not subject to U.S. taxation until they are distributed to a U.S. shareholder of the foreign corporation.⁶⁰ Under the provisions of subpart F, however, certain undistributed earnings of a controlled foreign corporation (CFC) are currently includible in the income of U.S. shareholders who own 10 percent or more of the voting stock of the corporation.⁶¹ A U.S. shareholder who is currently taxable as a result of

57. Treas. Reg. § 1.901-2(e)(2) (as amended in 1991). For example, to encourage foreign lenders to lend to their residents, some countries subsidize foreign loans by rebating to their residents some portion of the withholding taxes that the countries impose on the interest paid on loans from foreign lenders. The regulations disallow any foreign tax credits in such circumstances, however, by providing that a tax is not considered to be "paid" to a foreign country if it is used directly or indirectly as a subsidy to the taxpayer or certain persons who are related to the taxpayer or who are engaged in transactions with the taxpayer. Treas. Reg. § 1.901-2(e)(3) (as amended in 1991).

58. I.R.C. § 902 (1994); Treas. Reg. § 1.902-1(b) (as amended in 1979). I.R.C. § 902 provides as follows:

SEC. 902. DEEMED PAID CREDIT WHERE DOMESTIC CORPORATION OWNS 10 PERCENT OR MORE OF VOTING STOCK OF FOREIGN CORPORATION.

(a) **TAXES PAID BY FOREIGN CORPORATION TREATED AS PAID BY DOMESTIC CORPORATION.**—For purposes of this subpart, a domestic corporation which owns 10 percent or more of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of such foreign corporation's post-1986 foreign income taxes as—

- (1) the amount of such dividends (determined without regard to section 78), bears to
- (2) such foreign corporation's post-1986 undistributed earnings.

59. *Id.* There are actually two separate mechanisms for the computation of the indirect foreign tax credit depending upon whether the distribution is from the foreign corporation's "pre-1987 accumulated profits" or "post-1986 undistributed earnings." Distributions of pre-1987 earnings are controlled by the "layers of earnings" method that was in effect prior to 1986. *See infra* text accompanying notes 93-104. Distributions of post-1986 earnings are controlled by the "pool of earnings" method adopted by the 1986 Tax Act. *See infra* text accompanying notes 105-13.

60. 1986 BLUEBOOK, *supra* note 17, at 962.

61. *See* I.R.C. §§ 951-964 (1994). The primary purpose of subpart F is to prevent the unwarranted deferral of U.S. taxation of certain types of income when the motivation for earning such income through a CFC is the tax benefit that is expected to be gained by doing so. *See* 1986 BLUEBOOK, *supra* note 17, at 965.

subpart F may also claim the indirect foreign tax credit with respect to such income.⁶²

1. Background

The foreign tax credit provisions were first adopted in 1918 in response to the increases in income tax rates both in the United States and overseas during World War I.⁶³ The 1918 legislation included provisions for the direct and indirect foreign tax credit.⁶⁴ Although one or two countries had used a foreign tax credit mechanism prior to that time for taxes paid to its colonies, the United States was the first country to utilize the foreign tax credit on a worldwide basis as a means of alleviating international double taxation.⁶⁵ The original indirect foreign tax credit, however, was restricted to taxes paid by a foreign subsidiary in which a U.S. corporation owned a majority of the stock.⁶⁶

Since 1918, there have been numerous technical changes, as well as several major revisions, to the indirect foreign tax credit.⁶⁷ These changes have, in general, made the indirect foreign tax credit available to additional foreign corporations. In 1942, the indirect foreign tax credit was expanded to permit a credit for the foreign income taxes paid by a second tier foreign subsidiary if it was a wholly owned subsidiary of a first tier foreign subsidiary in which a U.S. corporation owned a majority of the voting stock.⁶⁸ In 1951, the required degree of stock ownership in a first tier foreign subsidiary was reduced from 50 percent to 10 percent and the first tier subsidiary's required ownership of a second tier subsidiary was reduced from 100 percent to 50 percent.⁶⁹ In 1971, the indirect foreign tax credit was made available for taxes paid by third tier foreign subsidiaries,⁷⁰ and Congress established the present requirements with respect to the necessary degree of stock ownership for second and third tier foreign subsidiaries.⁷¹

62. I.R.C. § 960 (1994). Even an individual U.S. shareholder of a CFC may claim the indirect foreign tax credit with respect to a subpart F inclusion provided the inclusion elects to have the subpart F inclusion taxed at the corporate tax rates. I.R.C. § 962(a) (1994). For a discussion of the coordination of subpart F with the foreign tax credit, see *infra* text accompanying notes 134-47.

63. For a discussion of the historical background of the indirect foreign tax credit, see generally, OWENS & BALL, *supra* note 17, § 1/4; ISENBERGH, *supra* note 5, ¶¶ 23.1-23.8.

64. Revenue Act of 1918, 65th Cong., 3rd Sess., Ch. 18, 40 Stat. 1057 (1918) [hereinafter the Revenue Act of 1918].

65. OWENS & BALL, *supra* note 17, § 1/4.

66. Revenue Act of 1918, *supra* note 64, § 240(c).

67. Significant revisions to the indirect foreign tax credit provisions were enacted, for example, in the Revenue Act of 1942, H.R. 7378, Pub. L. No. 753, 77th Cong., (1942) [hereinafter the Revenue Act of 1942]; the Revenue Act of 1951, H.R. 4473, P.L. 183, 82nd Cong., (1951) [hereinafter the Revenue Act of 1951]; the Revenue Act of 1962, H.R. 10650, P.L. 87-834, 87th Cong., 2nd Sess., (1962) [hereinafter the Revenue Act of 1962]; in H.R. 18549, P.L. 91-684, 91st Cong., 2nd Sess., (1971) [hereinafter P.L. 91-684]; and in the Tax Reform Act of 1976, H.R. 10612, P.L. 94-455, 94th Cong., 2nd Sess., (1976) [hereinafter the Tax Reform Act of 1976].

68. Revenue Act of 1942, *supra* note 67, § 158(e).

69. Revenue Act of 1951, *supra* note 67, §§ 332(a), (b).

70. Pub. L. No. 91-684, *supra* note 67, § 1.

71. *Id.* Currently, a domestic corporation may claim the indirect foreign tax credit for income taxes paid by second and third tier foreign subsidiaries provided there is a chain of actual stock

In 1962, Congress made several significant revisions to the indirect foreign tax credit.⁷² These revisions were enacted in accordance with other major changes made with respect to the taxation of foreign source income.⁷³

First, Congress determined that principles of equity required that the tax burdens of domestic corporations that operated overseas should be substantially the same regardless of whether they chose to operate through a branch or through a separately incorporated foreign subsidiary.⁷⁴ To equalize the tax treatment between foreign branches and foreign subsidiaries, Congress revised the method of calculating the indirect foreign tax credit.⁷⁵ In particular, Congress determined that the indirect tax credit should be allowed for the full amount of foreign taxes paid by a foreign subsidiary,⁷⁶ but that the amount of any dividend received from a foreign subsidiary was required to be "grossed up" for the amount of foreign taxes deemed paid by the domestic corporation.⁷⁷ These changes corrected a discrepancy between foreign branches and foreign subsidiaries by bringing the tax treatment of the two into line with each other.⁷⁸

ownership of at least 10% down through the corporate structure and the attenuated stock ownership at the second and third tiers does not fall below 5%. I.R.C. § 902(b) (1994). In general, the indirect foreign tax credit may not be claimed for foreign income taxes paid by subsidiaries below the third tier regardless of the degree of stock ownership. See *infra* text accompanying notes 84-88.

72. Revenue Act of 1962, *supra* note 67, §§ 9-16.

73. In the Revenue Act of 1962 Congress first acted to limit what it considered to be an unwarranted deferral of income earned through CFCs. Revenue Act of 1962, *supra* note 67, § 12(a) (adding I.R.C. §§ 951-964 (subpart F)). Congress also revised the indirect foreign tax credit provisions in order to equalize the tax treatment between foreign branches and foreign subsidiaries. Revenue Act of 1962, *supra* note 67, § 9(a).

74. Revenue Act of 1962, *supra* note 67, § 9(a); H.R. REP. NO. 1447, 87th Cong., 2nd Sess. 401, 455 (1963); S. REP. NO. 1881, 87th Cong., 2nd Sess. 703, 772 (1963).

75. Revenue Act of 1962, *supra* note 67, § 9(a).

76. *Id.* Prior to 1962, a domestic corporation conducting its foreign operations through a subsidiary was allowed only a partial tax credit for the foreign taxes paid by the subsidiary. H.R. REP. NO. 1447, 87th Cong., 2nd Sess. 401, 454 (1963). The amount of foreign income tax allowed as a credit was limited to the same proportion of the foreign income tax paid by the subsidiary as the amount of income included in the domestic corporation's U.S. tax base was to the subsidiary's total income. *American Chiclé Company v. United States*, 316 U.S. 450 (1942) (holding that the domestic parent corporation could not claim the foreign tax credit for the portion of the foreign subsidiary's income that was actually used to pay the foreign income taxes).

77. Revenue Act of 1962, *supra* note 67, § 9(b) (adding I.R.C. § 78). In the absence of such a "gross up," a corporation operating through a foreign subsidiary was effectively allowed both a deduction for the amount of foreign income taxes paid by the subsidiary (since dividends could only be paid out of income remaining after payment of the foreign taxes) and a partial credit for the foreign taxes paid. The double tax benefit of a deduction and a partial tax credit resulted in an overall tax advantage to corporations operating through foreign subsidiaries whenever the foreign tax rate was less than the U.S. tax rate. H.R. REP. NO. 1447, 87th Cong., 2nd Sess. 401, 455 (1963).

78. The double tax benefit of a deduction and a partial tax credit for corporations that operated through foreign subsidiaries was a major discrepancy between the tax treatment of foreign branches and foreign subsidiaries. Congress corrected this discrepancy by allowing a tax credit for the full amount of income taxes paid by a foreign subsidiary (as in the case of a foreign branch), but requiring, through the gross up provision, that the U.S. corporation include in income the full amount of pretax earnings of the foreign subsidiary (as would be the case with a foreign branch). Revenue Act of 1962, *supra* note 67, §§ 9(a) (amending I.R.C. § 902), 9(b) (adding I.R.C. § 78).

Notably, such a "gross up" of the taxes paid by a foreign subsidiary into the income of the U.S. corporation brings the computation of the indirect foreign tax credit into precise parallel with the taxation of accumulation distributions from trusts under the throwback rules of subchapter J. See

Second, Congress made several changes to the indirect foreign tax credit to coordinate the foreign tax credit with the provisions of the newly enacted subpart F.⁷⁹ The indirect foreign tax credit was made available to both corporate and individual shareholders who were subject to current U.S. taxation on the income of a CFC under subpart F.⁸⁰ In addition, the indirect foreign tax credit was made available to both corporate and individual shareholders selling or liquidating the stock of a CFC to the extent the amount received was taxable as a dividend.⁸¹ Finally, the indirect foreign tax credit was made available to corporate shareholders for actual minimum distributions which were permitted to be made to avoid the application of subpart F.⁸²

2. Stock Ownership Requirements

In order for a domestic corporation to claim the indirect foreign tax credit, it must own at least 10 percent of the voting stock of a foreign subsidiary at the time it receives a dividend from the subsidiary.⁸³ If a first tier subsidiary owns at least 10 percent of the voting stock of a second tier foreign subsidiary, a distribution from the second tier subsidiary to the first tier subsidiary has the effect of increasing the amount of foreign taxes that the first tier subsidiary is considered to have paid.⁸⁴ This can significantly benefit the U.S. parent, since it increases the amount of foreign taxes available to be claimed as a credit. This mechanism is also applicable to distributions from third tier foreign subsidiaries to second tier foreign subsidiaries provided the second tier subsidiary owns at least 10 percent of the voting stock of the third tier subsidiary.⁸⁵ The U.S. cor-

I.R.C. §§ 665-668 (1994). Under the throwback rules, the income taxes paid by the trust with respect to income accumulated in trust are deemed to be distributed to the trust beneficiary at the time of an accumulation distribution. I.R.C. §§ 666(b)-(c) (1994) (requiring a total or pro rata gross up of the taxes imposed on the trust with respect to a distribution of accumulated income). The trust beneficiary is then granted a tax credit for "the amount of taxes . . . deemed distributed to the beneficiary under sections 666(b) and (c)." I.R.C. § 667(b)(1) (1994). See *infra* text accompanying notes 233-51.

79. Revenue Act of 1962, *supra* note 67, § 12(a) (adding I.R.C. §§ 951-964 (subpart F)).

80. *Id.* U.S. shareholders of a controlled foreign corporation who are required to include in income all or a part of the income of the corporation, even though the income has not been distributed as a dividend, are allowed to claim the indirect credit for the foreign taxes paid by the corporation with respect to that income. I.R.C. §§ 960, 962 (1994).

81. Revenue Act of 1962, *supra* note 67, § 15 (adding I.R.C. § 1248).

82. Revenue Act of 1962, *supra* note 67, § 12 (adding I.R.C. § 963). I.R.C. § 963 was repealed by the Tax Reduction Act of 1975, Pub. L. No. 94-12, § 602(a)(1), 89 Stat. 58 (1975).

83. I.R.C. § 902(a) (1994); Treas. Reg. § 1.902-1(a)(1) (as amended in 1979).

84. I.R.C. § 902(b)(1) (1994); Treas. Reg. § 1.902-1(c)(1) (as amended in 1979). The first tier subsidiary is deemed to have paid the same proportion of any foreign income taxes paid by the second tier subsidiary as the amount of the dividend paid to the first tier subsidiary bears to the post-1986 undistributed earnings of the second tier subsidiary. Treas. Reg. § 1.902-1(c)(2) (as amended in 1979). The amount of foreign taxes that the first tier subsidiary is deemed to have paid is computed slightly differently with respect to distributions from the pre-1987 earnings of the second tier subsidiary. See *infra* text accompanying notes 93-100.

85. I.R.C. § 902(b)(2) (1994); Treas. Reg. § 1.902-1(d)(1) (as amended in 1979). As with distributions from second tier subsidiaries to first tier subsidiaries, the second tier subsidiary is deemed to have paid the same proportion of any foreign income taxes paid by the third tier subsidiary as the amount of the dividend paid to the second tier subsidiary bears to the post-1986 undistrib-

poration may only claim the indirect foreign tax credit for taxes paid by second and third tier foreign subsidiaries if, in addition to the chain of at least 10 percent actual stock ownership down through the corporate structure, the attenuated stock ownership at the second and third tiers does not fall below 5 percent.⁸⁶ However, as a result of an apparently arbitrary line drawn by Congress, the indirect foreign tax credit may not be claimed for foreign taxes paid by subsidiaries below the third tier regardless of the degree of stock ownership.⁸⁷

3. Foreign Taxes Deemed Paid

In the event of a dividend distribution or an inclusion under the provisions of subpart F, the amount of foreign taxes eligible for the indirect foreign tax credit is a fraction of the foreign taxes paid by the foreign corporation.⁸⁸ The numerator of the fraction for a dividend distribution is the amount of the dividend received from the foreign corporation and the denominator is the foreign corporation's post-1986 undistributed earnings.⁸⁹ In the case of an inclusion under subpart F, the numerator of the fraction is the amount of the subpart F inclusion and the denominator is the foreign corporation's post-1986 undistrib-

uted earnings of the third tier subsidiary. Treas. Reg. § 1.902-1(d)(2) (as amended in 1979). The computation of the amount of foreign taxes that the second tier subsidiary is deemed to have paid is also done slightly differently with respect to distributions from the pre-1987 earnings of the third tier subsidiary. See *infra* text accompanying notes 93-100.

86. I.R.C. § 902(b)(3) (1994); Treas. Reg. §§ 1.902-1(c)(1), 1.902-1(d)(1) (as amended in 1979). The degree of attenuated stock ownership of the second tier subsidiary is determined by multiplying the percentage of voting stock of the first tier subsidiary owned by the parent corporation by the percentage of voting stock of the second tier subsidiary owned by the first tier subsidiary. I.R.C. § 902(b)(3)(A) (1994); Treas. Reg. § 1.902-1(c)(1) (as amended in 1979). For example, if the domestic corporation owns 50% of the voting stock of the first tier subsidiary and the first tier subsidiary owns 40% of the second tier subsidiary, then the domestic corporation has an indirect ownership interest in the second tier subsidiary of 20%. The degree of attenuated stock ownership at the third tier is determined by multiplying the domestic corporation's indirect ownership interest in the second tier subsidiary by the percentage of voting stock of the third tier subsidiary owned by the second tier subsidiary. I.R.C. § 902(b)(3)(B) (1994); Treas. Reg. § 1.902-1(d)(1) (as amended in 1979). In addition, in order for a higher tier subsidiary to be treated as having paid the taxes paid by a lower tier subsidiary, the required degree of stock ownership must exist at the time that the higher tier subsidiary receives a dividend from the lower tier subsidiary. Treas. Reg. § 1.902-1(a)(2), (a)(3) (as amended in 1979).

87. I.R.C. § 902(b) (1994). Legislation has been proposed, however, that would allow the creditability of taxes paid by subsidiaries below the third tier provided such subsidiaries are CFCs. See the Tax Simplification Act of 1993, H.R. 13, 103d Cong., 1st Sess., § 414.

88. I.R.C. § 902 (1994). See 1986 BLUEBOOK, *supra* note 17, at 858. The computation of the indirect foreign tax credit is different for distributions from the foreign corporation's "pre-1987 accumulated profits" and distributions from the corporation's "post-1986 undistributed earnings." See I.R.C. § 902(c) (1994). For distributions of pre-1987 accumulated profits, see *infra* text accompanying notes 93-104. For distributions of post-1986 undistributed earnings, see *infra* text accompanying notes 105-13.

89. I.R.C. § 902(a) (1994). This is the fraction that is applicable to distributions from the foreign corporation's post-1986 undistributed earnings. For distributions from the foreign corporation's pre-1987 accumulated profits, the numerator of the fraction is the amount of the dividend from the foreign corporation and the denominator of the fraction is the foreign corporation's pre-1987 accumulated profits for the taxable year to which the dividend is attributable. I.R.C. § 902(c)(6) (1994) (applying I.R.C. § 902(a) as in effect before amendment by the Tax Reform Act of 1986 for distributions from pre-1987 accumulated profits). See *infra* text accompanying notes 93-104.

uted earnings.⁹⁰ For purposes of these fractions, the earnings of the foreign subsidiary are determined in accordance with the rules for computing the earnings of a domestic corporation.⁹¹

a. Distributions of Pre-1987 Earnings

For distributions from the pre-1987 earnings of a foreign corporation, the computation of the indirect foreign tax credit is governed by the "layers of earnings" method.⁹² Under the layers of earnings method, a distribution from a foreign subsidiary is traced to the accumulated profits of the corporation for a particular year and matched with the foreign taxes paid during that year.⁹³ The amount of taxes paid by the subsidiary for a particular tax year that qualifies for the indirect foreign tax credit is based on the portion of the corporation's accumulated profits for that year which were distributed as a dividend to the domestic corporation.⁹⁴

Under the layers of earnings method, foreign taxes paid during any year are only creditable to the extent the subsidiary has accumulated profits for that year,

90. I.R.C. § 960(a) (1994). As with actual distributions, this is the fraction that is applicable to subpart F inclusions for tax years after 1986. For subpart F inclusions for tax years before 1987, the numerator of the fraction is the amount of subpart F inclusion and the denominator of the fraction is the foreign corporation's pre-1987 accumulated profits for the taxable year of the subpart F inclusion. I.R.C. §§ 960(a), 902(c)(6) (1994) (applying I.R.C. § 902(a) as in effect before amendment by the Tax Reform Act of 1986 for subpart F inclusions for tax years before 1987). See *infra* text accompanying notes 93-104.

91. I.R.C. §§ 902(c)(1) (effective for tax years beginning after 1986), 964(a) (1994). For tax years beginning before 1987, the computation of the foreign corporation's accumulated profits is also to be made in accordance with the rules for computing the earnings and profits of a domestic corporation. Treas. Reg. § 1.902-1(e) (as amended in 1979); *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 145 (1989), *reh'g denied*, 493 U.S. 1095 (1990) (holding that "tax provision should generally be read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control").

92. 1986 BLUEBOOK, *supra* note 17, at 857. See generally ISENBERGH, *supra* note 5, ¶ 23.13; BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.3(3).

93. I.R.C. § 902(a) (before amendment in 1986); Treas. Reg. § 1.902-1(b)(2) (as amended in 1979). Prior to amendment in 1986, I.R.C. § 902(a) read as follows:

SEC. 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

(a) TREATMENT OF TAXES PAID BY FOREIGN CORPORATION.—For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid).

94. I.R.C. § 902(a) (before amendment in 1986). Stated as a formula, the indirect foreign tax credit for distributions from pre-1987 earnings may be expressed as follows:

$$\frac{\text{Dividend Received}}{\text{Accumulated Profits}} \times \text{Foreign Income Taxes Paid} = \text{Indirect Credit}$$

Treas. Reg. § 1.902-1(b)(2) (as amended in 1979).

and then only in proportion to the amount of such accumulated profits that were distributed as a dividend.⁹⁵ Accumulated profits are, therefore, placed into layers corresponding to particular tax years and are matched with the foreign income taxes paid during that year.⁹⁶ Under the regulations, the accumulated profits of a foreign corporation for any taxable year are generally equal to the corporation's earnings and profits for that year.⁹⁷ Based on the U.S. model of corporate taxation, distributions are treated as first being made out of the most recently accumulated profits of the distributing corporation.⁹⁸ Therefore, a distribution from a foreign subsidiary carries out the accumulated profits of the corporation in reverse chronological order.⁹⁹

If a foreign corporation has a deficit in earnings and profits in any year, such deficit is carried back and reduces the most recently accumulated earnings and profits of the corporation.¹⁰⁰ Such a carryback can have the effect of reducing a foreign corporation's accumulated profits for a prior year even though there is no corresponding reduction in the foreign income taxes paid during that year.¹⁰¹ The result of this rule can be the permanent loss of the indirect foreign tax credit for taxes paid in the prior year.¹⁰²

95. Treas. Reg. § 1.902-1(b)(2) (as amended in 1979); 1986 BLUEBOOK, *supra* note 17, at 857.

96. Treas. Reg. §§ 1.902-1(b)(2), 1.902-1(c)(2), 1.902-1(f) (as amended in 1979). See generally ISENBERGH, *supra* note 5, ¶ 23.13; BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.3.

97. For tax years before 1962, the denominator of the indirect foreign tax credit formula was the foreign corporation's accumulated profits. I.R.C. § 902(a) (before amendment by the Revenue Act of 1962). For tax years after 1962, the denominator of the indirect foreign tax credit formula for corporations other than the corporations of less developed countries was the foreign corporation's accumulated profits reduced by the foreign taxes imposed on the corporation. I.R.C. § 902(a)(1) (as amended by the Revenue Act of 1962). At the time of this change, the definition of accumulated profits was amended to be equal to the sum of the foreign corporation's earnings and profits and the foreign taxes imposed on the income to which such earnings and profits are attributable. See Treas. Reg. § 1.902-1(e) (as amended in 1979).

Unfortunately, the regulations do not prescribe the manner in which the earnings and profits of the foreign corporation are to be determined. The domestic corporation may elect to compute the earnings and profits of its foreign subsidiary using the rules for the determination of the earnings and profits of a CFC, but there is no provision for the determination of earnings and profits if the domestic corporation does not make such an election. See Treas. Reg. §§ 1.902-1(g) (as amended in 1979), 1.964-1 (as amended in 1983). With respect to the determination of the earnings and profits of a domestic corporation, see Treas. Reg. § 1.312-6 (1955); BITTKER & EUSTICE, *supra* note 10, ¶ 8.03. The regulations appear to indicate that the earnings and profits of a foreign corporation is equal to the gross income of the corporation reduced by the foreign income taxes imposed on such income. See Treas. Reg. § 1.902-1(k) (as amended in 1979).

98. Treas. Reg. § 1.902-1(a)(6) (as amended in 1979). See I.R.C. § 316(a) (1994); Treas. Reg. § 1.316-2(a) (1955). I.R.C. § 316(a) provides in part that "every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits."

99. Rev. Rul. 74-550, 1974-2 C.B. 209; H.H. Robertson Co. v. Commissioner, 59 T.C. 53 (1972).

100. Rev. Rul. 74-550, 1974-2 C.B. 209.

101. Since earnings and profits is determined under U.S. law while foreign taxes paid is determined under foreign law, if the deficit in earnings and profits is not matched with a loss carryback under foreign law, there will be a reduction in the foreign corporation's earnings and profits for the prior year without a corresponding reduction in foreign taxes paid during such year. *Id.*

102. *Id.* If a deficit in earnings and profits eliminates the accumulated profits of the corporation from a prior year, a distribution will not be "sourced" to such year for purposes of the indirect foreign tax credit. Cf. *Champion International v. Commissioner*, 81 T.C. 424 (1983) (holding that a

In the event of either a dividend distribution or a subpart F inclusion, the amount of the distribution or inclusion is "grossed up" by the amount of foreign taxes deemed paid by the domestic corporation so that the U.S. corporation can be treated as if it had received a proportionate part of the foreign subsidiary's pre-tax profits and paid a proportionate amount of the foreign taxes.¹⁰³

b. Distributions of Post-1986 Earnings

For distributions from the post-1986 earnings of a foreign corporation, the computation of the indirect foreign tax credit is governed by the "pool of earnings" method.¹⁰⁴ Under the pool of earnings method, distributions and subpart F inclusions are treated as though they were made from a pool of the foreign corporation's post-1986 undistributed earnings.¹⁰⁵ For this purpose, the undistributed earnings of the foreign corporation is equal to the accumulated earnings and profits of the foreign corporation without reduction for the current distribution or subpart F inclusion.¹⁰⁶ Under the pool of earnings method, a dividend or subpart F inclusion is treated as carrying out a proportionate part of the aggregate foreign taxes paid by the foreign subsidiary with respect to the undistributed earnings in the pool.¹⁰⁷

The pool of earnings method for computing the indirect foreign tax credit applies only on a prospective basis.¹⁰⁸ That is, dividends are treated as paid first out of the pool of post-1986 undistributed earnings of the foreign corporation.¹⁰⁹ Distributions that exceed the subsidiary's pool of post-1986 undistributed earnings are then treated as paid out of the corporation's pre-1987 accumulated profits under the layers of earnings method.¹¹⁰

If a second or third tier foreign subsidiary distributes a dividend to a higher-tier subsidiary, the dividend is included in the higher-tier subsidiary's

net operating loss reduces both the numerator (dividend received) and the denominator (accumulated profits) of the indirect foreign tax credit fraction). This loss of the indirect foreign tax credit because of a deficit in earnings and profits was identified as one of the problems with the layers of earnings method that formed the basis for its replacement with the pool of earnings method. 1986 BLUEBOOK, *supra* note 17, at 869. The pool of earnings method is supposed to more closely match the earnings and profits mechanism inherent in the U.S. model of corporate taxation.

103. I.R.C. § 78 (1994). The gross up provision prevents the U.S. corporate shareholder from effectively obtaining a deduction as well as a credit for foreign taxes, since the amount of an actual distribution or subpart F inclusion reflects only the after foreign tax profits of the foreign corporation. 1986 BLUEBOOK, *supra* note 17, at 858, note 6.

104. ISENBERGH, *supra* note 5, ¶ 23.15; 1986 BLUEBOOK, *supra* note 17, at 906. *See generally* BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.3(2).

105. ISENBERGH, *supra* note 5, ¶ 23.15; 1986 BLUEBOOK, *supra* note 17, at 906. *See generally* BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.3(2).

106. I.R.C. § 902(c)(1) (1994) (effective for tax years beginning after 1986). The computation of earnings and profits for purposes of the pool of earnings method is to be made using the rules applicable to the determination of the earnings and profits of a CFC under subpart F. I.R.C. §§ 902(c)(1), 964(a) (1994).

107. I.R.C. § 902(a) (1994).

108. I.R.C. § 902(c)(6) (1994) (applying the provisions of I.R.C. § 902(a) as in effect before amendment by the Tax Reform Act of 1986 for distributions from pre-1987 accumulated profits).

109. I.R.C. §§ 902(a), 902(c)(6)(B) (1994).

110. I.R.C. § 902(c)(6)(A)(ii) (1994).

pool of post-1986 undistributed earnings even if it is paid from the lower-tier subsidiary's pre-1987 accumulated profits.¹¹¹ To the extent the dividend is paid from the lower-tier subsidiary's pre-1987 accumulated profits, however, the layers of earnings method is utilized to determine the amount of foreign taxes attributable to the distribution.¹¹²

E. Limitations on the Foreign Tax Credit

A fundamental premise of the foreign tax credit is that it should only be available to offset taxpayers' U.S. tax liability with respect to their foreign source income and should be no greater than the amount of U.S. tax liability on such income.¹¹³ The policy of alleviating international double taxation does not require that the foreign tax credit be available to offset taxpayers' U.S. tax liability on their U.S. source income.¹¹⁴ To permit the foreign tax credit to reduce taxpayers' U.S. tax liability on their U.S. source income would "cede to foreign countries the primary right to tax income earned in the United States."¹¹⁵

1. The Overall Limitation

Section 904 imposes a limitation on the amount of the foreign tax credit that may be claimed in any year. It is designed to prevent taxpayers from using the foreign tax credit to offset their U.S. tax liability on their U.S. source income.¹¹⁶ Under this limitation, a taxpayer's pre-credit U.S. tax liability is allocated on a pro-rata basis to its worldwide taxable income.¹¹⁷ The amount of the taxpayer's pre-credit U.S. tax liability that is allocated to its net foreign source

111. 1986 BLUEBOOK, *supra* note 17, at 906.

112. *Id.* at 907. Just as the dividend from the lower-tier subsidiary is included in the upper-tier subsidiary's pool of post-1986 undistributed earnings, the foreign taxes attributable to the dividend are included in the upper-tier subsidiary's pool of post-1986 foreign taxes paid. *Id.*

113. *Id.* at 854. All that is required to implement the fundamental policy of alleviating international double taxation is an offset against U.S. tax liability for foreign taxes paid on foreign source income.

114. Such would be the case, for example, if a taxpayer has both U.S. source income and foreign source income and the amount of foreign income taxes that it pays on its foreign source income is greater than the amount of tax that is imposed on that income by the United States. To allow a foreign tax credit for the full amount of the foreign taxes paid on the taxpayer's foreign source income would permit the taxpayer to reduce its U.S. tax liability on its U.S. source income.

115. *Id.* at 854.

116. I.R.C. § 904(a) (1994); Treas. Reg. § 1.904-1(b) (as amended in 1977). I.R.C. § 904(a) provides as follows:

SEC. 904. LIMITATION ON CREDIT.

(a) LIMITATION.—The total amount of the credit taken under section 901(a) shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

117. 1986 BLUEBOOK, *supra* note 17, at 854. See generally BITTKER & LOKKEN, *supra* note 3, ¶ 69.5; ISENBERGH, *supra* note 5, ¶ 19.1. The taxpayer's taxable income for purposes of this limitation is computed with a number of modifications to reflect the preferential treatment of capital gains and the restrictions on the deduction of capital losses. See I.R.C. § 904(b) (1994).

income is the maximum amount of foreign tax credit that may be taken for the year.¹¹⁸

The overall limitation on the foreign tax credit has two major shortcomings.¹¹⁹ First, it permits the income and losses generated in, and the taxes paid to, different foreign countries to be "averaged" for foreign tax credit limitation purposes.¹²⁰ This averaging can have the effect of allowing a foreign tax credit with respect to certain foreign source income that is greater than the amount of U.S. tax that would have been imposed on the taxpayer with respect to such income if it had been U.S. source income.¹²¹ Thus, the allowance of such averaging goes beyond the fundamental premise of alleviating international double taxation.¹²²

118. Stated as a formula, the overall limitation on the foreign tax credit may be expressed as follows:

$$\frac{\text{Foreign Source Taxable Income}}{\text{Worldwide Taxable Income}} \times \text{Pre-credit U.S. tax} = \text{Overall Limitation}$$

I.R.C. § 904(a) (1994). The overall effect of this limitation is that a taxpayer's net tax liability on their foreign source income will be the greater of either the pre-credit U.S. tax allocated to that income or the foreign income tax paid on such income.

119. 1986 BLUEBOOK, *supra* note 17, at 862.

120. *Id.* The 1986 BLUEBOOK refers to this averaging of different foreign tax rates as "cross-crediting" of taxes, the result of which is that "the United States sometimes collects little or no residual U.S. tax—after aggregate foreign taxes are credited—on certain types of income that are themselves taxed abroad at below the U.S. rate." *Id.*

121. For example, suppose that a taxpayer has operations in two foreign countries and that both offshore operations are generating net income. Suppose further that country A taxes income from within its boundaries at the rate of 30%, that country B taxes income at the rate of 40%, that the U.S. tax rate is 35% and that the taxpayer has \$100,000 of net income from each source. In this situation, the taxpayer's pre-credit U.S. tax liability would be \$105,000 (\$300,000 × 35% = \$105,000). The amount of foreign income taxes the taxpayer would pay is \$70,000 (\$30,000 paid to country A + \$40,000 paid to country B = \$70,000). Under the overall limitation, the amount of foreign tax credit that the taxpayer could claim is \$70,000 (200,000/300,000 × \$105,000 = \$70,000). The elimination of international double taxation, however, requires only that the U.S. allow a foreign tax credit of \$65,000 (\$30,000 for the income taxes paid to country A plus \$35,000 for the income taxes paid to country B).

122. The alleviation of international double taxation requires only that the U.S. allow a foreign tax credit for the amount of tax that would have been imposed by the United States on such income. The averaging of the tax rates from different foreign countries, however, permits a foreign tax credit that is greater than the amount of U.S. tax that would have been imposed on such income.

To combat this averaging permitted by the overall limitation, Congress has at various times imposed a "per country" limitation in addition to the overall limitation. The per country limitation operates in the same manner as the overall limitation, except that it is applied on a country by country basis. Under the per country limitation, the taxes imposed by one country cannot be used to reduce the U.S. tax liability on income derived from other foreign countries. In the Tax Reform Act of 1976, however, Congress repealed the per country limitation and made the overall limitation mandatory.

The 1986 BLUEBOOK also notes that the allowance of tax rate averaging violates the principle of Capital Export Neutrality since

U.S. taxpayers with excess foreign tax credits have an incentive at the margin to place new investments abroad rather than in the United States when the income that those investments will generate will be taxed abroad at below the U.S. rate and the excess credits will be available to reduce or eliminate the U.S. tax on the income.

1986 BLUEBOOK, *supra* note 17, at 862.

The second major shortcoming of the overall limitation is that it permits the averaging of different rates of tax that may be applicable to different types of income.¹²³ This averaging can also have the effect of allowing a foreign tax credit with respect to certain income items that is greater than the taxpayer's U.S. tax liability with respect to such income.¹²⁴

2. The Categories of Income Limitation

To remedy the problems with the overall limitation on the foreign tax credit, Congress significantly expanded the categories of income limitation on the foreign tax credit.¹²⁵ Under the new categories of income limitation, a taxpayer's foreign source income is divided into a number of distinct "baskets" and the overall limitation is applied separately to each basket.¹²⁶ This limitation prevents a taxpayer from averaging the different rates of tax that may be applicable to the income within each basket.¹²⁷

The overall limitation and the categories of income limitation are also applicable to the indirect foreign tax credit.¹²⁸ For purposes of the indirect foreign tax credit, however, dividends from each foreign corporation that qualify for the indirect foreign tax credit are treated as a separate category of income.¹²⁹ This prevents the cross crediting of foreign taxes paid by such corporations.¹³⁰

123. *Id.* at 862.

124. For example, suppose that a taxpayer had operations in only one foreign country from which it derived \$100,000 of interest income taxable at a flat rate of 30% and \$100,000 of net business income taxable at a rate of 50%. If the taxpayer also had \$100,000 of U.S. source taxable income taxable at 35%, then the elimination of international double taxation would require no more than the allowance of a foreign tax credit of \$65,000 (\$30,000 for the foreign income taxes imposed on its foreign source interest income plus \$35,000 for the amount of U.S. tax that would have been imposed on its foreign source business income). Under the overall limitation, however, the foreign tax credit that the taxpayer could claim would be \$70,000 ($\$200,000/\$300,000 \times \$105,000 = \$70,000$).

125. 1986 Tax Act, *supra* note 24, § 1201(amending I.R.C. § 904(d)). Prior to 1986, certain types of income were subject to separate limitations in order to prevent the cross-crediting problems identified by Congress. 1986 BLUEBOOK, *supra* note 17, at 862-63.

126. I.R.C. § 904(b) (1994). Congress has identified nine different categories of income with respect to which the overall tax credit limitation must be separately computed. I.R.C. §§ 904(b)(1)(A)-(I) (1994).

127. The categories of income limitation, however, continues to allow the cross crediting of foreign taxes that are paid to different foreign countries with respect to income within each basket. Congress determined that such cross crediting of taxes was appropriate, however, with respect to earnings from foreign countries that were units of a worldwide business. 1986 BLUEBOOK, *supra* note 17, at 867.

128. I.R.C. §§ 904(d)(1), 902(c)(7) (1994).

129. I.R.C. § 904(d)(1)(E) (1994). Such a corporation is referred to as a "noncontrolled section 902 corporation," which is defined as "any foreign corporation with respect to which the taxpayer meets the stock ownership requirements of section 902(a)," but which is not a CFC. I.R.C. § 904(d)(2)(E)(i) (1994). See *supra* text accompanying notes 84-88.

130. 1986 BLUEBOOK, *supra* note 17, at 868 states that

In the case of foreign corporations that are not controlled foreign corporations, however, Congress did not believe that there is sufficient identity of interest with U.S. shareholders to treat nonmajority ownership positions as units of a worldwide business. Accordingly, Congress did not believe it is appropriate to allow cross-crediting of taxes from nonmajority interests against income derived from controlling interests

As a matter of statutory coordination, Congress intended there to be separate applications of the pool of earnings method to reflect the separate application of the foreign tax credit limitation provisions to separate types of income and loss.¹³¹ Therefore, to ensure that the limitations on the indirect foreign tax credit apply separately to different baskets of income, separate pools of undistributed earnings and foreign taxes must be maintained for each basket of income subject to the credit limitations.¹³²

F. Coordination with Subpart F

In general, the gains, profits and income of a foreign corporation are not subject to U.S. taxation until such earnings are repatriated.¹³³ The avoidance of current U.S. taxation on the income earned through a foreign corporation allows a significant economic benefit from tax deferral for corporations that choose to conduct their foreign operations through subsidiaries.¹³⁴ In Congress' view, such deferrals are inappropriate for certain types of "passive" income when it has been moved offshore for tax purposes instead of for economic reasons.¹³⁵

In general, the provisions of subpart F require the 10 percent shareholders of a CFC to include in gross income their pro rata share of the corporation's subpart F income and any increases in earnings invested in U.S. property.¹³⁶ A CFC for this purpose is a foreign corporation in which more than 50 percent of the stock is owned, directly or indirectly, by U.S. shareholders.¹³⁷ Subpart F income generally consists of income which is "passive" in nature, which is relatively movable from one taxing jurisdiction to another, and which is frequently subject to low rates of foreign tax.¹³⁸

In the event of a current income inclusion under subpart F, the shareholders of the CFC may claim the indirect foreign tax credit for foreign taxes paid by the

or vice versa, or of taxes from one nonmajority interest against income of another nonmajority interest.

131. *Id.* at 907. See I.R.C. § 902(c)(7) (1994) (mandating the issuance of regulations to implement the pool of earnings method for purposes of the indirect foreign tax credit and subpart F, including provisions "to reflect the separate application of section 904 to separate types of income and loss").

132. 1986 BLUEBOOK, *supra* note 17, at 908.

133. *Id.* at 962.

134. This tax deferral also creates a significant discrepancy between the tax treatment of foreign branches and foreign subsidiaries since such tax deferral is not available for operations conducted through foreign branches.

135. 1986 BLUEBOOK, *supra* note 17, at 964, noting that "it has long been the policy of the United States to impose current tax when a significant purpose of earning income through a foreign corporation is the avoidance of tax."

136. I.R.C. §§ 951-964 (subpart F) (1994). See, generally BITTKER & LOKKEN, *supra* note 3, ¶ 68.2.

137. I.R.C. § 957(a) (1994). For this purpose, a U.S. shareholder is a domestic corporation or U.S. citizen or resident who owns, directly or indirectly, 10% or more of the voting stock of the foreign corporation. I.R.C. § 951(b) (1994).

138. 1986 BLUEBOOK, *supra* note 17, at 963. See BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.6(1), describing such income as "income Congress found to be susceptible to tax haven abuse."

corporation.¹³⁹ The amount of foreign taxes paid by the CFC for the taxable year which are eligible for the indirect foreign tax credit is proportional to the amount of the CFC's earnings and profits attributable to the subpart F inclusion.¹⁴⁰ The indirect foreign tax credit is even available to individual shareholders of the CFC provided they elect to have their subpart F inclusion taxed at the corporate rate.¹⁴¹ When a CFC makes an actual distribution, adjustments must be made to take account of the fact that certain amounts have already been subjected to U.S. taxation.¹⁴²

There is a complex set of provisions designed to coordinate the rules of subpart F with the limitations on the foreign tax credit.¹⁴³ In the case of a CFC, the categories of income limitation is applied using a "look-through" rule to determine the amount of any subpart F inclusion in the hands of U.S. shareholders that must be placed into each of the different baskets of income.¹⁴⁴ Under the look-through rule, a subpart F inclusion is treated as consisting of a proportionate share of each category of income received during the taxable year by the CFC.¹⁴⁵ This rule is designed to prevent taxpayers from using the provisions of subpart F to circumvent the application of the tax credit limitations.¹⁴⁶

III.

THE POLICIES OF THE INDIRECT FOREIGN TAX CREDIT

Congress has articulated two primary concerns with respect to the indirect foreign tax credit.¹⁴⁷ These concerns are first, that the U.S. tax system should provide relief from international double taxation, and second, that domestic corporations that conduct their offshore operations through foreign subsidiaries should face the same overall tax consequences as corporations that operate directly in foreign countries through branches.¹⁴⁸ The desired similarity of tax treatment between foreign branches and foreign subsidiaries is based on notions of equity and economic efficiency and the underlying policy that the U.S. tax

139. I.R.C. § 960(a) (1994).

140. I.R.C. § 960 (1994).

141. I.R.C. § 962(a) (1994).

142. I.R.C. § 959(a) (1994).

143. I.R.C. §§ 904(d)(3), 902(c)(7) (1994). *See generally*, BITTKER & LOKKEN, *supra* note 3, ¶ 69.6.8.

144. I.R.C. § 904(d)(3)(B) (1994).

145. I.R.C. § 904(d)(3) (1994); *See* 1986 BLUEBOOK, *supra* note 17, at 866.

146. 1986 BLUEBOOK, *supra* note 17, at 901.

147. H.R. REP. NO. 1447, 87th Cong., 2nd Sess. 401, 455 (1963); S. REP. NO. 1881, 87th Cong., 2nd Sess. 703, 722 (1963); 1986 BLUEBOOK, *supra* note 17, at 861, 869.

148. 1986 BLUEBOOK, *supra* note 17, at 861, 869. As Congress has observed, there can undoubtedly never be total equality of tax treatment between foreign branches and foreign subsidiaries, but the tax consequences of these two methods of conducting foreign operations should be as close to the same as possible in order to further the stated congressional policy that the U.S. tax system should remain in the background, creating neither incentives nor disincentives for particular economic activities. *Id.* at 964-65.

system should not be a deciding factor in how corporations choose to conduct their foreign operations.¹⁴⁹

A. *Alleviation of International Double Taxation*

A foreign subsidiary will generally pay taxes to the foreign country in which it is incorporated whenever it has net income for a taxable year.¹⁵⁰ The net income of the subsidiary is then subject to U.S. taxation when it is repatriated to the domestic corporation in the form of a dividend.¹⁵¹ The direct foreign tax credit is not available to the U.S. parent corporation since the foreign taxes are paid by a separate taxable entity.¹⁵² In the absence of the indirect foreign tax credit, the same income would be taxed by two national taxing authorities, and thus be subject to international double taxation.¹⁵³

Based on the model of a domestic corporation that operates through a foreign branch, the alleviation of international double taxation requires a determi-

149. *Id.* at 964-65.

150. This assumes, of course, that the foreign country has an income tax of general application rather than raising its governmental revenues through other types of duties or imposts.

151. Dividends from foreign corporations do not qualify for the dividends received deduction except to the extent that the foreign corporation has income that is effectively connected to the conduct of a United States trade or business. I.R.C. §§ 243, 245 (1994). In the case of a CFC, repatriation will also occur to the extent that the foreign corporation makes an investment in U.S. property. I.R.C. § 956 (1994). In addition, the income of a CFC may be subject to current U.S. taxation in the hands of the domestic corporation under the provisions of subpart F. See *supra* text accompanying notes 137-47.

152. The direct foreign tax credit is only available for foreign taxes that are paid or accrued by U.S. taxpayers. I.R.C. § 901(b)(1) (1994). Treas. Reg. § 1.901-2(f)(1) (as amended in 1991) provides that "the person by whom tax is considered paid for purposes of [the foreign tax credit] is the person on whom foreign law imposes legal liability for such tax . . ." The indirect foreign tax credit is available to the U.S. corporation, however, to the extent that the income of a CFC is subject to current U.S. taxation in the hands of the domestic corporation under the provisions of subpart F. I.R.C. § 960 (1994).

153. Even without the indirect foreign tax credit, there would be some degree of relief from international double taxation. Since the taxes paid by a foreign subsidiary reduces the amount that is available to be distributed to the domestic corporation, taxation of the net distribution is the equivalent of granting the domestic corporation a deduction for the foreign taxes paid. This constructive deduction, however, provides only partial relief from international double taxation. For example, assume that a domestic corporation has a foreign operation that generates \$100,000 of foreign source taxable income subject to taxation by the foreign country at the rate of 30% and that the U.S. tax rate is 35%. If this operation were conducted through a foreign branch the domestic corporation would include the \$100,000 of taxable income in its U.S. tax base and would be allowed to claim a foreign tax credit of \$30,000 against its \$35,000 of U.S. tax liability with respect to such income. The corporation's overall tax liability on its foreign source income would be \$35,000 (\$30,000 paid to the foreign country + \$5,000 paid to the U.S. = \$35,000) and the corporation would be left with \$65,000 after taxes. If this operation were conducted through a foreign subsidiary, however, the foreign corporation would pay \$30,000 of taxes to the foreign country leaving \$70,000 to be distributed to the U.S. corporation. This \$70,000 would be included in the domestic corporation's U.S. tax base and would generate a U.S. tax liability of \$24,500 ($\$70,000 \times 35\% = \$24,500$) against which no foreign tax credit would be available. In this case the domestic corporation's overall tax liability with respect to its foreign source income is \$54,500 (\$30,000 paid to the foreign country + \$24,500 paid to the U.S. = \$54,500) and the corporation would be left with \$45,500 after taxes. While this is less of an overall tax burden than if the \$100,000 were taxable in full by both countries, there is a significant degree of international double taxation.

nation of the amount of taxable income generated in a foreign country¹⁵⁴ and the amount of foreign taxes paid with respect to that income. With this type of direct foreign operation, the foreign source taxable income is included in the corporation's U.S. tax base and, subject to limitations,¹⁵⁵ the foreign taxes paid are allowed as a credit reduction to the U.S. tax liability with respect to such income.¹⁵⁶ In addition, the U.S. taxation of a direct foreign operation does not depend upon the presence of distributions from a foreign entity since U.S. taxpayers are subject to taxation on their worldwide income.¹⁵⁷

In the case of a foreign subsidiary, the alleviation of international double taxation is more complex. As in the case of a foreign branch, it is necessary to determine the amount of taxable income generated in a foreign country¹⁵⁸ and the amount of foreign taxes paid with respect to such income. In addition, there must be a determination of the portion of the foreign taxable income that is subject to U.S. taxation.¹⁵⁹ It is at this point that the statutory mechanism of the indirect foreign tax credit breaks down. The statutory mechanism adopts a modified version of the U.S. model of corporate taxation to determine the portion of the foreign taxable income that is subject to U.S. taxation.¹⁶⁰ The use of the

154. Strictly speaking, the net amount of income that is includible in the U.S. tax base of the domestic corporation may not be the same as the net amount of income that is subject to taxation by the foreign country. The net amount of income subject to U.S. taxation is determined under U.S. law, but the net amount of income subject to foreign taxation is determined under foreign law. To the extent there are differences between U.S. and foreign law in the determination of gross income or allowable deductions, there will be differences in the amounts included in the U.S. and foreign tax bases. Such differences present theoretical difficulties for the foreign tax credit since the alleviation of international double taxation requires only that the foreign tax credit be allowable with respect to income that is subject to taxation by both countries. The alleviation of international double taxation, that is, only requires that the foreign tax credit be allowable with respect to an amount of income that is the lesser of (1) the amount of taxable income from within a country as determined under the laws of such country or (2) the amount that would be includible in the taxable income of the domestic corporation with respect to income derived from such foreign country. For clarification, the amount includible in the U.S. tax base with respect to income derived from a foreign country shall hereinafter be referred to as "foreign source taxable income," and the amount includible in the foreign tax base with respect to income derived from such country shall hereinafter be referred to as "foreign taxable income." If the difference between foreign source taxable income and foreign taxable income is significant, such difference is taken into account in the determination of whether the foreign taxes paid are creditable taxes. See *supra* text accompanying notes 51-62. If the difference between foreign source taxable income and foreign taxable income is not significant, it is simply disregarded.

155. See *supra* text accompanying notes 114-33.

156. I.R.C. §§ 61, 901, 904 (1994).

157. See *supra* text accompanying notes 3-5.

158. Unless it is a CFC, the taxable income of a foreign subsidiary is not currently includible in the U.S. tax base of the domestic corporation. This means, in the case of a foreign subsidiary, that the relevant amount is the taxable income of the subsidiary as determined under foreign law. The amount that would have been includible in the taxable income of the domestic corporation is irrelevant. It is foreign taxable income that generates foreign tax liability and the alleviation of international double taxation requires a determination of the amount of such foreign taxable income that is also subject to U.S. taxation.

159. Whether the portion of the foreign taxable income that is subject to U.S. taxation is determined by a pro rata allocation or on some other basis, the alleviation of international double taxation requires that the foreign tax credit be available only when and to the extent that the foreign taxable income becomes subject to U.S. taxation.

160. I.R.C. §§ 902(a), 902(c)(1) (1994). See *supra* text accompanying notes 93-113.

earnings and profits mechanism for international corporate distributions creates an inconsistency between the direct and indirect foreign tax credit provisions and results in situations in which the foreign tax credit may be lost.¹⁶¹ The use of the earnings and profits mechanism creates situations in which the indirect foreign tax credit simply fails to provide adequate relief from international double taxation.

The computation of the earnings and profits of a corporation is a complex procedure.¹⁶² This complexity is due in large part to the role that earnings and profits plays in the U.S. model of corporate taxation. Earnings and profits are the statutory mechanism that is used to distinguish between taxable and nontaxable corporate distributions.¹⁶³ To the extent that a corporation has earnings and profits a distribution is classified as a taxable dividend.¹⁶⁴ In the absence of earnings and profits, a corporate distribution is classified first as a nontaxable return of the shareholders' basis in their stock and then as a gain on a sale or exchange of the stock.¹⁶⁵

Under section 316, a distribution of property by a corporation to its shareholders is a dividend to the extent that it is "out of" either the current or accumulated earnings and profits of the corporation.¹⁶⁶ In addition, every

161. With a direct foreign operation, it is not the "earnings and profits" of the foreign branch that is subject to U.S. taxation, but the foreign source taxable income derived from such operation. There may be significant differences between the taxable income and the earnings and profits of a corporation which cause substantial discrepancies between the direct and indirect foreign tax credit provisions. See Treas. Reg. § 1.312-6 (1955); BITTKER & EUSTICE, *supra* note 10, ¶ 8.03. See *infra* text accompanying notes 171-89.

162. For a general discussion of the term "earnings and profits" and the role that it plays in corporate taxation, see BITTKER & EUSTICE, *supra* note 10, ¶ 8.03. While normally quite complete in the definition department, the Code does not provide any definition of the term "earnings and profits." The Treasury, however, has attempted to fill this gap. See Treas. Reg. § 1.312-6 (1955).

163. For suggestions that the earnings and profits mechanisms should be abandoned for purposes of distinguishing between taxable and nontaxable corporate distributions, see STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE SUBCHAPTER C REVISION ACT OF 1985, S. PRT. NO. 99-47 (1985); Lee A. Sheppard, *Eliminating Earnings and Profits*, 28 TAX NOTES 711 (1985); William M. Colby et al., *Elimination of Earnings and Profits From the Internal Revenue Code*, 39 TAX LAW. 285 (1986); Walter J. Blum, *The Earnings and Profits Limitation on Dividend Income: A Reappraisal*, 53 TAXES 68 (1975); William D. Andrews, "Out of Its Earnings and Profits": *Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403 (1956).

164. I.R.C. §§ 316(a), 301(a), 301(c)(1) (1994); Treas. Reg. §§ 1.316-1 (as amended in 1984), 1.301-1(a) (as amended in 1979).

165. I.R.C. §§ 301(c)(2), 301(c)(3) (1994); Treas. Reg. § 1.301-1(a) (as amended in 1979). In rare situations, a corporate distribution may be exempt from tax. After the shareholders have received a complete return of their basis in the corporation's stock and before a distribution is treated as a gain from the sale or exchange of such stock, a corporate distribution will be nontaxable to the extent that it results from an increase in value accrued before March 1, 1913. I.R.C. § 301(c)(3)(B) (1994).

166. I.R.C. § 316(a) (1994); Treas. Reg. § 1.316-1 (as amended in 1984). I.R.C. § 316(a) provides as follows:

§ 316. DIVIDEND DEFINED

(a) GENERAL RULE.—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made

distribution is deemed to be made out of the most recently accumulated earnings and profits to the extent the corporation has earnings and profits.¹⁶⁷ Although the taxability of a corporate distribution clearly depends upon the presence of earnings and profits, the Code does not provide any definition of the term.¹⁶⁸ The regulations, however, have attempted to fill this gap.¹⁶⁹

Under the regulations, the computation of earnings and profits is dependent upon the method of accounting used in calculating taxable income.¹⁷⁰ There are, however, numerous modifications and adjustments that must be made in the computation of earnings and profits.¹⁷¹ Various items that are excluded from gross income, and thus not included in the computation of taxable income must be included in the computation of earnings and profits.¹⁷² Moreover, various items that are deductible in the computation of taxable income may not be deducted in the computation of earnings and profits.¹⁷³ A number of items that are not deductible in the computation of taxable income must be subtracted in the

during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

167. I.R.C. § 316(a) (1994); Treas. Reg. § 1.316-2 (1955). In the absence of these presumptions, a distribution could possibly be designated as arising from a particular source in order to affect the tax consequences of the distribution.

168. Although I.R.C. § 312 contains a number of provisions concerning the effect of various corporate transactions on earnings and profits, it does not actually define the starting point for making such adjustments. See, e.g., I.R.C. §§ 312(a), (b), (c), (f), (k), (n) (1994).

169. Treas. Reg. § 1.312-6 (1955).

170. Treas. Reg. § 1.312-6(a) (1955) provides, by way of example, that "a corporation keeping its books and filing its income tax returns . . . on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits." The missing definition of earnings and profits implied by this regulation is that earnings and profits mean the taxable income of the corporation computed with the modifications and adjustments required by the Code and the regulations. See, e.g., I.R.S. Form 5452 "Worksheet for Computing Current-Year Earnings and Profits" (beginning the computation with the corporation's taxable income).

171. See, e.g., I.R.C. §§ 312(a), (b), (c), (f), (k), (n) (1994); Treas. Reg. §§ 1.312-6 (1955), 1.312-7(b) (as amended in 1972); BITTKER & EUSTICE, *supra* note 10, ¶ 8.03.

172. Treas. Reg. § 1.312-6(b) (1955) provides that "among the items entering into the computation of corporate earnings and profits . . . are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income." Items that would fall under this category of adjustments include the proceeds of life insurance excluded from gross income under I.R.C. § 101(a) (1994) and interest on state and local bonds excluded from gross income under I.R.C. § 103 (1994). Income from the discharge of indebtedness, which is excluded from gross income under I.R.C. § 108 (1994), is included in earnings and profits except to the extent it is used to reduce the basis of property under I.R.C. § 1017 (1994). I.R.C. § 312(l) (1994). See BITTKER & EUSTICE, *supra* note 10, ¶ 8.03[3], which provides an extensive list of additional items that potentially fits into this category of adjustments.

173. Treas. Reg. § 1.312-6(d) (1955). Items that would fall under this category of adjustments include the net operating loss deduction under I.R.C. § 172 (1994), the deduction for capital loss carryovers under I.R.C. § 1212 (1994) and the dividends received deduction under I.R.C. § 243 (1994). For additional examples of items that fit into this category of adjustments, see BITTKER & EUSTICE, *supra* note 10, ¶ 8.03[4].

computation of earnings and profits.¹⁷⁴ And finally, certain items must be included or deducted in the computation of earnings and profits at different rates than when they are used in the computation of taxable income.¹⁷⁵

The computation of earnings and profits is even more complex in the case of a foreign corporation. In general, the earnings and profits of a foreign corporation must be computed under the provisions of section 964,¹⁷⁶ which requires that the functional currency of the foreign corporation be used.¹⁷⁷ In addition to the numerous modifications and adjustments that must be made in the case of a domestic corporation,¹⁷⁸ the earnings and profits of a foreign corporation must

174. Treas. Reg. § 1.312-7(b) (as amended in 1972). Items that fall under this category of adjustments include dividend distributions in prior years, federal income taxes paid, interest and expenses allocable to tax exempt income, charitable contributions in excess of the percentage limitation of I.R.C. § 170(b)(2) (1994), capital losses in excess of capital gains and losses disallowed by I.R.C. § 267 (1994). For additional examples of items that fit into this category of adjustments, see BITTKER & EUSTICE, *supra* note 10, ¶ 8.03[6].

175. I.R.C. §§ 312(k), (n) (1994); Treas. Reg. §§ 1.312-7(c) (as amended in 1972), 1.312-15 (1972). For example, for earnings and profits purposes, tangible property must be depreciated under the alternative depreciation system of I.R.C. § 168(g)(2) (1994) and property that was expensed under I.R.C. § 179 (1994) must be amortized over a period of five years. I.R.C. § 312(k)(3) (1994). On the income side, I.R.C. § 312(n)(5) (1994) provides that “[i]n the case of any installment sale, earnings and profits shall be computed as if the corporation did not use the installment method.” For additional examples of items that fit into this category of adjustments, see BITTKER & EUSTICE, *supra* note 10, ¶ 8.03[5].

176. I.R.C. § 964(a) (1994). Prior to 1986, the § 964 method of computing earnings and profits was only required for purposes of determining the taxability of and the indirect foreign tax credit attributable to the subpart F income and investments in U.S. property of a CFC. In 1986, however, Congress made the § 964 method generally applicable to all foreign corporations. 1986 Tax Act, *supra* note 24, § 1202(a) (amending I.R.C. § 902(c)(1) to make the § 964 method of computing earnings and profits applicable to the computation of the indirect foreign tax credit for tax years beginning after December 31, 1986). The regulations under § 964(a) provide that “the earnings and profits (or deficit in earnings and profits) of a foreign corporation for its taxable year shall . . . be computed substantially as if such corporation were a domestic corporation” Treas. Reg. § 1.964-1(a) (as amended in 1983). The methodology for computing the earnings and profits of a foreign corporation, however, is quite different from the methodology for computing the earnings and profits of a domestic corporation. Rather than making modifications and adjustments to the taxable income of the corporation, the earnings and profits of a foreign corporation are computed by preparing a profit and loss statement from the books and records of the corporation and then adjusting such statement to comply with accounting principles and tax accounting standards generally accepted in the United States. Treas. Reg. § 1.964-1 (as amended in 1983). The amounts on the adjusted profits and loss statement must then be translated into U.S. dollars and adjusted to reflect any foreign currency exchange gains or losses when the earnings and profits of the foreign corporation are distributed, deemed distributed or otherwise taken into account for U.S. tax purposes. I.R.C. § 986(b) (1994); Temp. Treas. Reg. § 1.964-1T(g)(1) (1990).

177. I.R.C. § 986(b)(1) (1994). In general, the functional currency of a foreign corporation is “the currency of the economic environment in which a significant part of such [corporation’s] activities are conducted and which is used by such [corporation] in keeping its books and records.” I.R.C. § 985(b)(1)(B) (1994). If the functional currency of a foreign corporation is hyperinflationary, it may elect to use the U.S. dollar as its functional currency. Treas. Reg. § 1.985-2(a) (1989). A foreign currency is considered to be hyperinflationary if there is cumulative inflation of at least 100% during the thirty-six months immediately preceding the current taxable year. Treas. Reg. § 1.985-2(b)(2) (1989).

178. Some of the modifications and adjustments that must be made in the computation of earnings and profits of a domestic corporation are inapplicable to the computation of the earnings and profits of certain foreign corporations. See, e.g. I.R.C. §§ 312(k)(4), 312(n)(8) (1994) (eliminating the adjustments for accelerated depreciation, installment sales, the completed contract method of

be translated into U.S. dollars and adjusted for foreign currency exchange gains and losses.

Besides the difficulty involved in the computation of earnings and profits, the earnings and profits mechanism itself is an inept yardstick by which to measure the amount of foreign taxable income that has been repatriated in a distribution from a foreign corporation.¹⁷⁹ This is due to the dual nature of earnings and profits¹⁸⁰ and the interaction of current and accumulated deficits in a corporation's earnings and profits account.

In the case of a domestic corporation, if distributions during a taxable year exceed the corporation's current earnings and profits, the current earnings and profits are allocated on a pro-rata basis amongst all distributions.¹⁸¹ The remainder of the distributions are classified as dividends to the extent the corporation has accumulated earnings and profits that are "available" at the time of the distribution.¹⁸² If the corporation has a deficit in accumulated earnings and profits, the remainder of the distributions will not be classified as dividends, and the accumulated deficit will not be allowed as an offset to current earnings and profits.¹⁸³ On the other hand, if the corporation has a current deficit in earnings and profits, the current deficit will reduce the amount of accumulated earnings and profits that are available for distribution.¹⁸⁴ To the extent that a current deficit has accrued, it is allowed to reduce accumulated earnings and profits for purposes of determining the taxability of the distribution.¹⁸⁵

accounting and the LIFO recapture amount unless the foreign corporation derives 20% or more of its gross income from sources within the United States).

179. What is required to implement the policy of alleviating international double taxation is a determination of the amount of taxable income that has been subjected to foreign taxation since it is the amount of foreign taxes imposed on such income that must be allowed as a credit when the income is later subjected to U.S. taxation. The earnings and profits concept is a poor measuring device for this purpose because it does not purport to identify amounts that have been subjected to foreign taxation. See, e.g. Rev. Rul. 87-72, 1987-2 C.B. 170 (identifying situations in which a foreign corporation has foreign taxable income and has paid foreign taxes and yet has a deficit in earnings and profits as determined under U.S. tax rules). To have the indirect foreign tax credit tied to the receipt of a dividend which is measured by earnings and profits is like trying to translate liters into feet instead of into quarts. See *supra* text accompanying notes 171-76.

180. A distribution from a corporation is classified as a dividend if it is out of *either* current or accumulated earnings and profits without regard to the overall financial success of the company. I.R.C. § 316(a) (1994). Thus, a distribution will be taxable as a dividend if a corporation has current earnings and profits even though it has an overall historical deficit. Similarly, a distribution from a corporation with accumulated earnings and profits will be taxable as a dividend even if the corporation is currently operating at a loss, although a portion of the current deficit may be allowed to offset the accumulated earnings and profits that are available at the time of the distribution. Treas. Reg. § 1.316-2 (1955). See *infra* text accompanying notes 182-86.

181. Treas. Reg. § 1.316-2(b) (1955). See also Rev. Rul. 74-164, 1974-1 C.B. 74.

182. Treas. Reg. § 1.316-2(b) (1955).

183. If a corporation with an accumulated deficit in earnings and profits has current earnings and profits but does not make any distributions, the current earnings will be absorbed into and reduce the accumulated deficit. Rev. Rul. 74-164, 1974-1 C.B. 74.

184. Treas. Reg. § 1.316-2(b) (1955); Rev. Rul. 74-164, 1974-1 C.B. 74.

185. Treas. Reg. § 1.316-2(b) (1955); Rev. Rul. 74-164, 1974-1 C.B. 74. The regulations indicate that unless the corporation can pinpoint the time at which the current deficit arose, the deficit will be amortized ratably throughout the taxable year. Treas. Reg. § 1.316-2(b) (1955).

The carryback and carryover of deficits is, of course, more complex in the case of a foreign corporation. For tax years before 1987, a current deficit in earnings and profits is carried back and reduces the accumulated profits of the corporation in reverse chronological order.¹⁸⁶ The current deficit offsets the most recently accumulated earnings and profits. Under this procedure, a current deficit, by offsetting the accumulated profits from preceding taxable years, has the effect of locking an uncredited foreign tax into the prior years.¹⁸⁷ Since an uncredited foreign tax from a preceding taxable year can only be carried out of the corporation by a distribution of the accumulated profits from such year, a reduction in the corporation's accumulated profits from such prior year prevents a portion of the uncredited foreign tax from ever being distributed.¹⁸⁸ Such uncredited foreign tax is permanently lost.

These lost foreign tax credits were one of the principal reasons that Congress adopted the pool of earnings mechanism for distributions from foreign corporations.¹⁸⁹ Although this change reduced the amount of lost foreign tax credits, the problem was not resolved. Under the pool of earnings mechanism an operating loss decreases the pool of undistributed earnings but does not decrease the pool of uncredited foreign taxes.¹⁹⁰ The effect of such a loss is spread throughout the pool, but still results in a distortion of the amount of foreign tax credit that is available with respect to any particular distribution.¹⁹¹

186. Rev. Rul. 74-550, 1974-2 C.B. 209. A current deficit in earnings and profits also prevents any foreign income taxes paid during that year from ever being creditable. Because of the numerous differences between taxable income and earnings and profits, it is possible for a corporation to have foreign taxable income and pay foreign income taxes and yet have a current deficit in earnings and profits as determined under U.S. law. See, e.g., Rev. Rul. 87-72, 1987-2 C.B. 170. Since the foreign taxes paid during any year could only be carried out of the corporation by a distribution of the accumulated profits for such year, a current deficit in earnings and profits means that any foreign taxes paid during that year would never be creditable.

187. Rev. Rul. 74-550, 1974-2 C.B. 209.

188. *Id.* A lock-in of a portion of the uncredited foreign taxes occurred because the I.R.S. held that, although a deficit reduced the earnings and profits of the corporation for the preceding taxable year and thus reduced the "dividend received" numerator of the foreign tax credit formula, the deficit did not reduce the "accumulated profits" denominator of the formula. *Id.* See *supra* text accompanying notes 93-103. This result was modified, however, by Rev. Rul. 87-72, 1987-2 C.B. 170, based on the Tax Court's decision in *Champion International Corp. v. Commissioner*, 81 T.C. 424 (1983), acq., 1984-2 C.B. 1. In *Champion International* the Tax Court held that the carryback of a deficit from a net operating loss reduces both the earnings and profits numerator and the accumulated profits denominator of the foreign tax credit formula. Even with this modification, however, a lock-in of uncredited foreign taxes is still possible if a deficit completely eliminated the corporation's accumulated profits from a preceding taxable year. Rev. Rul. 87-72, 1987-2 C.B. 170. The carryback of losses creates other distortions with respect to the indirect foreign tax credit, however, that are still applicable to distributions from a foreign corporation's pre-1987 accumulated profits. See *infra* note 192 and accompanying text.

189. 1986 BLUEBOOK, *supra* note 17, at 869.

190. I.R.C. §§ 902(c)(1), 902(c)(2) (1994).

191. Following a decrease in the pool of undistributed earnings, a distribution will carry out a proportionately greater share of the pool of uncredited foreign taxes. See BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.3. The net result is that a distribution may generate a foreign tax credit that is far greater than the amount of foreign taxes that were imposed on the earnings being distributed. A similar distortion is created under the layers of earnings method when a deficit does not completely eliminate the accumulated profits of the corporation for a prior taxable year. In addition, even under

For tax years after 1986, a current deficit in earnings and profits reduces the corporation's pool of post-1986 undistributed earnings.¹⁹² If the deficit exceeds the corporation's pool of post-1986 undistributed earnings, the excess is carried back to years before 1987, thereby reducing the corporation's accumulated profits for such years in reverse chronological order.¹⁹³ If the accumulated profits of the corporation for years before 1987 are sufficient to absorb the post-1986 deficit, the deficit is eliminated from the pool of post-1986 undistributed earnings.¹⁹⁴ On the other hand, if the corporation's pre-1987 accumulated profits can not fully absorb the excess post-1986 deficit, the unabsorbed amount remains as a deficit in the corporation's pool of post-1986 undistributed earnings.¹⁹⁵

Under these provisions it is possible for a corporation to receive a distribution from a foreign subsidiary that is taxable as a dividend and yet receive no tax credit for the foreign taxes paid on the earnings before distribution.¹⁹⁶ In such a situation, the indirect foreign tax credit, as tied to the earnings and profits mechanism, clearly does not provide adequate relief from international double taxation.

As a result of these complexities, the use of the earnings and profits mechanism, as adapted from the U.S. model of corporate taxation, is not an effective device to determine the taxability of international corporate distributions. The

the pool of earnings mechanism it is possible for an operating loss to cause a "lock-in" of uncredited foreign taxes. If an operating loss creates a deficit in the pool of post-1986 undistributed earnings, the pool of post-1986 uncredited foreign taxes will remain uncreditable until the pool of post-1986 undistributed earnings shows a positive balance. 1986 BLUEBOOK, *supra* note 17, at 907. Even if the foreign corporation makes a distribution in a succeeding taxable year that is taxable as a dividend because of the presence of current earnings and profits, no indirect foreign tax credit will be available for such dividend due to the overall deficit in the pool of post-1986 undistributed earnings. *Id.* The only difference is that the lock-in is not permanent under the pool of earnings mechanism as it was under the layers of earnings mechanism. The lock-in will result in an indefinite deferral of the uncredited foreign taxes, however, until the corporation achieves an overall surplus in its pool of post-1986 undistributed earnings. Suppose, for example, that the corporation continues to generate current earnings and profits in succeeding taxable years on which it pays foreign taxes and that it makes distributions each year equal to its current earnings. In such a case, the distributions each year will be taxable as dividends due to the presence of current earnings and profits, but no indirect foreign tax credit will be available for such dividends even though the pool of uncredited foreign taxes continues to increase. This will occur because, even though the pool of undistributed earnings is not decreased by dividends distributed during the current year, accumulated earnings and profits and thus the pool of undistributed earnings is decreased for dividends distributed in prior taxable years. I.R.C. §§ 902(c)(1), 312(a) (1994); BITTKER & EUSTICE, *supra* note 10, ¶ 8.03[6]. Thus, the corporation's pool of uncredited foreign taxes will continue to grow and will remain locked in until the corporation generates current earnings and profits greater than the accumulated deficit in its pool of undistributed earnings.

192. I.R.C. § 902(c)(1) (1994). See BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.3.

193. Notice 87-54, 1987-2 C.B. 363. A post-1986 deficit is carried back to a pre-1987 tax year only if the foreign corporation makes a distribution or a U.S. shareholder is taxed under the provisions of subpart F for the tax year of the deficit. Otherwise the post-1986 deficit is retained in the corporation's pool of post-1986 undistributed earnings. *Id.* See BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.3. For the effects of such a carryback, see *supra* text accompanying notes 187-89.

194. Notice 87-54, 1987-2 C.B. 363.

195. *Id.* See BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.3.

196. 1986 BLUEBOOK, *supra* note 17, at 907. See *supra* note 192 and accompanying text.

use of the earnings and profits mechanism as the trigger for the indirect foreign tax credit results in situations in which the credit is permanently lost or indefinitely deferred.¹⁹⁷

B. Similar Treatment of Foreign Branches and Subsidiaries

The second major concern that Congress expressed with respect to the indirect foreign tax credit is that domestic corporations which operate through foreign subsidiaries should be treated in substantially the same manner as corporations that operate through foreign branches.¹⁹⁸ Similarity of treatment, however, has both quantitative and qualitative aspects. Quantitative similarity means that the overall amount of tax that a domestic corporation pays with respect to its offshore operations should be the same whether those operations are conducted through a branch or a foreign subsidiary. Qualitative similarity, on the other hand, means that the manner in which a domestic corporation is taxed, particularly with respect to the timing of the recognition of income, should be the same regardless of whether it chooses to conduct its offshore operations through a branch or through a foreign subsidiary.¹⁹⁹

The presence of some form of indirect foreign tax credit as a counterpart to the direct foreign tax credit is sufficient to ensure a substantial degree of quantitative similarity in the tax treatment of foreign branches and foreign subsidiaries.²⁰⁰ Moreover, there are a number of methods for implementing the indirect foreign tax credit that significantly affect the qualitative similarity between foreign branches and foreign subsidiaries. The method that was in force prior to 1986, and which is still applicable to distributions of pre-1987 accumulated profits, is the "layers of earnings" method. This is based on the corporate model of an annual determination of earnings and profits.²⁰¹ For distributions of post-1986 earnings the "pool of earnings" method is applicable. This is based on a

197. See *supra* text accompanying notes 187-92.

198. H.R. REP. NO. 1447, 87th Cong., 2nd Sess. 405, 455 (1963); S. REP. NO. 1881, 87th Cong., 2nd Sess. 703, 722 (1963); 1986 BLUEBOOK, *supra* note 17, at 861, 869.

199. The indirect foreign tax credit in its current manifestation is concerned solely with quantitative similarity between foreign branches and foreign subsidiaries and does not consider the time value of money and the economic benefit of tax deferral that is available through the use of foreign subsidiaries. Corrective legislation should address the qualitative or timing aspects of the indirect foreign tax credit as well as its quantitative measures.

200. Corporations that operate through foreign branches have the election of claiming a credit or taking a deduction for the amount of foreign taxes paid on their foreign source income. Without the indirect foreign tax credit, corporations that operate through foreign subsidiaries would be limited to the equivalent of a U.S. tax deduction for foreign taxes paid since such taxes reduce the amount of foreign income available for distribution to the U.S. corporation. The presence of the indirect tax credit means that domestic corporations with foreign subsidiaries also have the election of claiming a tax credit for foreign taxes paid or simply reporting the net amount of foreign income distributed, the equivalent of a tax deduction for the amount of foreign taxes paid.

201. I.R.C. § 902(c)(6) (1994) (applying the provisions of § 902(a) as in effect before amendment by the 1986 Tax Act to distributions of a foreign corporation's pre-1987 accumulated profits). See *supra* text accompanying notes 93-104.

modified form of the accumulated earnings and profits mechanism.²⁰² An alternative method, not considered by Congress but endorsed in this paper, is the "throwback" method, which is similar to the taxation of accumulation distributions applicable to trusts.²⁰³

1. *The Layers of Earnings Model*

Under the layers of earnings method, a distribution from a foreign subsidiary is treated as carrying out the accumulated profits of the subsidiary in reverse chronological order.²⁰⁴ The accumulated profits of the foreign subsidiary are computed on an annual basis and a corresponding identification is made of the foreign taxes that were paid on the income to which these profits are attributable.²⁰⁵ If a distribution exceeds the accumulated profits of the subsidiary for a particular year, the excess is considered to arise out of the accumulated profits from the next preceding taxable year and so on until the distribution or the accumulated profits is exhausted.²⁰⁶ In this manner, a distribution is "sourced" to the accumulated profits of the subsidiary for a particular tax year, and the amount of foreign tax credit that may be claimed with respect to the distribution is the amount of foreign taxes that were paid by the subsidiary during that year.²⁰⁷ Thus, under the layers of earnings model, the subsidiary's accumulated profits are deemed to be distributed on a last-in first-out basis and attract a corresponding amount of foreign taxes for purposes of the indirect foreign tax credit. This model for identifying the proper amount of foreign taxes attributable to a particular distribution has a number of failings which Congress identified at the time of its repeal in 1986.²⁰⁸

Under the layers of earnings model, the key component of the indirect foreign tax credit formula is the concept of "accumulated profits."²⁰⁹ Accumulated

202. I.R.C. § 902(c)(1) (1994) (effective for tax years beginning after 1986). See *supra* text accompanying notes 105-13.

203. See *infra* text accompanying notes 255-81.

204. I.R.C. § 316(a) (1994); Treas. Reg. § 1.316-2(a) (1955). See also Rev. Rul. 74-550, 1974-2 C.B. 209; *H. H. Robertson Co. v. Commissioner*, 59 T.C. 53 (1972). See *supra* text accompanying notes 93-104.

205. Treas. Reg. § 1.902-1(e) (as amended in 1979).

206. Rev. Rul. 74-550, 1974-2 C.B. 209; *H. H. Robertson*, 59 T.C. at 53.

207. If a distribution exceeds the accumulated profits of the subsidiary for a particular year, the excess is carried back to the next preceding taxable year in which there are accumulated profits. Rev. Rul. 74-550, 1974-2 C.B. 209; *H. H. Robertson*, 59 T.C. at 53. If less than the full amount of the accumulated profits for a particular year are distributed, then the tax credit that may be claimed is a proportional amount of the foreign taxes paid during that tax year. Treas. Reg. § 1.902-1(b)(2) (as amended in 1979). See *supra* text accompanying notes 93-100.

208. 1986 BLUEBOOK, *supra* note 17, at 869. The layers of earnings model had failings with respect to both of the major policy concerns regarding the foreign tax credit. Since the layers of earnings approach resulted in situations in which the foreign tax credit was lost, it did not fulfill the primary objective of alleviating international double taxation. In addition, the layers of earnings model created a major dissimilarity between foreign branches and foreign subsidiaries since, as Congress observed, "in a branch situation in which foreign income is taxed currently, this loss of foreign tax credits generally would not occur." *Id.*

209. The other components of the indirect foreign tax credit formula are "dividends received" and "foreign taxes paid." The regulations provide that the term "dividend" for purposes of the

profits, in general, means the net income of a foreign corporation.²¹⁰ The statutory definition, however, specified neither the manner in which accumulated profits were to be determined nor whether accumulated profits were an annual or an aggregate concept.²¹¹ To fill this definitional gap, the Treasury invoked the earnings and profits mechanism from the U.S. model of corporate taxation. This enabled corporations to calculate the accumulated profits of a foreign corpora-

numerator of the indirect foreign tax credit formula means amounts that are taxable as dividends under I.R.C. § 316. Treas. Reg. § 1.902-1(a)(6) (as amended in 1979). The "foreign taxes paid" component of the formula is simply the amount of qualifying taxes, as determined under foreign law, that the subsidiary paid to the foreign government. Treas. Reg. § 1.902-1(a)(5) (as amended in 1979). It is the "accumulated profits" component of the formula that is assigned the task of coordinating the other two. See BITTKER & EUSTICE, *supra* note 10, ¶ 15.21[2][c].

210. I.R.C. § 902(c)(1) (before amendment by the Revenue Act of 1962, *supra* note 67). Before amendment in 1962, I.R.C. § 902(c)(1) provided as follows:

(c) APPLICABLE RULES.—

(1) The term "accumulated profits," when used in this section in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income; . . .

For tax years after 1962, this definition continued to be applicable to the accumulated profits of a foreign corporation that was a less developed country corporation. With respect to other foreign corporations, however, the definition of accumulated profits was modified to mean the income of the corporation "without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income . . ." I.R.C. § 902(c)(1) (as amended by the Revenue Act of 1962, *supra* note 67). This change did not cause significant differences in the computation of the indirect foreign tax credit, however, since Congress also changed the denominator of the indirect tax credit formula to reduce accumulated profits by the amount of foreign taxes imposed on the accumulated profits from which dividends were paid. I.R.C. § 902(a) (as amended by the Revenue Act of 1962, *supra* note 67). See *supra* text accompanying notes 93-100. This latter definition of accumulated profits became applicable to all foreign corporations with the repeal of the less developed country corporation provisions in the Tax Reform Act of 1976, *supra* note 67, until the accumulated profits concept was replaced with the pool of earnings concept in the 1986 Tax Act, *supra* note 24.

211. The statutory definition implied that accumulated profits was intended to be the net income of the foreign corporation as determined under foreign law since that was the source from which distributions could be made and thus provided the base over which the foreign taxes should be allocated for purposes of the foreign tax credit. The taxability of a distribution as a dividend to the domestic corporation was a completely separate issue from the determination of the source "from which such dividends were paid." I.R.C. § 902(a) (as amended by the Tax Reform Act of 1976, *supra* note 67).

tion.²¹² However, the Tax Court has concluded that accumulated profits and earnings and profits are not the same.²¹³

Even when accumulated profits were properly treated as an annual concept, the use of the earnings and profits mechanism in the computation of accumulated profits²¹⁴ created situations in which the indirect foreign tax credit could be lost because of carrybacks and carryovers of deficits in a foreign corporation's earnings and profits account.²¹⁵ This possible loss of the foreign tax credit created a major dissimilarity between foreign branches and subsidiaries and was a principal factor behind Congress' adoption of the pool of earnings method in the 1986 Tax Act.²¹⁶

2. The Pool of Earnings Model

The pool of earnings model is based on a modified version of the accumulated earnings and profits mechanism borrowed from the U.S. model of corpo-

212. Treas. Reg. § 1.902-3(c)(1) (as amended in 1971). See also Rev. Rul. 63-6, 1963-1 C.B. 126, which discusses the meaning of the term "accumulated profits" as used in section 902. In a marvelous example of flawed logic, Rev. Rul. 63-6 states the following:

Section 902(a) of the Code refers to "accumulated profits" as being the source from which the "dividends" received by the domestic corporation are paid. "Dividends" are elsewhere in the Code (section 316) defined as distributions of "earnings and profits," and the definition is stated to be "for purposes of this [the income tax] subtitle."

Since both "accumulated profits" and "earnings and profits" denote the same source from which "dividends" are paid, the criteria applicable to the determination of "earnings and profits" are equally applicable to the determination of "accumulated profits."

Rev. Rul. 63-6, 1963-1 C.B. at 127-128. This is the logical equivalent of saying that since California and New York are both in the United States, being from California is the same as being from New York.

213. *H.H. Robertson Co. v. Commissioner*, 59 T.C. 53 (1972). The Court provided a detailed discussion of the relationship between accumulated profits and earnings and profits and noted that

accumulated profits [are] sharply to be distinguished from the familiar 'earnings and profits,' which embodies primarily the concept of an *aggregate* of a corporation's undistributed profits realized, usually from February 28, 1913, to the time in question, and out of which taxable dividends are payable without regard generally to the year or years when such profits were earned or realized. . . . The term 'accumulated profits' in respect of the foreign tax credit, on the other hand, is solely an *annual* concept. . . . It is of critical importance to determine the 'accumulated profits' of each year, so that they can be matched against the foreign taxes paid for *that* year, and so that when dividends are paid 'out of' or 'from' such 'accumulated profits,' a foreign tax credit may properly be computed as a portion (in accordance with the statutory formula) of the foreign taxes paid in respect of the 'accumulated profits' of that year.

Id. at 78-79.

214. Even while distinguishing between "accumulated profits" and "earnings and profits," the Tax Court noted that "like criteria" are employed in determining both earnings and profits and accumulated profits. *Id.* at 78. See also *Goodyear Tire & Rubber Co. v. United States*, 493 U.S. 132 (1989), *reh'g denied* 493 U.S. 1095 (1990) (holding that "accumulated profits," in general, means the same thing as "earnings and profits" and is to be determined in accordance with U.S. tax principles).

215. Rev. Rul. 74-550, 1974-2 C.B. 209. See *supra* text accompanying notes 187-89.

216. 1986 BLUEBOOK, *supra* note 17, at 869.

rate taxation.²¹⁷ Under the pool of earnings method, a foreign corporation must maintain a pool of its post-1986 undistributed earnings and a corresponding pool of the uncredited foreign taxes that it has paid during that period.²¹⁸ A distribution from the corporation is treated as made first from this pool of undistributed earnings and the foreign taxes attributable to this distribution consist of a proportionate share of the pool of uncredited foreign taxes.²¹⁹ Distributions that exceed the corporation's pool of post-1986 undistributed earnings are treated as paid out of its pre-1987 accumulated profits under the layers of income method.²²⁰

There are two principal failings of the pool of earnings mechanism. Its first failing, as with the layers of earnings approach, is that it is unnecessarily tied to the earnings and profits mechanism of the U.S. model of corporate taxation.²²¹ Tying the indirect foreign tax credit to the earnings and profits mechanism injects a substantial layer of complexity²²² and creates distortions in the amount and timing of the foreign tax credit.²²³

The second failing of the pool of earnings method is that it does not address the tax deferral available through the use of a foreign subsidiary,²²⁴ which is the principal difference between foreign branches and foreign subsidiaries. The

217. A foreign corporation's pool of post-1986 undistributed earnings is similar to the concept of accumulated earnings and profits applicable to a domestic corporation in that the pool of undistributed earnings consists of the aggregate earnings and profits of the corporation accumulated since 1986. I.R.C. § 902(c)(1) (1994). Undistributed earnings, therefore, like accumulated earnings and profits, is an aggregate concept as opposed to accumulated profits, which is an annual concept. See *supra* text accompanying notes 105-08. The computation of a corporation's pool of post-1986 undistributed earnings, however, is reminiscent of the computation of current earnings and profits. Cf. I.R.C. § 902(c)(1) (1994) with I.R.C. § 316(a)(2) (1994).

218. I.R.C. §§ 902(c)(1), 902(c)(2) (1994); 1986 BLUEBOOK, *supra* note 17, at 906; BITTKER & LOKKEN, *supra* note 3, ¶ 69.8.3(2). See *supra* text accompanying notes 105-13. In addition, if the foreign corporation is a CFC, it must maintain separate pools of undistributed earnings and corresponding pools of uncredited foreign taxes for each basket of income subject to the categories of income limitation on the foreign tax credit. Notice 88-70, 1988-2 C.B. 369. See KUNTZ & PERONI, *supra* note 3, ¶ B4.10[3].

219. I.R.C. §§ 902(a), 902(c)(6)(B) (1994); 1986 BLUEBOOK, *supra* note 17, at 906.

220. I.R.C. § 902(c)(6)(A) (1994) (applying the provisions of § 902(a) as in effect before amendment by the 1986 Tax Act to distributions of a foreign corporation's pre-1987 accumulated profits).

221. Effective implementation of the policy of alleviating international double taxation requires an identification of the amount of foreign taxes that have been paid with respect to identifiable amounts of foreign taxable income. The foreign tax credit, both direct and indirect, is a credit for the foreign taxes that have been paid with respect to foreign source *income*, not with respect to foreign source earnings and profits.

222. The computation of earnings and profits is a complex procedure which is complicated further in the case of a foreign corporation by the fact that the corporation's earnings and profits is required to be determined under U.S. law while both foreign taxable income and foreign taxes paid are determined under foreign law. See *supra* text accompanying notes 171-79.

223. See *supra* text accompanying notes 187-92.

224. Because of the worldwide reach of the U.S. tax system, the offshore earnings of a foreign branch are currently taxable to a domestic corporation. The earnings of a foreign subsidiary, however, are only taxable to a domestic corporation when the earnings are repatriated in the form of a dividend. Tax deferral is not available, however, to the extent the U.S. corporation is taxable under the provisions of subpart F on the income of a CFC. 1986 BLUEBOOK, *supra* note 17, at 962-63.

pool of earnings mechanism for determining the proper amount of foreign taxes attributable to distributions from foreign subsidiaries is only concerned with the quantitative similarity of tax treatment between foreign branches and foreign subsidiaries.²²⁵ Even with substantial equality in the quantitative tax consequences, however, tax deferral benefits are still available to corporations conducting their offshore operations through a foreign subsidiary.²²⁶

3. *The Throwback Model*

The throwback model of taxing distributions of accumulated income is a statutory mechanism that is designed, among other things, to eliminate the benefits of tax deferral.²²⁷ Under the throwback method, income is taxable to a distributee at the time a distribution is received, but it is taxed in a manner that is designed to approximate the tax consequences that would have applied to the distributee if the income had been distributed immediately by the foreign subsidiary rather than accumulated.²²⁸

Under the international throwback model proposed by this paper, a distribution from a foreign subsidiary is treated as a distribution of the subsidiary's undistributed net income from preceding taxable years in the chronological order in which such income was accumulated.²²⁹ When a distribution is received by the domestic corporation, it is "thrown back" to the taxable years of the corporation which relate to the taxable years in which the foreign subsidiary earned such income.²³⁰ Under this method, the U.S. corporation is taxed in a manner that approximates how it would have been taxed if the net income of the subsidiary had been distributed as it was earned.

225. Provided that some reasonably acceptable method is adopted to identify the amount of foreign income taxes that have been paid with respect to a distribution, there will be substantial *quantitative* similarity between foreign branches and foreign subsidiaries. Even with quantitative equality, however, there is still the major distinction between foreign branches and foreign subsidiaries of the timing of the recognition of foreign source income.

226. Recent proposed legislation would repeal the current deferral regime with respect to controlled foreign corporations. H.R. 5270, Foreign Income Tax Rationalization and Simplification Act of 1992.

227. JOINT COMMITTEE ON TAXATION, 94TH CONGRESS, 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 159 (Comm. Print 1976) [hereinafter 1976 GENERAL EXPLANATION].

228. *Id.*

229. The throwback approach to distributions from foreign subsidiaries would thus operate on a first-in first-out (FIFO) basis rather than the last-in first-out (LIFO) approach of the layers of earnings method. The LIFO approach of the layers of earnings method arose because of the Congressional attachment to the U.S. model of corporate taxation and the reverse chronological utilization of earnings and profits inherent in that model.

230. If a foreign corporation has undistributed net income from taxable years before the U.S. corporation met the stock ownership requirements of § 902, a distribution is still treated as carrying out the undistributed net income of the subsidiary in chronological order, but the distribution is simply included in income of the domestic corporation for the year received. See *infra* text accompanying notes 264-68.

a. *The Subchapter J Throwback Rules*

Subchapter J of the Code contains a set of provisions to govern the tax treatment of distributions from trusts that have accumulated income in preceding taxable years.²³¹ One of the purposes of the throwback rules is to eliminate the benefit of tax deferral by taxing the recipient of an accumulation distribution in substantially the same manner the person would have been taxed if the income had been distributed as it was received by the trust.²³²

The throwback rules are triggered when a trust makes an accumulation distribution.²³³ The amount of the accumulation distribution is deemed to consist of the undistributed net income²³⁴ of the trust and is "thrown back" to the earliest taxable years²³⁵ of the trust in which the trust had any undistributed net income.²³⁶ In addition to the undistributed net income of the trust, an accumulation distribution in the hands of the beneficiary is "grossed up" by the amount of taxes imposed on the trust with respect to the income being distributed.²³⁷ To

231. I.R.C. §§ 665-668 (1994). These provisions constitute subpart D of part I of subchapter J of the Code.

232. 1976 GENERAL EXPLANATION, *supra* note 229, at 159. The throwback rules are also aimed at preserving the integrity of the progressive tax rate structure by preventing the splitting of income between a trust and its beneficiaries. *Id.*

233. I.R.C. § 666(a) (1994); Treas. Reg. § 1.666(a)-1A(a) (1972). An accumulation distribution, in general, is the amount by which trust distributions during a taxable year exceed the distributable net income of the trust reduced by the amount of income the trust is required to distribute currently. I.R.C. § 665(b) (1994); Treas. Reg. § 1.665(b)-1A (1972). The distributable net income of a trust, in general, is the taxable income of the trust computed in the same manner as in the case of an individual with certain modifications necessary to implement the conduit tax treatment of trust income. I.R.C. §§ 641(b), 643(a) (1994).

234. Treas. Reg. § 1.665(a)-0A(a)(2) (1972). The undistributed net income of a trust for any taxable year, in general, is the amount by which the distributable net income of the trust for such year exceeds the amounts distributed by the trust and the amount of taxes imposed on the trust with respect to its undistributed income. I.R.C. § 665(a) (1994); Treas. Reg. § 1.665(a)-1A (1972).

235. In general, the preceding taxable years of a trust only include taxable years after 1968 during which the trust was not classified as a "simple" trust. In the case of a foreign trust created by a U.S. person, however, the preceding taxable years of the trust include all taxable years beginning after 1953. I.R.C. § 665(e) (1994).

236. I.R.C. § 666(a) (1994); Treas. Reg. § 1.666(a)-1A (1972). With respect to the methodology to be applied in allocating an accumulation distribution to the preceding taxable years of the trust, Treas. Reg. § 1.666(a)-1A(b)(1) (1972), provides as follows:

An accumulation distribution made by a trust . . . in any taxable year . . . is allocated to the preceding taxable years of the trust . . . according to the amount of undistributed net income of the trust for such years. For this purpose, an accumulation distribution is first allocated to the earliest such preceding taxable year in which there is undistributed net income and shall then be allocated in turn, beginning with the next earliest, to any remaining preceding taxable years of the trust. The portion of the accumulation distribution allocated to the earliest preceding taxable year is the amount of the undistributed net income for that preceding taxable year. The portion of the accumulation distribution allocated to any preceding taxable year subsequent to the earliest such preceding taxable year is the excess of the accumulation distribution over the aggregate of the undistributed net income for all earlier preceding taxable year.

237. I.R.C. §§ 666(b), 666(c) (1994); Treas. Reg. §§ 1.666(b)-1A (1972), 1.666(c)-1A (1972). If the portion of an accumulation distribution allocated to a preceding taxable year is equal to the undistributed net income of the trust for such year, "then an additional amount equal to the 'taxes imposed on the trust attributable to the undistributed net income' . . . for such preceding taxable year

prevent double taxation, however, the beneficiary is allowed a credit for the amount of taxes imposed on the trust²³⁸ to be applied against his tax liability for the accumulation distribution.

The tax treatment of an accumulation distribution in the hands of the beneficiary is a statutory masterpiece of interrelated averages.²³⁹ In general, the average amount of the accumulation distribution is added to the taxable income of the beneficiary for three of the five immediately preceding taxable years in order to compute an average increase in tax liability.²⁴⁰ The tax liability of the beneficiary with respect to the accumulation distribution is equal to the average increase in tax liability multiplied by the number of preceding taxable years to which the accumulation distribution was allocated.²⁴¹ The beneficiary, however, is allowed to reduce the tax liability on the accumulation distribution by the amount of taxes that were imposed on the trust with respect to the accumulated income that was distributed.²⁴² Ironically, this method for computing the tax liability of a beneficiary with respect to an accumulation distribution is referred to as the "shortcut method."²⁴³

If the beneficiary receives accumulation distributions from more than one trust in the same taxable year, the distributions are treated as having been made consecutively in whichever order the beneficiary chooses.²⁴⁴ For the purpose of

is also deemed distributed . . ." Treas. Reg. § 1.666(b)-1A (1972). If the portion of an accumulation distribution allocated to a preceding taxable year is less than the undistributed net income of the trust for such year, then the distribution is grossed up by a proportionate amount of the taxes imposed on the trust for such year. Treas. Reg. § 1.666(c)-1A (1972).

238. I.R.C. § 667(b)(1) (1994); Treas. Reg. § 1.667(b)-1A (1972). However, if the amount of tax imposed on the beneficiary with respect to an accumulation distribution is less than the amount of tax that was imposed on the trust with respect to the undistributed net income, neither the trust nor the beneficiary is entitled to a refund or credit of the excess taxes. I.R.C. § 666(e) (1994).

239. I.R.C. § 667(b) (1994). See also 1976 GENERAL EXPLANATION, *supra* note 229, at 162.

240. I.R.C. § 667(b) (1994). The average accumulation distribution is determined by dividing the total accumulation distribution by the number of preceding taxable years of the trust to which it is allocated, excluding from the calculation any preceding taxable year in which the undistributed net income of the trust is less than 25% of the average accumulation distribution. I.R.C. §§ 667(b)(1)(C), 667(b)(3) (1994). The average accumulation distribution is then added to the taxable income of the beneficiary for each of the three of the five taxable years immediately preceding the taxable year of the distribution that remain after excluding from the five year base period, the taxable year in which the taxable income of the beneficiary was the highest and the taxable year in which it was the lowest. I.R.C. §§ 667(b)(1)(B), 667(b)(1)(C) (1994). For the three remaining years, the tax liability of the beneficiary is recomputed using the tax rates that were in effect during those taxable years. The increase in tax liability during the three years is then averaged in order to determine the average increase in tax liability over the three years attributable to the accumulation distribution. I.R.C. § 667(b)(1)(D) (1994).

241. The number of preceding taxable years of the trust to which the accumulation distribution was allocated is determined, once again, by excluding any preceding taxable year in which the undistributed net income of the trust was less than 25% of the average accumulation distribution. I.R.C. § 667(b)(3) (1994).

242. I.R.C. § 667(b) (1994). However, if the taxes imposed on the trust with respect to the undistributed income are greater than the tax liability of the beneficiary on the accumulation distribution, neither the trust nor the beneficiary may receive a refund or a credit for such excess. I.R.C. § 666(e) (1994).

243. 1976 GENERAL EXPLANATION, *supra* note 229, at 161.

244. I.R.C. § 667(b)(5) (1994).

computing the tax liability with respect to any accumulation distribution, however, the taxable income of the beneficiary for each preceding taxable year includes the amount of any prior accumulation distributions that were thrown back to such year.²⁴⁵ In addition, in the case of an accumulation distribution from a foreign trust, the beneficiary is assessed a nondeductible interest charge for the period of time between the taxable years in which the income was accumulated and the taxable year in which the accumulation distribution was received.²⁴⁶

Prior to 1976, there was an alternative "exact" method for computing the beneficiary's tax liability with respect to an accumulation distribution.²⁴⁷ Under the exact method, the grossed up amount of an accumulation distribution thrown back to any preceding taxable year was included in the taxable income of the beneficiary for that year.²⁴⁸ After computing the increased tax liability for each preceding taxable year due to such inclusion, the beneficiary was allowed a credit for the taxes imposed on the trust with respect to the undistributed income of the trust for that year.²⁴⁹

In addition to preventing the double taxation of trust income, the throwback rules eliminate the benefit of tax deferral that could be obtained by accumulating income in a trust.²⁵⁰ These objectives are largely achieved because the throwback effect taxes the beneficiary in approximately the same manner in which he would have been taxed if the trust income had been distributed immediately.²⁵¹

The stated policies of the indirect foreign tax credit, on the other hand, are to alleviate international double taxation and to equalize the tax treatment of foreign branches and foreign subsidiaries.²⁵² Since the principal difference be-

245. I.R.C. § 667(b)(4) (1994). The taxable income of the beneficiary for each preceding taxable year includes any amounts previously thrown back to such years whether the prior accumulation distributions came from the same or another trust. *Id.*

246. I.R.C. § 668 (1994). Interest is charged on the tax liability with respect to the accumulation distribution, but can not be greater than the amount by which the accumulation distribution (before gross up) exceeds the tax liability on such distribution. I.R.C. § 668(b) (1994). This interest charge effectively eliminates the benefit of tax deferral attributable to the time value of money otherwise available by accumulating income in a separate taxable entity.

247. I.R.C. § 668(b)(1)(A) (before repeal by the Tax Reform Act of 1976).

248. *Id.* As with the shortcut method, the amount of the gross up for the taxes imposed on the trust was total or proportional depending upon whether the portion of an accumulation distribution allocated to a preceding taxable year was equal to or less than the undistributed net income of the trust for such year. I.R.C. §§ 666(b), 666(c) (1994).

249. I.R.C. § 668(b)(1) (before repeal by the Tax Reform Act of 1976). The exact method for computing the tax liability of a beneficiary with respect to an accumulation distribution also contained provisions, similar to those applicable to the shortcut method, regarding the effect of prior accumulation distributions and the receipt of multiple accumulation distributions in the same taxable year. I.R.C. §§ 668(b)(3), 668(b)(4) (before repeal by the Tax Reform Act of 1976).

250. 1976 GENERAL EXPLANATION, *supra* note 229, at 161.

251. The throwback effect thus prevents the beneficiaries of a trust from receiving any benefit by timing the taxable years in which they receive distributions to coincide with those years in which they are paying taxes at a relatively low rate. In addition, in the case of distributions from foreign trusts, the benefit of tax deferral is eliminated entirely by the nondeductible interest charge for the period of time during which the distribution is delayed.

252. H.R. REP. NO. 1447, 87th Cong., 2nd Sess. 401, 455 (1963); S. REP. NO. 1881, 87th Cong., 2nd Sess. 703, 772 (1963); 1986 BLUEBOOK, *supra* note 17, at 861, 869.

tween foreign branches and subsidiaries is the tax deferral available to domestic corporations with a foreign subsidiary, the policies of the indirect foreign tax credit, stated differently, are to eliminate the benefit of tax deferral that can be obtained by accumulating income in a foreign subsidiary while also preventing the international double taxation of foreign source income. Because the stated objectives of the indirect foreign tax credit closely parallel those of the throwback rules, a throwback mechanism for determining the taxability of international corporate distributions would be effective in achieving both quantitative and qualitative similarity between foreign branches and subsidiaries.

b. A Proposed International Throwback Model

1. In General

The proposed model for the taxation of international corporate distributions is a hybrid of the subchapter J throwback rules and the layers of earnings model. In general, a domestic corporation may claim the indirect foreign tax credit for the foreign taxes paid by a foreign subsidiary on its undistributed income for taxable years during which the domestic corporation met the stock ownership requirements of section 902.²⁵³ The foreign tax credit is available at the time the foreign subsidiary distributes its undistributed net income to the domestic corporation. The manner in which the domestic corporation is taxed, however, is based on the throwback rules of subchapter J.

Similar to the layers of earnings model, there is an annual determination of the taxable income of a foreign subsidiary and the amount of foreign taxes paid with respect to such income.²⁵⁴ The net amount after foreign taxes paid is the undistributed net income of the subsidiary for that taxable year.²⁵⁵ Unlike the layers of earnings model, however, such undistributed net income is not processed through the earnings and profits mechanism to determine accumulated profits.²⁵⁶ The undistributed net income of the foreign corporation, standing

253. I.R.C. §§ 902(a), 902(b) (1994). See *supra* text accompanying notes 84-88. Under the international throwback model a domestic corporation may claim the foreign tax credit for taxes paid by a subsidiary during years in which the domestic corporation met the stock ownership requirements of section 902 with respect to such subsidiary even if such requirements are not met during the year in which the net income from such preceding years is distributed to the domestic corporation.

254. These are the two critical elements for foreign tax credit purposes as they identify the amount that may be claimed as a credit (foreign taxes paid) and the base over which such foreign taxes must be allocated (foreign taxable income) for purposes of claiming the foreign tax credit. The only element that remains to be determined is the amount of the foreign taxable income that is subject to U.S. taxation.

255. This is similar to the definition of accumulated profits under the layers of income model, except that the undistributed net income of the foreign subsidiary is determined under foreign law rather than under the U.S. tax principles used to determine earnings and profits.

256. Avoidance of the earnings and profits mechanism results in substantial simplification of the indirect foreign tax credit provisions and eliminates a number of problems that have plagued both the layers of income model and the pool of earnings model. Use of the earnings and profits mechanism creates the situations under the layers of income model in which the foreign tax credit can be lost. See *supra* text accompanying notes 187-89. The earnings and profits mechanism is also responsible for creating the situations under the pool of earnings model in which there are distortions

alone, is a sufficient identification of both the amount of income that has been generated by the offshore operation and the amount of foreign taxes that have been paid with respect to such income.²⁵⁷

Any distribution by a foreign subsidiary is deemed to be a distribution of its undistributed net income in the chronological order in which such income was realized.²⁵⁸ Distributions from foreign corporations carry out the corporation's undistributed net income on a first-in first-out basis regardless of whether the corporation has any undistributed net income for the year in which the distribution is made. Distributions are, in effect, "thrown back" to the earliest taxable years in which the foreign corporation had any undistributed net income.²⁵⁹

When a distribution is made, the amount of the distribution is "grossed up" by the amount of foreign taxes that were paid on the undistributed net income

in the amount of foreign tax credit that may be claimed with respect to particular distributions, and which can result in an indefinite lock-in of the foreign tax credit despite the fact that the foreign subsidiary is making distributions of earnings that were taxable under foreign law and that are taxable as dividends to the U.S. corporation. See *supra* text accompanying notes 190-97. Finally, the dual nature of the earnings and profits concept gave rise to the procedure for making distributions known as the "rhythm method" which created distortions in the amount and timing of the foreign tax credit. See *infra* note 260 and accompanying text. All of these problems are avoided by eliminating the earnings and profits mechanism from the indirect foreign tax credit computation.

257. One concern with respect to the proposed international throwback model may be that the undistributed net income of the foreign subsidiary is determined under foreign law. To the extent there are differences between U.S. and foreign tax law in the determination of gross income or allowable deductions there will be differences in the amount of the subsidiary's undistributed net income and the amount that would have been included in the U.S. tax base of the domestic parent corporation if the offshore operation had been conducted through a branch. If such differences are significant, they are taken into account in the determination of whether the foreign taxes qualify as creditable taxes. See *supra* text accompanying notes 49-57. To the extent such differences are not significant, they are disregarded as they are under the existing provisions with respect to the direct foreign tax credit. See *supra* note 155 and accompanying text.

258. Unlike the subchapter J throwback rules which throw back "excess" distributions, the proposed international throwback model is one of complete throwback. This is also different from the earnings and profits mechanism in which distributions are considered to arise first from the earnings and profits of the taxable year and then from earnings and profits from prior taxable years. This dual aspect of the earnings and profits mechanism was responsible for the practice known as the "rhythm method" under which distributions were timed to correspond to tax years in which the foreign corporation was paying tax at a relatively high rate in order to inflate the value of the foreign tax credit. The use of a total throwback approach under which any distribution is considered to arise from the very first undistributed net income would eliminate any possibility of timing distributions to give birth to a new rhythm method.

259. Distributions are thrown back to the earliest years in which the foreign corporation had undistributed net income even if the U.S. corporation did not meet the stock ownership requirements of section 902 with respect to the foreign corporation during such years. The domestic corporation can only claim a foreign tax credit with respect to a distribution, however, to the extent that the distribution is thrown back to a taxable year in which it met such stock ownership requirements. Such a mechanism prevents a foreign corporation from accumulating a pool of uncredited foreign taxes which a domestic corporation can "buy" by acquiring stock in such foreign corporation.

If a foreign currency is determined to be hyperinflationary, the throwback of distributions could be discounted to counteract the effects of inflation and thereby prevent the overvaluation of the foreign tax credit available with respect to delayed distributions. See I.R.C. § 885(b) (1994). Such adjustments would probably not be necessary, however, since both the undistributed net income and the foreign taxes paid by the subsidiary would be affected in a similar manner by any inflation in the foreign economy.

now being distributed.²⁶⁰ The domestic corporation is required to include in income the grossed up amount of undistributed net income of the subsidiary but is then allowed a tax credit for the amount of foreign taxes related to such undistributed net income.²⁶¹

Under the international throwback model, the taxability of the domestic corporation is based on the "exact method" used for taxing accumulation distributions from trusts.²⁶² A distribution from a foreign corporation is thrown back to the taxable years of the U.S. corporation in which the foreign subsidiary received the undistributed net income which is now being distributed.²⁶³ The grossed up amount of undistributed net income is added to the U.S. tax base of the domestic corporation for the taxable years during which it was accumulated by the foreign subsidiary and is taxable to the U.S. corporation at the tax rates that were applicable to it for such years.²⁶⁴ The international throwback model also incorporates provisions similar to the subchapter J throwback rules for the treatment of prior distributions and for multiple distributions in the same taxable year.²⁶⁵ In addition, as with distributions from foreign trusts, the U.S. tax liability with respect to the portion of any distribution that is thrown back to a preceding taxable year is assessed a nondeductible interest charge for the period of

260. In a manner similar to the subchapter J throwback rules, the amount of the gross up for foreign taxes paid is proportional depending on whether the portion of the distribution allocated to a preceding taxable year is equal to or less than the undistributed net income of the subsidiary for such year. See I.R.C. §§ 666(b), 666(c) (1994). A gross up for foreign taxes paid is not required, however, for the portion of any distribution that is thrown back to a preceding taxable year of the subsidiary during which the domestic corporation did not meet the stock ownership requirements of section 902 with respect to the subsidiary. A gross up is not required for such portion of the distribution since the domestic corporation can not claim any foreign tax credit with respect to such portion of the distribution.

261. See I.R.C. § 668(b)(1) (before repeal by the Tax Reform Act of 1976).

262. *Id.*

263. If a foreign subsidiary has undistributed net income from taxable years before the domestic corporation met the stock ownership requirements of section 902 with respect to such subsidiary, a distribution, although treated as carrying out the undistributed net income of the subsidiary from such preceding taxable years, is not thrown back to the prior taxable years of the domestic corporation, but is simply included in income for the year in which received. In addition, a distribution of the undistributed net income of a subsidiary from taxable years before the domestic corporation met the stock ownership requirements of section 902 is not grossed up by the amount of foreign taxes that were paid with respect to such income. See *supra* note 260.

To the extent a distribution from a foreign subsidiary exceeds the undistributed net income of the corporation, such distribution will not carry out any income with respect to which the subsidiary has paid any foreign taxes and thus will not qualify for the foreign tax credit. Such distributions will simply be included in the income of the domestic corporation for the taxable year in which it was received.

264. Such a throwback mechanism prevents a domestic corporation from taking advantage of variations in the U.S. tax rates by timing the distributions from its foreign subsidiaries to fall into taxable years in which it is paying U.S. taxes at a relatively low rate.

265. For example, if a domestic corporation receives more than one distribution in the same year, either from the same or from different foreign subsidiaries, such distributions are treated as having been received consecutively in whatever order the domestic corporation chooses. See I.R.C. § 667(b)(5) (1994). In addition, for purposes of computing the tax liability of the domestic corporation with respect to any distribution from a foreign subsidiary, the taxable income of the domestic corporation for any preceding taxable year includes the amount of any distribution that has previously been thrown back to such year. See I.R.C. § 667(b)(4) (1994).

time between the taxable year in which the income was received by the foreign subsidiary and the taxable year in which it is distributed to the U.S. corporation.²⁶⁶

2. Treatment of Losses

One of the most troublesome problems for both the layers of earnings model and the pool of earnings model is the treatment of losses and the resulting deficits in earnings and profits. This is because it can result in the permanent loss or indefinite deferral of the foreign tax credit.²⁶⁷ Under the international throwback model, if a foreign corporation incurs an operating loss for a taxable year, the effect of such loss for foreign tax credit purposes depends on the treatment of the loss under foreign law.²⁶⁸ The immediate effect, of course, is that the subsidiary will have no undistributed net income or foreign taxes paid for the year of the loss. If foreign law allows a carryback or carryover of losses, however, there will be an effect on both the subsidiary's undistributed net income and the foreign taxes it paid for the taxable years to which such losses are carried.²⁶⁹ If the year to which a loss is carried back is not a year to which a distribution has been thrown back, the only effect of the carryback will be a decrease in both the undistributed net income and the foreign taxes paid for such year. However, if the year to which a loss is carried back is a year in which a distribution was previously thrown back for foreign tax credit purposes, there would be a "foreign tax redetermination"²⁷⁰ which may require a retroactive redetermination of U.S. tax liability.²⁷¹ In the event of a loss carryforward, there will be a decrease in the taxable income of the subsidiary and a corresponding reduction in both the subsidiary's undistributed net income and the foreign taxes it paid in the taxable years following the year of the loss.

266. See I.R.C. § 668 (1994). Such an interest charge could be waived, however, for any period during which the undistributed net income of the foreign subsidiary could not have been distributed to the U.S. corporation because of currency or other restrictions imposed by foreign law. See I.R.C. § 964(b) (1994).

267. See *supra* text accompanying notes 187-97.

268. Since the critical components for determining the indirect foreign tax credit under the international throwback model (foreign taxes paid and undistributed net income) are determined under foreign law, it is appropriate for the effect of an operating loss also to be determined under foreign law. See *supra* note 259 and accompanying text.

269. If foreign law allows the carryback of losses, for example, there would be a reduction in both the subsidiary's undistributed net income and foreign taxes paid for the taxable years to which the loss is carried.

270. Temp. Treas. Reg. § 1.905-3T(c) (1988). See KUNTZ & PERONI, *supra* note 3, ¶ B4.08[7][b].

271. If the subsidiary has undistributed net income for the taxable year to which the loss is carried that is sufficient to absorb the loss carryback, a redetermination of U.S. tax liability would not be required. In such event, there would simply be decreases in the remaining amounts of undistributed net income and foreign taxes paid for such taxable year. If the subsidiary's undistributed net income for the taxable year to which the loss is carried cannot absorb the loss carryback, however, there would be a recapture of the foreign tax credit to the extent the refund of foreign taxes exceeds the subsidiary's uncredited foreign taxes paid for such taxable year. I.R.C. § 905(c) (1994). See KUNTZ & PERONI, *supra* note 3, ¶ B4.08[7][b].

It is crucial for purposes of the conceptual integrity of the international throwback model that the carryback and carryover of losses not create the types of situations under the layers of earnings model and the pool of earnings model in which there could be a permanent loss or an indefinite deferral of the foreign tax credit.²⁷²

3. Other Aspects

There are two other aspects of the international throwback model that must be considered. They are the application of the foreign tax credit limitation provisions and the coordination of the throwback model with the provisions of subpart F.

For purposes of the limitations on the foreign tax credit, the treatment of a distribution from a foreign subsidiary depends upon whether the subsidiary is a CFC. Under current law, distribution from a foreign subsidiary which is not a CFC is treated as constituting a separate category of income.²⁷³ Under the international throwback model, however, the distribution is treated as a separate category of income for each taxable year to which the distribution is thrown back.²⁷⁴ The maximum amount of foreign tax credit that may be claimed with respect to such a distribution is computed on a year by year basis and is equal to the pre-credit U.S. tax liability of the domestic corporation with respect to the portion of the distribution thrown back to each preceding taxable year.²⁷⁵

In the case of a CFC, the foreign tax credit limitation provisions are applied, as under current law, by using the "look-through" rules of section 904(d)(3).²⁷⁶ Thus, for purposes of the foreign tax credit limitation provisions, any amount included in the income of the U.S. corporation under the provisions of subpart F is treated as consisting of a proportionate share of each category of income received by the CFC. Since the operation of subpart F requires a current income inclusion to the extent of both the CFC's subpart F income and its increases in U.S. property holdings,²⁷⁷ such inclusion is not thrown back to the preceding taxable years of the subsidiary.

However, a CFC will have undistributed net income for purposes of the international throwback model to the extent the subsidiary's taxable income for any year exceeds the amounts required to be included in income of the U.S. corporation under the provisions of subpart F.²⁷⁸ In the event of an actual distribution by a CFC, the distribution is thrown back to the preceding taxable years

272. See *supra* text accompanying notes 187-97.

273. See *supra* text accompanying notes 126-31.

274. In the event of multiple distributions from the same noncontrolled foreign subsidiary that are thrown back to the same preceding taxable year of the U.S. corporation, all such distributions would be aggregated and treated as a separate category of income for such year.

275. See *supra* text accompanying notes 117-19.

276. I.R.C. § 904(d)(3) (1994). See *supra* text accompanying notes 144-47.

277. See *supra* text accompanying notes 134-47.

278. The amount of foreign taxes attributable to such undistributed net income is equal to the total foreign taxes paid by the subsidiary for such taxable year reduced by the amount of foreign taxes attributable to the subpart F inclusion.

of the subsidiary, commencing with the earliest year. The distribution is treated, on a year by year basis, as consisting first of any previously taxed subpart F inclusion from the subsidiary for such year and then as carrying out any undistributed net income of the subsidiary for such year.²⁷⁹ In this manner, the international throwback model can be easily and effectively integrated with the foreign tax credit limitation provisions and coordinated with the provisions of subpart F.

The proposed throwback model achieves all of the express Congressional objectives with respect to the indirect foreign tax credit and does so in a manner that is conceptually simpler than the pool of earnings model currently used. The model avoids both the numerous complexities of the earnings and profits mechanism and the inevitable inconsistencies that exist between the amount of taxable income determined under foreign law with respect to which foreign taxes are paid and the amount of undistributed earnings determined under U.S. law with respect to which foreign taxes are allowable as a credit.

IV.

CONCLUSION

A principal objective for corrective tax legislation is to directly address a perceived problem in the tax system and to do so in a manner that contributes the least amount of additional complexity to the Code.²⁸⁰ The expressed Congressional policies with respect to the indirect foreign tax credit are, first, to alleviate the problem of international double taxation and, second, to equalize the tax treatment between domestic corporations that conduct their offshore operations through foreign branches and those that operate through foreign subsidiaries.²⁸¹ Although the policies of the indirect foreign tax credit are clear, the statutory mechanism chosen by Congress to attain these goals has been far from successful.

The pool of earnings method that Congress adopted for the computation of the indirect foreign tax credit uses a modified form of the earnings and profits

279. See I.R.C. § 959 (1994). To the extent a distribution exceeds the subpart F inclusion and the undistributed net income of the subsidiary for any preceding taxable year, it is treated as carrying out such items in the same manner from the next succeeding taxable year of the subsidiary. If a distribution is thrown back to a taxable year during which the subsidiary was not a CFC, then for purposes of the foreign tax credit limitation provisions, the distribution is treated as a separate category of income for such year. If the distribution is thrown back to a taxable year during which the subsidiary was a CFC, the portion of the distribution comprising the subsidiary's undistributed net income for such year is treated as consisting of a proportionate share of each category of income of the subsidiary for the taxable year to which the distribution is thrown back.

280. This is not to say that Congress can not or should not cast a broader net than necessary to correct a perceived abuse. It has frequently been the case that Congress has needed to "over" legislate to curb the enthusiasm of aggressive tax professionals. See, e.g. I.R.C. § 469 (1994). The "best" legislative solution, however, is one that addresses the perceived problem directly and in such a manner that it contributes the least amount of additional complexity to an already highly complex document.

281. H.R. REP. NO. 1447, 87th Cong., 2nd Sess. 401, 455 (1963); S. REP. NO. 1881, 87th Cong., 2nd Sess. 703, 772 (1963); 1986 BLUEBOOK, *supra* note 17, at 861, 869.

mechanism applicable to distributions from domestic corporations.²⁸² Because of the treatment of losses in the computation of earnings and profits, however, the use of the earnings and profits mechanism results in situations in which the foreign tax credit can be permanently lost or indefinitely deferred.²⁸³ The pool of earnings method, therefore, fails to provide adequate relief from international double taxation.

The pool of earnings method also fails to equalize the tax treatment between foreign branches and foreign subsidiaries. This is because the indirect foreign tax credit fails to take account of the time value of money and the economic benefit of tax deferral that is available through the use of foreign subsidiaries.²⁸⁴ The pool of earnings method does not prevent a U.S. corporation from benefitting from the time value of money by deferring the U.S. taxation of its foreign source income by having its foreign subsidiaries withhold distributions.²⁸⁵ This type of tax deferral is not available to corporations that operate overseas through foreign branches. Simply stated, Congress has failed to achieve its objectives.

The underlying problem is that Congress has been too attached to the U.S. model of corporate taxation to construct (or borrow) a statutory solution that addresses the problem directly.²⁸⁶ Since similarity of tax treatment is actually an issue of deferral of income, the statutory solution to this problem should be one that is designed to eliminate or minimize the benefits of tax deferral. The pool of earnings method does not do this. Because it is tied to the U.S. model of taxing corporate distributions, which has its focus on corporate earnings and profits, the Congressional solution to the issue of similarity of tax treatment between foreign branches and foreign subsidiaries addresses only the *quantitative* aspects of the problem and completely overlooks the *qualitative* aspects of

282. See *supra* text accompanying notes 219-22.

283. See *supra* text accompanying notes 187-97.

284. 1986 BLUEBOOK, *supra* note 17, at 869. Although the utilization of a foreign subsidiary may sometimes be mandated by the host country for certain types of business activities or dictated by the economic incentives that are available from the host country, the deferral of U.S. taxation remains a significant factor in the selection of the form of international operations. In addition, the availability of tax deferral because of the structure of the U.S. tax system for a particular form of business operation violates stated U.S. international tax policy. See 1986 BLUEBOOK, *supra* note 17, at 964.

285. The time value of money attributable to the deferral of U.S. taxation is one of the major benefits of using a foreign subsidiary to conduct offshore operations. In numerous other situations, Congress has determined that the time value of money must be taken into account for tax purposes. See, e.g., I.R.C. §§ 1271-1275 (1994) (the treatment of original issue discount). Such deferral is not available, however, if the subsidiary is a CFC subject to the provisions of subpart F. See *supra* text accompanying notes 134-43.

286. Even though Congress recognized that tax deferral is a major dissimilarity between foreign branches and foreign subsidiaries, it did not devise (or adapt) a statutory mechanism designed to eliminate the benefits of tax deferral. Congress was focused only on the possible loss of the indirect foreign tax credit due to the treatment of deficits in the subsidiary's earnings and profits account. 1986 BLUEBOOK, *supra* note 17, at 870. Unfortunately, Congress did not even succeed completely in eliminating the problem of lock-in of the foreign tax credit as a result of deficits in corporate earnings. See *supra* note 192 and accompanying text.

the problem.²⁸⁷ This omission can be easily corrected without a loss of equality with respect to the quantitative aspects of the problem if the issue of similarity of tax treatment is directly addressed by the adoption of the international throwback model.

Under the international throwback model, a distribution from a foreign subsidiary is treated as a distribution of the subsidiary's undistributed net income from preceding taxable years in the chronological order in which such income was accumulated.²⁸⁸ When the distribution is received by the domestic corporation, it is taxable to the U.S. corporation in a manner that approximates how it would have been taxed if the net income of the subsidiary had been distributed as it was earned. In this manner, the international throwback model would accomplish the stated Congressional objective of alleviating international double taxation and would do so in a manner that would achieve both quantitative and qualitative similarity between foreign branches and foreign subsidiaries.²⁸⁹

When Congress revisits the indirect foreign tax credit, which IRS and Treasury officials have indicated will happen in the near future,²⁹⁰ Congress should consider the adoption of a statutory mechanism that is designed to eliminate the benefits of tax deferral available through the use of foreign subsidiaries. If Congress were able to divorce itself from its attachment to the U.S. model of corporate taxation, the international throwback model proposed in this paper would be much simpler than the pool of earnings method of current law, and would be much more effective at achieving all of the stated Congressional policy goals with respect to the indirect foreign tax credit.

287. Another aspect of being tied to the U.S. model of corporate taxation is that it caused Congress to construct a legislative solution for the problems facing the indirect foreign tax credit that is needlessly complex because it is based on the concept of earnings and profits. This layer of complexity can also be removed through the use of the international throwback model for the taxation of distributions from foreign subsidiaries.

288. The international throwback model operates on a first-in first-out (FIFO) basis rather than the last-in first-out (LIFO) approach that was used by the layers of earnings method. The LIFO approach of the layers of earnings method arose because of the Congressional bond to the U.S. model of corporate taxation and the reverse chronological utilization of earnings and profits inherent in that model.

289. The international throwback model is conceptually simpler than the pool of earnings model because it does not require the intervening and highly complex step of computing the earnings and profits of a foreign corporation using U.S. tax law. *See supra* text accompanying notes 171-78. In addition, by eliminating the dependence on the earnings and profits mechanism of the U.S. model for taxing corporate distributions, the international throwback model avoids the problem of the possible loss of the foreign tax credit because of a deficit in corporate earnings. *See supra* text accompanying notes 187-97. The international throwback model operates simply on the amount of taxable income that has been received by the foreign subsidiary and the amount of foreign taxes that have been paid with respect to that income. Tremendous simplification would be achieved if the indirect foreign tax credit provisions could be divorced from their artificial attachment to the U.S. model of taxing distributions by domestic corporations.

290. *See Note, 62 TAX NOTES 137*, indicating that statutory changes to the foreign tax credit provisions may soon be necessary.