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The Tax Reform Act of 1976: Treatment of Foreign Income and Effects on U.S. Development of Foreign Mineral Resources

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The Tax Reform Act of 1976[1] includes the most extensive changes in the treatment of foreign income in over a decade of federal tax legislation. The changes range from various modifications in the computation of the foreign tax credit limitation to a reduction in the foreign earned income exclusion for U.S. employees abroad. In many cases these changes will result in a substantial increase in the costs of doing business overseas, thereby lessening the ability of U.S. corporations to maintain foreign operations and to compete effectively in foreign markets.

Given the high level of capital investment required for the development of mineral resources, coupled with the long lead time between capital expenditure and the commencement of production, changes in the tax laws are of particular interest to U.S. mineral resource corporations. This is especially so in the foreign area, since many U.S. mineral resource corporations would be unable to maintain needed levels of production without a continuing role in the development of foreign mineral deposits. This article will provide a brief explanation of the principal changes in the treatment of foreign income, with emphasis on the effects these changes will have on U.S. development of foreign mineral resources.[2]

I. FOREIGN TAX CREDIT

The basic purpose of the foreign tax credit is to prevent international double taxation. Like most other countries, the United States recognizes that the country in which income is

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1. The Tax Reform Act of 1976 [hereinafter cited as TRA] was passed by Congress as Pub. L. No. 94-455, 90 Stat. 1525 (1976), and was signed by the President on Oct. 4, 1976. Citations to the Internal Revenue Code of 1954 [hereinafter cited as I.R.C.] are, unless otherwise indicated, as amended through 1976.

2. Although the primary concern is with hard minerals, the article will also touch on some of the special problems which have arisen for oil and gas.

produced has the primary right to tax that income. Thus, although the United States taxes its citizens, residents, and domestic corporations on their worldwide income, it has long granted a credit against that tax for income taxes paid to foreign countries.[3] In the absence of this credit, U.S. taxpayers would be taxed twice on their foreign income: first by the country in which it was earned and second by the United States. As a result, taxpayers with foreign income would suffer a substantial, if not prohibitive, penalty as compared to taxpayers with solely domestic income.

Of equal significance—particularly with respect to U.S. multinational corporations—is the fact that most other developed countries employ similar means to protect their own taxpayers from double taxation.[4] Thus, in addition to preventing undue discrimination between U.S. taxpayers—*i.e.*, discrimination in favor of taxpayers with solely domestic income—the foreign tax credit permits U.S. multinational corporations to compete effectively with the multinational corporations of other developed countries. It is generally recognized that, in the absence of the foreign tax credit, U.S. commercial interests would be forced to withdraw from the foreign scene.[5]

Although the Tax Reform Act leaves the foreign tax credit more or less intact, it makes a number of changes affecting the computation of the credit which, whatever their theoretical merits, can only undermine the competitive potential of U.S. multinational corporations. No doubt, much of the pressure for these changes arose from the conviction that faltering investments abroad would lead to an increase in productive investment at home. However, this conviction is not sustained by the

3. I.R.C. §§ 901-908.

4. *See generally* Norr, *Jurisdiction to Tax and International Income,* 17 TAX L. REV. 431, 439-41 (1962). Those countries which do not follow the credit approach typically limit their taxing jurisdiction to domestic income.

5. In testimony before the Senate Foreign Relations Committee, Professor Stanley S. Surrey, then Assistant Secretary of the Treasury, stated that:

> American investment would not proceed at all without the foreign tax credit because then, as the Chairman pointed out, two taxes would be imposed and the overall burden of two taxes would be so great that international investment would practically cease.

Hearings on Tax Conventions with Brazil, Canada, and Trinidad and Tobago Before the Senate Comm. on Foreign Relations, 90th Cong., 1st Sess. 19-20 (1967).

bulk of available evidence.[6] Moreover, in the case of mineral resources, the fact that such a shift in investment would generally not occur should be obvious. Mineral resources are where you find them.

A. Repeal of Per Country Limitation

Almost since its inception, the foreign tax credit has been limited to an amount determined by multiplying the precredit U.S. tax liability by the ratio of foreign taxable income to total taxable income, both foreign and domestic.[7] Where the foreign tax rate is less than the U.S. rate, this ratio assures that the foreign income will incur a residual U.S. tax at the difference between the U.S. and foreign rates. Conversely, where the foreign tax rate is higher than the U.S. rate, the limitation assures that the "excess" foreign tax will not offset the U.S. tax liability on domestic income. However, in order to account for timing differences between foreign and U.S. taxes, the "excess" in the latter case may be carried back to the two preceding taxable years and carried forward for the next five taxable years.

Prior to the Tax Reform Act, a taxpayer was required to compute the foreign tax credit limitation on a per country basis, unless the taxpayer made an election (binding thereafter) to use the overall method of computation. The per country limitation was computed separately for the income tax imposed by each foreign country, with only the income from that particular country being taken into account. In contrast, the overall limitation encompasses all foreign income taxes in a single computation with total foreign income being treated as a unit. As explained more fully below, the per country limitation was often advantageous for a taxpayer with a loss in one foreign country and income in another. The comparative advantage of the overall limitation is that it allows a taxpayer to average high and low foreign tax rates.

The Tax Reform Act repeals the per country limitation and requires all taxpayers to compute the foreign tax credit limitation under the overall method.[8] In general, this change is

6. *See, e.g.*, SENATE COMM. ON FINANCE, 93D CONG., 1ST SESS., REPORT ON IMPLICATIONS OF MULTINATIONAL FIRMS FOR WORLD TRADE AND INVESTMENT AND FOR U.S. TRADE AND LABOR 426-29 (Comm. Print 1973).

7. I.R.C. § 904.

8. TRA § 1031, *amending* I.R.C. § 904.

effective for taxable years beginning after December 31, 1975. However, the effective date is postponed for three years in the case of a mineral resource corporation which has (i) derived at least 80 percent of its cumulative gross receipts from the mining and sale of hard minerals, (ii) been engaged in the mining of such minerals outside the United States and its possessions for less than five years, (iii) incurred losses from such foreign mining activities during at least two years, and (iv) made commitments for a substantial expansion of these activities.

The principal reason given for the repeal of the per country limitation was that it allowed taxpayers with a loss in one foreign country, and income in another, to take the entire loss from the one country as a deduction against their domestic income, while obtaining an undiminished foreign tax credit with respect to the income from the other country.[9] This would not be possible under the overall method, since the loss from the one country would offset the income from the other, thus reducing the potential foreign tax credit. However, although this may be interpreted as a technical justification for the repeal of the per country limitation, it requires even less interpretation to see that the repeal will work to the particular and unfair disadvantage of corporations with only limited foreign operations. When such corporations undertake an expansion of their operations into additional countries, they will not only face the possibility of start-up losses, but a corresponding erosion of their potential foreign tax credit. Although, as indicated above, there is a transitional rule for certain mineral resource corporations, this rule is extremely narrow in scope and will not relieve mineral resource corporations planning an expansion of their operations in the future.

B. Recapture of Foreign Losses

Prior to the Tax Reform Act, taxpayers with a foreign loss in one year (either per country or overall) and foreign income in subsequent years could deduct the foreign loss for the earlier year from their domestic income for that year and in the later years still obtain an undiminished foreign tax credit with respect to their foreign income. The Tax Reform Act alters this

9. H.R. REP. No. 94-658, 94th Cong., 1st Sess. 225 (1975); S. REP. No. 94-938, 94th Cong., 2d Sess. 236 (1976).

situation by requiring, in general, that the foreign loss for the earlier year—though still deductible from domestic income for that year—be "recaptured" in the later years, *i.e.*, by recharacterizing an equivalent amount of the foreign income in the later years as domestic income.[10] The effect of such recapture is to reduce the potential foreign tax credit for the later years. However, the amount of foreign income recharacterized as domestic in any year cannot generally exceed 50 percent of that income.

The reason given for the recapture requirement was that the allowance of an undiminished foreign tax credit in years following a foreign loss could be viewed as resulting in a double benefit in a case where the foreign country did not allow a loss carryover.[11] However, the requirement is not limited to such a case, but applies as well to the more usual case where the foreign country does allow a loss carryover. A double benefit would not occur in the latter case, because the loss carryover would reduce the foreign taxes in years following the foreign loss, and this in itself would reduce the foreign tax credit. The result is that, by undermining the potential foreign tax credit in both cases alike, the Tax Reform Act not only eliminates what may have been perceived as a double benefit, but also introduces a widespread potential for double taxation. In many instances this additional burden will prolong the recovery period for corporations which have experienced foreign losses. In particular, while the risk of incurring a foreign loss is not unique to mineral resource corporations, the prospect of an ensuing reduction in potential foreign tax credit will tend to discourage U.S. development of foreign mineral resources.

The recapture requirement is generally effective for foreign losses sustained in taxable years beginning after December 31, 1975. However, among other exceptions, the recapture requirement does not apply to expropriation losses, regardless of when sustained. In addition, the requirement does not apply to losses sustained on the disposition of debt obligations issued by a foreign country before May 14, 1976, in exchange for property located within that country. This latter exception was intended as a transitional rule for corporations which, under the threat

10. TRA § 1032, *amending* I.R.C. § 904.

11. H.R. REP. No. 94-658, 94th Cong., 1st Sess. 225 (1975); S. REP. No. 94-938, 94th Cong., 2d Sess. 236 (1976).

of expropriation, had accepted low-yield government bonds in exchange for their property.

C. Foreign Capital Gains

For the purpose of the foreign tax credit limitation, the Tax Reform Act will require that certain foreign capital gains be treated as domestic.[12] Under prior law, taxpayers occasionally sought to enlarge their foreign tax credit limitation by selling capital assets or property used in a trade or business in a foreign country where the tax on capital gains was either minimal or nonexistent. However, effective after November 12, 1975, such sales will generally be treated as giving rise to domestic capital gain, unless the country in which the sale takes place imposes a tax of at least 10 percent on that gain. Exceptions include (i) the sale by one corporation of stock in another, if the sale takes place in a country in which the second corporation derives more than 50 percent of its gross income, and (ii) the sale of personal property (other than stock in a corporation) in a country in which the seller derives more than 50 percent of its gross income or in which the property was used in the seller's trade or business. In addition to the foregoing, the Tax Reform Act requires that net foreign capital gains be taken into account only to the extent that they exceed net domestic capital losses, and that only 30/48ths of the excess be treated as foreign income. These latter provisions are effective for taxable years beginning after December 31, 1975.

D. Foreign Oil and Gas Extraction Income

The Tax Reduction Act of 1975[13] introduced the requirement that the foreign tax credit limitation on foreign oil-related income be computed on a separate overall basis and coupled this requirement with an outright denial of foreign tax credit for foreign income taxes paid on foreign oil and gas extraction income to the extent that these taxes exceeded 52.8 percent of such income for 1975, 50.4 percent for 1976, and 50 percent for all subsequent years.[14] The Tax Reform Act reduces the allowable amount to 48 percent commencing with 1977.[15]

12. TRA § 1032, *amending* I.R.C. § 904(b).

13. The Tax Reduction Act of 1975 [hereinafter cited as Tax Reduction Act] was passed by Congress as Pub. L. No. 94-12, 89 Stat. 26 (1975), and was signed by the President on Mar. 29, 1975.

14. Tax Reduction Act § 601(a), *adding* I.R.C. § 907.

15. TRA § 1035, *amending* I.R.C. § 907.

However, foreign taxes in excess of the 48 percent limit, but not over 50 percent, may be carried back to the two preceding taxable years (subject to the 48 percent limit) and carried forward for the next five taxable years.

II. INCOME OF FOREIGN SUBSIDIARIES; DEEMED-PAID FOREIGN TAX CREDIT

A foreign subsidiary is not subject to U.S. tax so long as it is not engaged in a trade or business within the United States and does not receive dividends, interest, or other forms of passive income from U.S. sources.[16] Moreover, the income of the foreign subsidiary is, in general, not taxable to the U.S. parent until distributed as a dividend.[17] In theory the resulting "deferral" of U.S. tax liability on the income of a foreign subsidiary can give rise to a substantial advantage. Generally, this could happen where the tax rate in the country of the subsidiary's incorporation is less than the U.S. rate. In such a case, by interposing a foreign subsidiary, the U.S. parent may be able to conduct its foreign operations at a reduced tax cost—provided, of course, that the subsidiary's income is not distributed. However, the cases in which a U.S. parent is actually able to obtain this advantage have become increasingly rare. For one thing, the tax rates in most developed countries are now comparable with the U.S. rate. In addition, the tax laws contain a complex set of rules under which certain categories of foreign income are taxed to a U.S. parent as a constructive dividend, *i.e.*, even though not actually distributed by the foreign subsidiary.[18] These same rules require a U.S. parent to treat as a constructive dividend any net increase in a foreign subsidiary's investment of accumulated earnings in U.S. property. Finally, the tax laws contain a separate rule under which dividend treatment is generally required for a portion of any gain recognized on the sale of stock in a foreign subsidiary.[19]

When a U.S. parent becomes taxable on the income of a foreign subsidiary—because of either an actual or constructive dividend—it becomes entitled to a derivative, or "deemed-

16. *See* I.R.C. §§ 881-82.

17. For a general discussion of this point, see Norr, *Jurisdiction to Tax and International Income*, 17 TAX. L. REV. 431, 435-37 (1962).

18. I.R.C. §§ 951-64.

19. I.R.C. § 1248.

paid" foreign tax credit on account of any foreign income tax paid by the subsidiary.[20] For this purpose, the deemed-paid foreign tax generally includes not only the tax attributable to the net income (after foreign tax) from which the distribution is made, but also the tax attributable to the income used to pay the foreign tax. However, the amount of the deemed-paid tax must generally be grossed up, *i.e.*, included as part of the taxable dividend.[21] The end result of this rather complicated computation is that the U.S. parent obtains the same foreign tax credit as it would have gotten had it operated through a branch rather than a subsidiary.

A. Investment in U.S. Property

As indicated above, the tax laws require a U.S. parent to treat as a constructive dividend any net increase in a foreign subsidiary's investment of accumulated earnings in U.S. property. This exception to the general rule of "deferral" is directed primarily against the acquisition of the stock or debt obligations of the U.S. parent or related U.S. corporations, since such investments are, in many cases, tantamount to a distribution of dividends. However, prior to the Tax Reform Act, the term "U.S. property" was broadly defined to include the stock or debt obligations of any U.S. corporation, whether related or not. The Tax Reform Act changes this by narrowing the definition of "U.S. property" to include only the stock or obligations basically of the U.S. parent and U.S. corporations at least 25 percent owned by the U.S. parent.[22]

The Tax Reform Act also limits the definition of "U.S. property" to exclude movable drilling rigs and related oil exploration and production equipment used on the Continental Shelf. The purpose of this exclusion is to promote the exploration for oil in and around U.S. territorial waters.

B. Less Developed Country Corporations

Under prior law, the general requirement of dividend treatment on the sale of stock in a foreign subsidiary (mentioned above) did not apply where that subsidiary was a less developed country corporation. However, in many cases this

20. I.R.C. § 902.
21. I.R.C. § 78.
22. TRA § 1021, *amending* I.R.C. § 956(b)(2)(F)-(G).

exemption was a mixed blessing. Although the U.S. parent was entitled to treat the entire gain as capital gain, the lack of dividend treatment deprived the parent of the deemed-paid foreign tax credit. Effective for taxable years beginning after December 31, 1975, the Tax Reform Act extends the requirement of dividend treatment to the sale of stock in a less developed country corporation.[23] However, the requirement does not apply to the extent that the "dividend" would be out of pre-1976 earnings.

Prior law also accorded special treatment for the deemed-paid foreign tax credit from less developed country corporations. Although the deemed-paid foreign tax included only the tax attributable to the net income (after foreign tax) from which the distribution was made, the amount of the deemed-paid tax was not subject to the gross-up requirement discussed above. In many cases, this special treatment produced a more favorable foreign tax credit and was consistent with the general policy of promoting investment in less developed countries. The Tax Reform Act repeals the special treatment effective for taxable years beginning after December 31, 1975.[24] However, for dividends out of pre-1976 earnings, the repeal does not take effect until January 1, 1978. The loss of special treatment for the deemed-paid foreign tax credit will tend to discourage the continuing investment necessary to the growth of less developed countries, including the further development of their mineral resources.

III. REORGANIZATIONS INVOLVING FOREIGN SUBSIDIARIES

Acquisitions and mergers involving foreign subsidiaries, the organization of such subsidiaries, and their liquidation into a domestic parent are all transactions which, under prior law, required an advance ruling by the Internal Revenue Service that tax avoidance was not one of the transaction's principal purposes. In the absence of this advance ruling, the tax-free treatment to which such transactions are ordinarily entitled was denied.

In recognition of the extraordinary delays which the advance ruling requirement often created, the Tax Reform Act

23. TRA § 1022, *amending* I.R.C. § 1248(d)(3).
24. TRA § 1033, *amending* I.R.C. § 902.

replaces it with a new and more flexible set of procedures.[25] In the case of so-called "outbound" transactions (*e.g.*, the organization of a foreign subsidiary) a ruling need not be requested until 183 days after the transaction has begun. In the case of "inbound" transactions (*e.g.*, the liquidation of a foreign subsidiary) and in the case of exclusively foreign transactions (*e.g.*, the acquisition of a foreign subsidiary by another foreign corporation) the ruling requirement will be dispensed with entirely. In general, these changes are effective for transactions begun after October 9, 1975. However, the repeal of the ruling requirement for "inbound" transactions and exclusively foreign transactions will not take effect until 1978. In the meantime, these transactions will be governed by the procedures for "outbound" transactions.

IV. SPECIAL TRADE AND INVESTMENT INCENTIVES

The tax laws have long granted a number of positive incentives in the foreign area in order to promote particular national interests. Such incentives are granted to corporations which meet the definitional requirements of certain specialized trade and investment vehicles. These specialized vehicles include the Western Hemisphere Trade Corporation (WHTC) and the Possessions Corporation, both of which are affected by the Tax Reform Act. Another vehicle in this category is the Domestic International Sales Corporation (DISC). Although DISCs are affected by the Tax Reform Act in a number of ways, these changes are generally irrelevant here, since natural resources were excluded from DISC benefits by the Tax Reduction Act of 1975, effective for sales made after March 18, 1975.[26] The only change that the Tax Reform Act makes in this connection is to provide a limited reprieve for natural resources being sold pursuant to fixed contracts entered into on or before March 18, 1975. Such sales will continue to qualify for DISC benefits until March 18, 1980.[27]

A. Western Hemisphere Trade Corporations

Prior to the Tax Reform Act, a WHTC was entitled to a special deduction which reduced its effective tax rate by almost 14 percentage points. In order to qualify for this benefit, the

25. TRA § 1042, *amending* I.R.C. § 367.
26. Tax Reduction Act § 603(b), *amending* I.R.C. § 993(c)(2).
27. TRA § 1101(f), *amending* Tax Reduction Act § 603(b)(1).

corporation had to be incorporated in the United States and conduct its trade or business (other than incidental purchases) exclusively within North, Central, or South America or the West Indies. In addition, the corporation had to meet certain percentage tests as to the character and source of its income. First, it had to derive at least 90 percent of its gross income from the active conduct of a trade or business. Secondly, it had to derive at least 95 percent of its gross income from sources outside the United States.

Under the Tax Reform Act, the WHTC benefit is phased out over a 4-year period beginning with 1976.[28] The 14 percentage point reduction in effective tax rate is lowered to 11 percentage points for 1976, eight for 1977, five for 1978 and two for 1979. Commencing with 1980, the WHTC provisions are repealed.

B. Possessions Corporations

For a corporation to qualify as a Possessions Corporation, it must be incorporated in the United States, and must (i) derive at least 80 percent of its gross income from sources within a U.S. possession *(e.g.,* Puerto Rico) and (ii) derive at least 50 percent of its gross income from the active conduct of a trade or business within that possession. Under prior law, a Possessions Corporation could exclude from gross income its possessions source income together with all *other* foreign source income. Effective in 1976, the Tax Reform Act replaces this exclusion with an elective tax credit equal to the U.S. tax attributable to the corporation's foreign source income from its possessions trade or business and from "qualified" possessions investments.[29] One of the stated purposes of this change was to eliminate the benefit which prior law had afforded to all *other* foreign source income and thereby end the incentive for reinvesting possessions earnings in foreign countries or in possessions other than the one in which the corporation conducts its trade or business. In keeping with this purpose, "qualified" possessions investments are limited to investments in the possession where the trade or business is conducted.

Under prior law, dividends paid by a Possessions Corpora-

28. TRA § 1052, *amending and repealing* I.R.C. §§ 921-22.

29. TRA § 1051(c), *amending* I.R.C. § 931; TRA § 1051(b), *adding* I.R.C. § 936.

tion were ineligible for the dividends-received deduction; therefore, it was the usual practice for the corporation to accumulate its earnings for a long period of time, until these earnings could be passed up in a tax-free liquidation. For the purpose of encouraging a more rapid reinvestment of possessions earnings in the United States, the Tax Reform Act extends the dividends-received deduction to include dividends paid by a Possessions Corporation.[30]

V. COMPENSATION OF U.S. EMPLOYEES ABROAD

The Tax Reform Act makes a number of changes in the foreign earned income exclusion which will substantially increase the cost of maintaining U.S. employees abroad. Under prior law, individuals employed overseas could exclude from their income up to \$20,000—and in some cases \$25,000—of their salaries. Moreover, in computing their foreign tax credit, such individuals could treat the foreign taxes paid on their excluded income as being attributable to their *non*excluded income. In some cases, this had the effect of increasing the amount of the income exclusion.

The Tax Reform Act replaces both the \$20,000 and the \$25,000 exclusion with a single maximum exclusion of \$15,000.[31] In addition, it eliminates any foreign tax credit for foreign taxes paid on the excluded amount. Finally, it requires that the exclusion be ignored in determining the rates at which any nonexcluded income is taxed.

30. TRA § 1051(f), *amending* I.R.C. § 243(b).
31. TRA § 1011, *amending* I.R.C. § 911.