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John S. Stroebe

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## REVENUE RULING 74-550 AND THE EFFECTS OF FOREIGN LOSSES

Generally, a United States corporation is taxed on net income "from whatever source derived."<sup>1</sup> There are, however, two significant exceptions to this general rule in the taxation of foreign source income. The first is the foreign tax credit.<sup>2</sup> The second is the treatment accorded the income earned abroad by subsidiaries of United States corporations.<sup>3</sup>

The direct foreign tax credit first appeared in the 1919 revision of the Revenue Act. Prior to that time, foreign taxes, like state and local taxes, had been treated as deductible expenses in the calculation of federal taxable income. This practice was severely criticized by corporate interests which alleged that it resulted in "double taxation" and placed United States companies operating abroad at a competitive disadvantage vis-a-vis local enterprises. The upshot of this criticism was the enactment of section 238 of the Revenue Act of 1919 which provided a tax credit for "any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein . . . ."<sup>4</sup>

The second major "exception"<sup>5</sup> to the United States taxation of for-

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1. INT. REV. CODE OF 1954 § 11.

2. The foreign tax credit may be direct or indirect. U.S. corporations which have paid taxes directly to a foreign government are entitled to "direct" tax credits under § 901 of the 1954 Internal Revenue Code. The "indirect" foreign tax credit, found in § 902 of the 1954 Code, allows a 10 percent or more United States corporate shareholder which has received dividends from a foreign subsidiary corporation to credit its pro rata share of the income, war-profits, or excess-profits taxes paid by the controlled foreign corporation to a foreign government.

3. For an excellent encapsulated discussion of the significant features of these two exceptions, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS* §§ 17-23 (3d ed. 1971). See also Surrey, *The United States Taxation of Foreign Income*, 1 J. LAW & ECON. 72, 73 (1958).

4. Rev. Act of 1919, ch. 18, § 238, 40 Stat. 1080 (now INT. REV. CODE OF 1954 §901).

5. The use of the word "exception" in this context is not intended to be in any way pejorative. A strong case can be made for the view that the deferral of United States taxes granted the income earned abroad by a United States subsidiary corporation is not in any sense an exception to the general operation of the concepts embodied in the Internal Revenue Code, but rather a logical deduction from one of its most basic principles: that an entity is taxed only upon the income that is fairly attributed to it.

The subsidiary corporation, like any other corporation, is generally regarded as a separate tax entity from the corporate parent. This general rule holds true whether the subsidiary corporation is domestic or foreign. Only in rare circumstances do the tax laws disregard the corporate fiction and attribute the income of one corporation to a legally separate, but related, entity.

foreign source income is the total deferral of United States tax which is accorded the profits earned abroad by United States subsidiary corporations. These profits are not taxed by the United States as earned and only become subject to United States taxes as they are repatriated in the form of dividends or otherwise. Since 1921, an indirect foreign tax credit has been available to prevent a double taxation of these profits at the corporate level.<sup>6</sup>

The mechanics of the section 902 calculation are relatively straightforward when the distributing foreign corporation has been consistently profitable with no intervening earnings and profits loss years.<sup>7</sup> The effect of such earnings and profits loss years on the calculation of the section 902 credit for prior or subsequent years, however, has long been a matter of speculation. Revenue Ruling 74-550<sup>8</sup> provides procedures for tracing each dollar of any given dividend distribution to the accumulated profits of a single past year.<sup>9</sup> Almost as an aside, the ruling establishes procedures for the carrying back of the earnings and profits deficits incurred in loss years to reduce the earnings and profits surplus accounts of prior years. This Note will be devoted in large part to elucidating the broader implications of the ruling for the treatment of foreign losses, a topic that hitherto has been largely ignored by the commentators. This is not surprising, considering the previous profitability of United States foreign investment.<sup>10</sup> However, the financial climate, which was so favorable to United States overseas investment throughout the 1960's, has undergone drastic changes. The current worldwide recession, coupled with frequent and unpredictable monetary adjustments and foreign expropriations, should cause a marked decrease in the profitability of United States overseas investment and a concomitant increase in the importance of foreign losses.<sup>11</sup>

## I

### THE STATUTE

There are currently two sets of provisions for the calculation of the

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6. § 238(e) of the Rev. Act of 1921, 42 Stat. 258, later § 131(f) of the 1928 Act and currently § 902 of the INT. REV. CODE OF 1954.

7. See the explanation of the § 902 calculation at note 14 *infra*.

8. Rev. Rul. 74-550, 1974 INT. REV. BULL. NO. 45, at 14.

9. A year-by-year calculation of the § 902 credit and hence the importance of determining the exact source year of any given distribution is the consequence of the *General Foods* case. See text accompanying notes 21-23 *infra*.

10. See Gifford, *United States Tax Effects of Foreign Losses*, 83 YALE L.J. 312 (1973).

11. See Rose, *Multinational Corporations in a Tough New World*, FORTUNE, Aug. 1973, at 52, 134. See also Gifford, *United States Tax Effects of Foreign Losses*, *supra* note 10, at 315.

indirect foreign tax credit. The first, appearing in section 902(a)(1) of the Code, regulates the calculation of the credit for a non-less developed country corporation; section 902(a)(2) sets out a different formula in the event the distributing foreign corporation does qualify as a less developed country corporation.<sup>12</sup> Generally, section 902(a)(1) provides that a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends during the taxable year may, to the extent such dividends are paid out of the accumulated profits of the foreign corporation,<sup>13</sup> elect to take a credit for its pro rata share of the taxes paid by the subsidiary to the foreign government. The credit or "deemed paid" foreign tax is to bear the same proportion to the foreign taxes actually paid by the subsidiary on or with respect to its accumulated profits as the amount of the dividend bears to the amount of accumulated profits in excess of foreign taxes.<sup>14</sup>

12. The definition of the less developed country corporation appears in § 902(d) of the INT. REV. CODE OF 1954.

13. The term "accumulated profits" is defined in § 902(c)(1)(A) of the INT. REV. CODE OF 1954.

14. Mathematically, this could be expressed as follows:  $\frac{FTC}{Tw} = \frac{D}{AP - FT}$ , or  $FTC = \frac{D}{AP - FT} \times Tw$ ; where FTC equals the allowable foreign tax credit, D equals the dividend received by the domestic corporation claiming the credit, AP equals the accumulated profits of the distributing corporation, and Tw equals the foreign taxes paid by the distributing corporation on or with respect to its AP. Section 902(c)(1)(A) defines AP for the non-less developed country corporation as the amount of gains unreduced by the taxes paid to the foreign government. As the total gains of the corporation could be expressed by adding the amount of foreign taxes (FT) paid to the corporation's after-tax earnings and profits (E&P), then substituting E&P + FT for AP in the above equation we have:

$$FTC = \frac{D}{E\&P + FT - FT} \times Tw = \frac{D}{E\&P} \times Tw.$$

The language of § 902(a)(2) yields a similar formula for the less developed country corporation:  $\frac{FTC}{Tw} = \frac{D}{AP}$ . As § 902(c)(1)(B) defines AP for purposes of the less developed country corporation calculation as the corporation's total gains in excess of the foreign taxes imposed on such gains, the statutory formulas, at first glance, seem to differ not at all. The difference only becomes apparent when the *American Chicle* fraction is applied to the two formulas. See *American Chicle Co. v. United States*, 316 U.S. 450 (1942). For examples highlighting this difference, see Treas. Reg. § 1.902-3(i), Ex. 1 and 2 (1973). This Note only considers the case where the distributing foreign corporation is a non-less developed country corporation, because (a) the less developed country corporation calculations are quantitatively unimportant, and (b) they are likely to be legislated out of the Code in the near future. See H.R. 17,488 93d Cong., 2d Sess. § 343 (1974), reported to the House on Nov. 26, 1974, H.R. Rep. No. 1502, 93d Cong., 2d Sess. (1974), which eliminated the separate calculation for the less developed country corporation. The final product, the Tax Reduction Bill of 1975, Pub. L. No. 94-12, 89 Stat. 26 (codified in

In *American Chicle Co. v. United States*,<sup>15</sup> the Supreme Court interpreted the phrase "taxes paid . . . upon or with respect to [such] accumulated profits . . ." <sup>16</sup> The Court reasoned that the total taxes paid by the subsidiary in question were levied on the entire pre-tax earnings and profits of the distributing corporation, whereas only the subsidiary's after tax earnings and profits were available for eventual distribution and taxation in the United States:

The subsidiary pays tax on, or in respect of, its entire profits; but, since the parent receives distributions out of what is left after payment of the foreign tax—that is, out of what the statute calls "accumulated profits," it should receive a credit only for so much of the foreign tax paid as relates to or, as the Act says, is paid upon, or with respect to, the accumulated profits.<sup>17</sup>

Thus, the Court held that the statutory phrase "taxes paid . . . upon or with respect to [such] accumulated profits" required the application of a further ratio to the total amount of foreign taxes paid to determine just how much of those taxes was paid on or with respect to the accumulated profits of the corporation.<sup>18</sup> Underlying the Court's reasoning is the notion that, to be creditable, each dollar of foreign tax must be traceable to earnings that will be eventually distributed and taxed in the United States.<sup>19</sup>

In 1944 the requirements of section 902<sup>20</sup> were further refined by judicial decision in the *General Foods* case,<sup>21</sup> in which the Tax Court ruled

scattered portions of 26 U.S.C.A.), significantly cut back on the favored treatment accorded the less developed country corporation.

15. 316 U.S. 450 (1942).

16. Rev. Act of 1938, § 131(f). This section was the forerunner of § 902 of the INT. REV. CODE OF 1954.

17. 316 U.S. at 452-53 (1942). The petitioner in the case had argued that its indirect foreign tax credit be determined by applying the statutory ratio of the dividend received over the accumulated profits of the distributing corporation to the total amount of taxes paid by the distributing corporation to the foreign government.

18. To determine the tax paid on or with respect to the subsidiary's accumulated profits (Tw), we multiply the total taxes paid by the subsidiary to the foreign government (FT) by the ratio of the accumulated profits of the subsidiary to its total pre-tax gains (G):

$$Tw = FT \times \frac{AP}{G} \text{ For a non-less developed country corporation } AP = G, \text{ and therefore,}$$

$$FTC = \frac{D}{E\&P} \times FT. \text{ For further clarification of the } Chicle \text{ fraction, see E. OWENS \& G.}$$

BALL, THE INDIRECT CREDIT 73-77 (1975) [hereinafter cited as OWENS & BALL].

19. Earlier in the opinion, the Court noted that the purpose of the section was to avoid "double taxation." This goal would require only that the taxpayer receive a credit for so much of the foreign taxes that were paid on income that was also ultimately taxable in the United States.

20. Then § 131(f) of the Rev. Act of 1938.

21. 4 T.C. 209 (1944).

on the proper method of calculating the foreign tax credit due an American corporation which had received dividends from certain Canadian subsidiaries during the taxable year by virtue of the taxes paid the Canadian government by the distributing subsidiary corporations. The petitioner argued that the term "accumulated profits" should be construed not as relating to the accumulated profits of a particular accounting year, but as referring to the *entire amount* of the accumulated profits of the foreign corporation—as such, as synonymous with the corporation's earned surplus.<sup>22</sup> Similarly, it argued that the dividend received in 1935 (though larger than the accumulated profits for that year and as such attributable to the accumulated profits of prior years as well) should also be considered as a single sum. Thus construed, the statute would require a single application of the statutory formula to determine the allowable foreign tax credit. The court rejected this interpretation, however, and held in favor of the Commissioner, whose method demanded that each of the above criteria be segregated by annual periods:

Taxes are imposed on the profits of an accounting year or period and the term "accumulated profits" as defined in the subsection would indicate a meaning of annual accumulated profits rather than accumulated profits in the nature of a surplus. To properly give effect to the language of the subsection, it is necessary to relate the tax credit to the particular year or years in which the accumulated profits (from which the dividends were paid) were earned and taxed.<sup>23</sup>

The result of this holding is that "[t]he credit is calculated just as if the foreign corporation had distributed its profits currently rather than accumulating them over several years. Averaging of the foreign tax rates over the years is thus precluded."<sup>24</sup>

## II

### EARNINGS AND PROFITS VERSUS ACCUMULATED PROFITS

For the purposes of section 902 it is important to distinguish between the terms "accumulated profits" and the more familiar "earnings and profits." For a non-less developed country corporation the term "accumulated profits" is defined as the gains of the corporation undiminished by the foreign taxes imposed on those gains.<sup>25</sup> The term which appears in the denominator of the section 902(a)(1) fraction is accumulated profits in excess of the taxes imposed on gains. Generally, then, the

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22. Petitioner's argument would essentially equate "AP" with the accumulated E&P of § 316(a)(2).

23. 4 T.C. 209, 216 (1944).

24. OWENS & BALL 81.

25. INT. REV. CODE OF 1954, § 902(c)(1)(A).

denominator of the fraction is equivalent to the more common term "earnings and profits." However, for many of the statutory purposes, it is important to distinguish between the two terms.

Two other sections of the Code, sections 316 and 243, utilize concepts similar to the term "accumulated profits" in section 902 and thus provide useful analogues for determining the effects of various tax events, notably losses and distributions, on accumulated profits for purposes of the section 902 credit.

#### A. LOSSES UNDER SECTION 316

Section 316 of the Code defines the term "dividend," for "purposes of this subtitle,"<sup>26</sup> as any distribution made by a corporation to its shareholders out of either its accumulated or current earnings and profits. For section 316 dividend determination purposes, then, there are only two significant groupings of earnings and profits—the earnings and profits accumulated since February 28, 1913 and the earnings and profits of the current year.<sup>27</sup> If a distribution is made out of either of these earnings and profits "pots," it is denominated a dividend and will be taxed to its recipient at ordinary income rates. The regulations under section 316 do not permit an accumulated earnings and profits deficit to carryover to reduce the earnings and profits of the current year,<sup>28</sup> and therefore current earnings and profits, as calculated at the close of the taxable year,<sup>29</sup> remain inviolate except for gains or losses accruing in the current year.<sup>30</sup> However, an earnings and profits deficit in the current

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26. *I.e.*, Subtitle A which includes § 902.

27. In very rare instances, if a loss in the current year exceeds the earnings and profits accumulated since Feb. 28, 1913, it may carryback even further to reduce the accumulated earnings and profits as of Mar. 1, 1913. *See* Treas. Reg. § 1.316-2(a) (1960).

28. To this effect, see Treas. Reg. § 1.316-1(d), Ex. 1 (1968) and § 1.312-6(d) (1960): "A loss sustained for a year before the taxable year does not effect the earnings and profits of the taxable year." The 1934 case, *Arthur Stifel*, 29 B.T.A. 1145 (1934), which suggested a contrary result, has not been followed.

29. *See* Treas. Reg. § 1.316-1(a)(1) (1968).

30. A rare example of an event tied to an earlier taxable year whose consequences affect the earnings and profits of the current year is found in Rev. Rul. 64-146, 1964 CUM. BULL. 129. In the example given in the Ruling, the carryback of a net operating loss to an earlier year resulted in the elimination of taxable income for the earlier year [note that the Ruling says nothing about the effect of the carryback on the earnings and profits of the carryback year; under § 316 the carryback would merely reduce the accumulated earnings and profits of the corporation generally. *See* note 31 *infra*.] and hence a refund of the taxes paid in that earlier year. The Ruling indicates that the refund of the prior year's taxes will be reflected in the current year's earnings and profits—the year in which the right to the refund accrued—thus presumably reducing the year's earnings and profits deficit. The Ruling makes no mention of the effect of the refund on the current year's taxable income. Logically there could be none, since otherwise the loss would have a bootstrapping effect.

year will "carryback" to reduce the surplus of accumulated earnings and profits generally.<sup>31</sup>

### B. LOSSES UNDER SECTION 243

Section 243 contains the rules to be followed in determining the dividend received deduction. The effect of current earnings and profits defi-

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31. The use of the term "carryback" in this context is perhaps a misnomer. The deficit in the current earnings and profits account will not be carried back in the sense that a net operating loss deduction under § 172 is carried back. This is because losses are fully deducted currently in arriving at the current year's earnings and profits. See H. EDELSTEIN, *EARNINGS & PROFITS—GENERAL PRINCIPLES & TREATMENT OF SPECIFIC ITEMS A-30* (Tax Management No. 175-2d, 1975):

For income tax purposes a corporate taxpayer is allowed to deduct for the taxable year the sum of the net operating loss carryovers and carrybacks to such year . . . . For earnings and profits purposes, such net operating loss carryovers and carrybacks are not taken into account inasmuch as the amount of each year's net operating loss is subtracted in full in arriving at that year's earnings and profits; the year of loss was, after all, the year in which corporate resources available for distribution were depleted by the amount of the loss. (footnote omitted)

Therefore, a net operating loss carryback under § 172, while reducing taxable income for the year of the carryback, will leave the carryback year's earnings and profits unaffected (if we were to make such a calculation of an individual past year's earnings and profits). To do otherwise would be to allow the same earnings and profits loss to reduce the accumulated earnings and profits account twice—once by virtue of the carryback and again when the negative earnings and profits figure for the current year passed into the ledger of accumulated earnings and profits with the start of a new taxable year. See *BITTKER & EUSTICE, supra* note 3, at 7-17, where the authors note that "[t]he net operating loss deduction of § 172 cannot be used to reduce earnings and profits, since it is simply a carryback or carryover of losses that reduced earnings and profits in the year they occurred."

Thus, there is no allocation of the loss for § 316 purposes to any given year's earnings and profits; it merely decreases the accumulated earnings and profits account generally. The "carryback" occurs by virtue of the definition of accumulated earnings and profits, rather than by operation of any particular Code section. The earnings and profits deficit of the current year will "carryback" when a new current taxable year begins and the old "current year" and its fixed earnings and profits deficit merges into the accumulated earnings and profits account which subsumes all past year's earnings and profits up to the current year. To illustrate this point and its potential importance assume the case where a corporation has been in operation just two years:

<u>Year</u>	<u>E&amp;P</u>	<u>D</u>
1975	\$100,000	
1976	(\$200,000)	\$100,000

The distribution of \$100,000 to a shareholder in 1976 will be considered a dividend out of accumulated earnings and profits. The current earnings and profits deficit will not "carryback" to eliminate the \$100,000 accumulated earnings and profits surplus until the start of the taxable year 1977.

cits under section 243 is especially interesting for our purposes because section 243 is one of the few sections in the Code which contemplates a year-by-year segregation of past earnings and profits.<sup>32</sup> Under this section, a dividend is to be treated as distributed first out of the earnings and profits of the year during which the distribution is made, and then, to the extent the dividend exceeds the earnings and profits of the current taxable year, out of the earnings and profits of the immediately preceding taxable year, the next preceding taxable year, etc.<sup>33</sup> As for losses, the regulations specify:

[a] deficit in an earnings and profits account for any taxable year shall reduce the most recently accumulated earnings and profits for a prior year in such account. If there are no accumulated earnings and profits in an earnings and profits account because of a deficit incurred in a prior year, such deficit must be restored before earnings and profits can be accumulated in a subsequent year.<sup>34</sup>

The regulations under section 243, then, allow for both carrybacks and carryovers of deficits in any given year's earnings and profits account. What must be kept in mind, however, is that the carrybacks and carryover rules provided under section 243 are relevant only for determining the source year of a given distribution. As such they are only applied in the year of the dividend distribution to determine from what year's earnings and profits that distribution was derived. Tax events subsequent to the year of distribution will have no effect on the source determination.<sup>35</sup>

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32. Under this section it may be important to determine the exact year from which a dividend is derived. *See* Treas. Reg. § 1.243-4(a)(7), Ex. 2 (1969). The dividend will not qualify for treatment under this section if it is derived from a year during which the two corporations were not members of an affiliated group.

33. Treas. Reg. § 1.243-4(a)(6) (1969).

34. *Id.*

35. Consider the following examples:

	<u>E&amp;P</u>	<u>D</u>
1969	10,000	
1970	4,000	
1971	5,000	
1972	(6,000)	
1973	8,000	10,000

Following the source rules of § 243 we would determine that the 1973 distribution was derived as follows:

D Source

1970	2,000
1971	0
1972	0
1973	8,000

### C. THE EFFECT OF DISTRIBUTIONS AND LOSSES ON ACCUMULATED PROFITS PRIOR TO REVENUE RULING 74-550

We start with the general principle announced in Revenue Ruling 63-6:

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."<sup>36</sup>

This rule, unfortunately, seems more honored in the breach than in the observance. The area of corporate distributions is one in which discrepancies between earnings and profits and accumulated profits become readily apparent. To qualify as a dividend, a distribution must be paid out of the earnings and profits of the distributing corporation. However, for purposes of the section 902 indirect foreign tax credit, a dividend must be paid out of the distributing corporation's accumulated profits. Thus, ". . . it is possible to have a dividend includible in income without being entitled to a foreign tax credit."<sup>37</sup>

The classic example of this was the situation litigated in *H.H. Robert-*

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Now, assume that in 1974 the same corporation incurred a loss of \$8,000 and made a distribution of \$3,000:

	<u>E&amp;P</u>	<u>D</u>	<u>D Source</u>
1969	10,000		3,000
1970	1,000		
1971	0		
1972	0		
1973	0		
1974	(8,000)	3,000	

The 1974 loss year would not require any recomputation of the source of the 1973 distribution. The amount of the distribution itself is deducted from the earnings and profits of the various years then on hand and is treated just as if it were paid out currently in the deemed source year. See OWENS & BALL 171:

. . . the amount of current earnings and profits is unaffected by losses sustained in years prior to or subsequent to the year of the distribution. In other words, when an operating loss is applied against accumulated earnings and profits, it is not applied to the extent that the profits were distributed as a dividend in the year in which they were earned. (footnote omitted)

The 1974 loss can only be applied against the excess of an earnings and profits account remaining after that account has been reduced by the amount of the distribution deemed to have been derived from that year (e.g. the \$1,000 remaining in the earnings and profits account of 1970).

36. Rev. Rul. 63-6, 1963-1 CUM. BULL. 126, 128.

37. Fuller, *The "Deemed Paid" Foreign Tax Credit*, paper presented to the World Trade Institute, Nov. 20-22, 1974, at 4.

*son Co. v. Commissioner*.<sup>38</sup> The petitioner was a domestic corporation which had decided to liquidate its wholly-owned foreign subsidiary (S1). It received a section 367 ruling in advance of the liquidation under which it was to include the accumulate earnings and profits of the foreign subsidiary in its gross income as a dividend.<sup>39</sup> Two years prior to the liquidation the petitioner had received an in-kind dividend of its subsidiary's stock-holdings in a second subsidiary (S2) which had a basis in S1's hands equal to only about one-eighth of the stock's fair market value on the date of distribution. For the year of the distribution the parent corporation had included the full fair market value of the in-kind distribution in its gross income as required under section 301(b)(1)(C). For purposes of calculating the section 902 credit as well, the relevant figure is the fair market value of the property distributed, and hence the Tax Court held that S1's accumulated profits were to be reduced by the full fair market value of the distribution. However, under section 312(a)(3), S1's earnings and profits may only be reduced by the adjusted basis of the stock. This resulted in a substantial difference between the amount of S1's accumulated profits and its accumulated earnings and profits. Thus, the final dividend which had to be included in the parent's gross income was much larger than S1's remaining accumulated profits, with the result that a large part of the liquidating distribution was not out of the accumulated profits of the distributing foreign corporation and thus no foreign tax credit was available with respect to that excess. The court noted in its opinion that the more familiar term "earnings and profits"<sup>40</sup> is to be "sharply distinguished" from the corporation's "accumulated profits," which is "solely an *annual* concept." For the purposes of section 902, then, the court concluded that any given dividend distribution must be traced to the "accumulated profits" of a particular year or years.<sup>41</sup>

Prior to Revenue Ruling 74-550, two cases provided authority for the effect of carryback losses on prior years' accumulated profits: *Pacific Gamble Robinson Co. v. United States*<sup>42</sup> and *Steel Improvement and Forge Co. v. Commissioner*.<sup>43</sup> The facts of the two cases were similar and can be illustrated by the following chart:

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38. 59 T.C. 53 (1972).

39. As required under Rev. Pro. 68-23, 1963-1 CUM. BULL. 821.

40. Which the Court characterized as the "aggregate of a corporation's undistributed profits . . . out of which taxable dividends are payable without regard generally to the year or years when such profits were earned . . ." 59 T.C. 53, 78 (1972).

41. 59 T.C. 53, 78-79 (1972).

42. 62-1 U.S. Tax Cas. 9160 (W.D. Wash. 1961).

43. 36 T.C. 265 (1961).

<u>Year</u>	<u>E&amp;P</u>	<u>D</u>
1951	1X	
1952	2X	1X
1953	(2X)	

In 1952 the taxpayer corporation received a dividend paid out of current (1952) earnings and profits. The taxpayer accordingly took a section 902 tax credit of one half of the taxes paid by the distributing corporation to the Canadian Government in 1952 ( $FTC = 1X/2X \times FT$ ). In 1953, however, the foreign subsidiary incurred a net operating loss which under the carryback provisions of Canadian law eliminated its taxable income for 1952 and resulted in a total refund of 1952 taxes. Pursuant to section 905(c) the petitioner notified the Commissioner of the refund and recomputed its foreign tax credit,<sup>44</sup> treating the distribution as having been made out of the accumulated profits of 1951, apparently assuming that the 1952 accumulated profits had been wiped out by the net operating loss carryback. The Commissioner disallowed the taxpayer's claim, asserting that the 1952 accumulated profits remained unaffected by the loss carryback and that therefore the distribution was still deemed to have come from the accumulated profits of 1952. However, because of the total tax refund, there were no foreign taxes paid on or with respect to such accumulated profits and therefore no foreign tax credit was allowable. Both courts agreed with the Commissioner and disallowed the foreign tax credit claimed by the petitioners, although neither court gave a satisfactory explanation of its decision. To the extent, however, that the result implies that the accumulated profits of a past year will be unaffected by the carryback of a net operating loss deduction,<sup>45</sup> the court's handling of accumulated profits seems consistent with the source determination rule of section 243.<sup>46</sup>

44. Notice of the refund was given the Commissioner only in *Pacific Gamble*—in the *Steel Improvement* case the petitioner had disposed of its stock in the foreign corporation and was thus unaware of the tax refund.

45. At least to the extent those accumulated profits were either distributed currently or deemed distributed currently by application of the source rule of § 243.

46. Because in each instance the carryback resulted in a complete elimination of foreign taxable income in the carryback year and thus a full refund of the foreign tax paid, the court did not have to deal with the question of whether or not the carryback of a net operating loss deduction would reduce the accumulated profits denominator of the § 902 fraction apart from dividend source determination purposes. To illustrate this point, consider again the example given at note 35 *supra* (slightly altered to increase the 1972 deficit to \$7,000):

<u>Year</u>	<u>AP</u>	<u>D</u>	<u>FT(50%)</u>
1969	\$10,000		\$5,000
1970	\$4,000		\$2,000
1971	\$5,000		\$2,500
1972	(\$7,000)		0
1973	\$8,000	\$10,000	\$4,000

Yet the court's conclusion that the refund of the foreign taxes (under the carryback provisions of Canadian law) precluded the United States parent corporation from taking a foreign tax credit on the distribution seems inconsistent with Revenue Ruling 64-146.<sup>47</sup> In that ruling, the Service indicated that a tax refund due to the carryback of a net operating loss will affect the corporation's earnings and profits for the year in which the refund was received. Extrapolating the application of this ruling to the situation in *Pacific Gamble* and *Steel Improvement* (where a foreign subsidiary receives a foreign tax refund), it would seem that the tax refund would have the effect of increasing the subsidiary's earnings and profits for the year of the refund and thus reducing any foreign tax credit claimed for that year proportionately by increasing the denominator of the section 902 fraction.<sup>48</sup> Combining this ruling with the principles announced in *Pacific Gamble* and *Steel Improvement*, the effect of such a tax refund would be to reduce the claimed foreign tax credit in two different years by reducing the foreign taxes paid in the carryback as well as increasing the earnings and profits in the year of the refund. Such a result would seem unduly harsh.

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Applying the 1972 earnings and profits deficit to the accumulated yearly earnings and profits accounts of 1971 and 1970 (as mandated by § 243), we find the source of the 1973 dividend to be:

<u>Year</u>	<u>D Source</u>
1969	0
1970	\$2,000
1971	0
1972	0
1973	\$8,000

But how are accumulated profits for purposes of § 902 fraction to be calculated? If the 1972 deficit were applied against accumulated profits for purposes of determining the denominator of the § 902 fraction in the same way they are applied under § 243 for determining the source of the distribution, then in 1970 the United States recipient of the dividend would be able to credit the entire foreign tax of \$2,000 (which was paid on foreign taxable income of \$4,000) even though he had only received a deemed distribution of \$2,000 out of 1970 accumulated profits. The other approach would be to leave accumulated profits for purposes of the § 902 denominator completely unaffected by the carryback of a net operating loss deduction. This is the approach suggested by § 316—a deficit of earnings and profits in the current year is deducted entirely currently and “carries back” only by operation of the section's definition of accumulated earnings and profits. See note 31 *supra*. See also OWENS & BALL 172:

. . . the only ground on which the court could have reached this conclusion is by reasoning that the dividend was from current earnings and profits, which, under § 316(a), are not reduced by losses in other years.

47. Rev. Rul. 64-146, 1964-1 CUM. BULL. 129.

48. The foreign subsidiary's earnings and profits for United States purposes are calculated by United States tax methods. To this effect see Rev. Rul. 63-6, 1963-1 CUM. BULL. 126, 127.

## III

## REVENUE RULING 74-550

This Ruling provides a rule for determining the source-year of a dividend distribution for purposes of section 902. The Ruling assumes that the applicable foreign law contains no provisions for the carryback or carryover of net operating losses. The factual situation of the Ruling is summarized in the following chart:

<u>Year</u>	<u>E&amp;P</u>	<u>For. Taxes</u>	<u>Deficits Applied</u>	<u>D. Source</u>
1964	\$55,000	0	0	\$10,000
1965	\$50,000	0	(\$10,000)	\$40,000
1966	(\$10,000)	0	0	0
1967	\$40,000	\$32,000	(\$10,000)	\$30,000
1968	\$20,000	\$18,000	(\$20,000)	0
1969	(\$30,000)	0	0	0
1970	\$20,000	\$20,000	0	<u>\$20,000</u>
				\$100,000

The Service, noting that section 902(c)(1) declares that the dividend shall be treated "as having been paid from the most recently accumulated gains, profits, or earnings," adopts the loss carryback rule found in Treas. Reg. § 1.243-4(a)(6) (1969).<sup>49</sup> The thrust of the Ruling is that the 1969 deficit in accumulated profits of \$30,000 will be carried back to eliminate the \$20,000 of accumulated profits earned in 1968, so that for purposes of determining the source year of the 1970 dividend, no foreign tax credit can be claimed on the basis of 1968 taxes and earnings and profits because there are no accumulated profits out of which a dividend can be paid. In the next paragraph, however, the Service states that had the dividend been paid out in 1968, a recalculation of the section 902 credit would not be necessitated by a subsequent loss year.

The implications of this statement are twofold: (1) that a subsequent earnings and profits deficit would not require a re-determination of the source of the 1968 dividend, regardless of whether it was paid completely out of current (1968) earnings and profits or partially "deemed derived"

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49. *Quaere* whether this source rule is consistent with the mandate of the language quoted in the text. The use of a current earnings and profits deficit to offset earnings and profits of the most *recent* taxable years results in pushing the deemed source year of the dividend further back than were such earnings and profits deficits not carried back at all. The statutory mandate that dividends should be treated as having been paid out of the most recently accumulated profits led many commentators to conjecture that if losses were to offset accumulated profits at all for source determination purposes, they would reduce the earliest accumulated profits and work their way forward.

from the earnings and profits of earlier years,<sup>50</sup> and (2) that the carryback of a subsequent year's earnings and profits deficit will not affect the earnings and profits<sup>51</sup> denominator of the section 902 fraction. The Service makes this second inference explicit in the next sentence of the Ruling:

A deficit in earnings and profits for a taxable year does not carryback or carryover to compute the earnings and profits for another taxable year, although such a deficit will reduce the accumulated profits available for distribution as a dividend.

Thus, Ruling 74-550 embodies a two-tier system, with losses affecting the most recently accumulated profits for source determination purposes, while having no effect at all on the earnings and profits denominator of the section 902 fraction.<sup>52</sup> The result of the Ruling, then, is to force the taxpayer to reduce the dividend numerator in the carryback year's foreign tax credit equation without allowing him to reduce the earnings and profits denominator correspondingly.<sup>53</sup> In so doing, the

50. This is consistent with the earlier observations about the effect of subsequent loss years on the determination of the source years of a dividend under § 243. See section II.B. *supra*. Once a distribution is made out of current earnings and profits or deemed made out of a past year's earnings and profits account, the amount of that year's earnings and profits is diminished by the amount of the distribution made or deemed made. Subsequent losses carried back to such a year can only offset any remaining earnings and profits.

51. Or, more accurately, the accumulated profits less the foreign taxes paid.

52. This latter result is consonant with the rules governing the effect of earnings and profits loss years on past earnings and profits under § 316. An earnings and profits loss year will not carryback to affect an individual earnings and profits account of a prior year.

53. To illustrate this, consider the following example:

<u>Year</u>	<u>E&amp;P</u>
1967	\$50,000
1968	\$20,000
1969	(\$10,000)
1970	\$20,000
Dividend in 1970 = \$50,000	

For purposes of ascertaining the dividend source, we utilize the carryback rules of Treas. Reg. § 1.243-4(a)(6) (1969) and conclude that:

<u>Year</u>	<u>D. Source</u>
1967	\$20,000
1968	\$10,000
1969	0
1970	\$20,000

However, this will apparently be another situation (as in *H.H. Robertson*) where the accumulated profits, constituting the source of the dividend, and the earnings and profits (or accumulated profits less the foreign taxes paid, the denominator of the § 902 fraction) of a year will be different for tax purposes. The Ruling says there will be no carryback of

Service has avoided a problem<sup>54</sup> pointed out by Owens and Ball in their recently published book on the foreign tax credit:

. . . the effect of reducing both the numerator and denominator of the credit fraction by the same figure is to increase the effective foreign tax rate . . . . One difficulty is that reducing both the numerator and the denominator of the allocation fraction gives anomalous results. The greater the portion of the year's earnings and profits that is offset by the loss, the higher the effective tax rate and the greater the benefit of the credit in relation to the amount taxable as a dividend. But as soon as the loss equals (or exceeds) earnings and profits for the year, the entire credit disappears.<sup>55</sup>

Thus, Owens and Ball conclude that subsequent earnings and profits loss years should operate only to reduce the dividend numerator of the credit fraction while leaving the earnings and profits denominator unaffected.<sup>56</sup>

Although the Ruling avoids the problem outlined above, it results in other apparent inequities.<sup>57</sup> Using the figures provided in the Ruling's example, consider the case where the 1970 distribution is in complete liquidation of the foreign corporation's earnings and profits—*e.g.*,

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the 1969 loss for purposes of re-calculating the earnings and profits of prior years. Therefore:

<u>Year</u>	<u>E&amp;P</u>
1967	\$50,000
1968	\$20,000
1969	(\$10,000)
1970	\$20,000

54. The problem is illustrated by the following example:

<u>Year</u>	<u>E&amp;P</u>	<u>Dividend</u>	<u>For. Taxes</u>
1972	500		200
1973	(450)	50	

Applying the 1973 accumulated profits deficit for source purposes, we would conclude that the entire \$50 dividend originated in 1972 earnings and profits. However, if the 1973 deficit were also applied for the purpose of determining the denominator (E&P) of the § 902 fraction, we would arrive at a fraction of one, meaning that the entire tax (\$200 assuming a 40 percent foreign tax rate) paid on 1972 earnings and profits would be creditable.

55. OWENS & BALL 174 (footnote omitted). The last statement is somewhat misleading in light of Rev. Rul. 74-550. The credit will merely be calculated by using the tax data of an earlier year, as once the accumulated profits of a year are wiped clean by the carryback of a subsequent loss year, the source of the dividend will be found in an earlier year. This may, however, result in a reduction of the allowable foreign tax credit if the effective foreign tax rate in the earlier year is lower.

56. *Id.* at 174-75.

57. The following example is taken from a letter from Randall K. C. Kau to William C. Gifford, Nov. 19, 1974.

\$145,000. In such a situation, it would seem that the recipient of the dividend should be allowed a section 902 credit for all the foreign taxes paid on or with respect to the distributed earnings and profits of the foreign corporation—a total of \$70,000. However, applying the loss carryback rule of Ruling 74-550, we conclude:

<u>Year</u>	<u>E&amp;P</u>	<u>D. Source</u>	<u>AP</u>	<u>FT</u>	<u>FTC</u>
1964	\$55,000	\$55,000	\$55,000	0	0
1965	\$50,000	\$40,000	\$50,000	0	0
1966	(\$10,000)	0	(\$10,000)	0	0
1967	\$40,000	\$30,000	\$40,000	\$32,000	\$24,000
1968	\$20,000	0	\$20,000	\$18,000	0
1969	(\$30,000)	0	(\$30,000)	0	0
1970	\$20,000	<u>\$20,000</u>	\$20,000	<u>\$20,000</u>	<u>\$20,000</u>
		\$145,000		\$70,000	\$44,000

The Ruling combined with the year-by-year principle of the *General Foods* case has resulted in a loss of \$26,000 of creditable foreign tax.<sup>58</sup>

#### IV

#### WHAT THE RULING LEFT OUT (SINS OF OMISSION)

This is an area where perhaps any rule is better than no rule at all. Yet, by explicitly refusing to consider the case where the applicable foreign law has provided procedures for the carryback of net operating losses and eventual tax refunds, the Ruling has failed to address one of the most difficult issues in this area.

One wonders, however, if some of the broader statements in the Ruling were meant to be limited to its stated prerequisite circumstances. For example, consider the conclusion that a "deficit in earnings and profits for a taxable year does not carry back or carry over to compute the earnings and profits for another taxable year . . ." This statement is couched in language that would seem to give it validity beyond the circumstances considered in the Ruling.<sup>59</sup> Does the Ruling then imply that there is to be no adjustment of a prior year's earnings and profits

58. Were the tax calculated without the year by year segregation demanded in the *General Foods* case, we would conclude:

$$\text{FTC} = \frac{\text{Tot D}}{\text{Tot AP}} \times \text{FT} = \frac{\$145,000}{\$145,000} \times \$70,000 = \$70,000.$$

59. Furthermore, as noted earlier in this Note, this result would be consistent with the rules governing the treatment of earnings and profits deficit years under § 316.

in light of subsequent operating losses<sup>60</sup> even when foreign law provides for carryback reductions to foreign taxable income and eventual tax refunds?

Logically, there are six possibilities:

a) Earnings and profits in the carryback year could be reduced by the amount of any earnings and profits deficit properly carried back to that year under either United States or the applicable foreign law provisions. This approach has the difficulties pointed out by Owens and Ball earlier, and Revenue Ruling 74-550 appears to rule out this result.

b) The foreign taxes actually paid by the foreign corporation in the year of the carryback could be reduced by the amount of any tax refund allowed in the current year by the carryback provisions of foreign law. This result would be contrary to the result suggested by Revenue Ruling 64-146.<sup>61</sup>

c) Total adoption of foreign law procedures, with both earnings and profits<sup>62</sup> and the foreign taxes in the carryback year to be reduced as provided under foreign law.

d) No effect whatsoever, the argument being that the dividend was paid out of accumulated profits as they then existed and the foreign taxes were paid on or with respect to the earnings and profits as originally calculated.

e) No effect on the calculation of the foreign tax credit for the past year, but with the foreign tax refund netting against the earnings and profits deficit of the current year with any remaining deficit to be de-

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60. With earnings and profits deficits merely affecting the deemed source of the distribution, not the earnings and profits denominator of the § 902 fraction.

61. A more fundamental problem with this approach is suggested in the following commentary:

[If the tax refund under foreign law is to reduce the foreign taxes multiplicand in the § 902 formula in the carryback year] . . . then it would seem to be necessary to reduce the earnings and profits of the earlier years by the losses carried back to them in order to coordinate low-tax and low-earnings years in the way necessary for rational functioning of both the § 902 foreign tax credit and the minimum distribution provisions.

W. GIFFORD, U.S. TAX TREATMENT OF FOREIGN LOSSES A 12 (Tax Management No. 306, 1974). This is because the function of the carryback provisions is presumably to average income over a period of years. The indirect foreign tax credit therefore will reflect average income only if the loss is allocated against earnings and profits in the same manner as provided by foreign law or to the most recent years if there is no foreign law provision.

Note that this proposal is not subject to the infirmities pointed up by Owens and Ball earlier in this Note. They considered only the case where the deemed dividend and the earnings and profits of the carryback year would be reduced by the same amount. They did not address themselves to the situation where, due to the carryback provisions of foreign law, the foreign tax term of the § 902 formula would be reduced as well.

62. Which under current practices must be determined according to United States tax practices. See Rev. Rul. 63-6, 1963-1 CUM. BULL. 126, 127 and cases cited therein.

ducted fully currently as provided under section 316.<sup>63</sup> This approach would be the hybrid of Revenue Ruling 64-146 and 74-550. Both of these Rulings seem to indicate a policy of the Service to prevent recalculations under section 902 due to subsequent loss years. If this is indeed the Service's policy, this approach may well have strong appeal.

f) A further possibility would be to reduce the accumulated profits of each carryback year by a portion of the subsequent year's deficit. Analogous provisions of the minimum distribution and subpart F loss regulations<sup>64</sup> suggest that an appropriate apportionment might distribute the loss in proportion to the ratio of a prior year's accumulated profits to the sum of the accumulated profits for all profitable years.<sup>65</sup> This suggestion has several advantages over the approach adopted by the Service in Ruling 74-550. In the first place, it would avoid the "crack" problem which arises under the Service's approach.<sup>66</sup> As under this approach no one prior year's accumulated profits would be completely erased by the carryback of a subsequent earnings and profits deficit, there would be no danger that foreign taxes actually paid could become non-creditable ("fall into the crack") simply because the accumulated profits which they were originally paid on or with respect to were wiped out due to the carryback of the subsequent year's earnings and profits loss. Such an allocation would have the additional advantage of distributing the effects of the loss ratably with the resultant even impact on the effective foreign tax rates of the earlier years.

## V

### ALTERNATIVES

A final possibility might be to abandon the long-standing policy of computing a foreign company's earnings and profits with United States income tax procedures. The superimposition of these procedures on other procedures and calculations done under foreign law can lead to some anomalous results. For example, the section 902 credit is equal to the dividend received by the domestic corporation multiplied by the effective foreign tax rate.<sup>67</sup> Under some circumstances, this effective

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63. This approach was suggested by Gifford, *Tax Implications of Foreign Losses*, 74-4 TAX MANAGEMENT INT'L J. 3, 5 n.96 (April 1974).

64. See Treas. Regs. §§ 1.963-4(b)(2)(i) (1974) and 1.952-1(d)(2)(iii) (1965).

65. This approach was suggested by Prof. William C. Gifford in a letter to the Commissioner of Internal Revenue, August 14, 1975.

66. See note 58 *supra* and accompanying text.

67. The effective foreign tax rate is determined by dividing the actual foreign tax paid by the pre-tax earnings and profits as calculated under United States law. See OWENS & BALL 169.

foreign tax rate could be a negative figure, e.g., there might have been earnings and profits as calculated under foreign law and thus actual taxes paid to the foreign government even though earnings and profits as calculated using United States tax practices resulted in a negative figure (an earnings and profits loss year). This result could be avoided by accepting the earnings and profits figure arrived at by utilizing the applicable foreign accounting methods.<sup>68</sup>

Compelling arguments also exist for utilizing the carryback methods provided by foreign law for determining the effects of net operating losses on prior years' earnings and profits. As Owens and Ball have pointed out:

This would have the effect of preventing a wide discrepancy between the amount of taxable income computed under foreign law and the amount of earnings and profits, after allocation of losses, under U.S. law . . . an allocation consistent with the carryover provisions under foreign law is simply one method of allocating the losses so that they will offset those foreign profits subject to a low rate or a zero rate of foreign taxation.<sup>69</sup>

The espoused purpose of section 902 was to eliminate "double taxation."<sup>70</sup> Exactly what the phrase "double taxation" means is open to some debate, and the procedures best adapted to obviate it are even more uncertain. However, the rationale behind offering a credit for foreign taxes seems to indicate one easy method for identifying double taxation—that is, when a taxpayer's tax bill exceeds the amount he would have had to pay had his income only been subject to the tax jurisdiction of the country with the highest rate of income taxation.<sup>71</sup> Still, before we can determine a given person's tax bill, we must know his taxable income as well as the applicable tax rate. The former term with regard to United States taxpayers has always been determined according to United States tax procedures.<sup>72</sup> Thus, his deductions (and

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68. To demand that all bookkeeping matters relevant for United States tax calculations be done strictly according to accepted United States tax procedures might well be a practical impossibility, especially if the United States shareholder claiming the credit owns only a small percentage of the stock (say, the minimum requirement—10 percent) and the foreign corporation otherwise is not United States controlled. See Schoenfeld, *Some Definitional Problems in the Deemed Paid Foreign Tax Credit of Section 902: "Dividends and Accumulated Profits,"* 18 TAX. L. REV. 401, 413-14 (1963).

69. OWENS & BALL 173.

70. *American Chicle Co. v. United States*, 316 U.S. 450 (1942).

71. This test is more useful than trying to identify various segregated items of income which have been taxed to the full extent by both countries, or searching for instances where two taxes of the same kind have been imposed on the same item of income by two different sovereigns. See SURREY, *supra* note 3, at 72-73 n.2.

72. The argument being that he does not suffer from double taxation as long as his tax bill does not exceed the figure arrived at by applying the higher applicable tax rate to his taxable income defined under United States tax standards.

hence the effect which will be given to net operating loss deductions) are to be determined under United States tax law concepts and procedures. The result is and has been a great deal of confusion. This grafting of United States tax law definitions onto tax events necessarily governed, at least in part, by foreign law, has needlessly complicated an already difficult area. For example, because a foreign company's earnings and profits are to be defined according to United States standards for United States tax purposes, the effective foreign tax rate may fluctuate from year to year even though the statutory foreign tax rate remains unchanged. This will result in variations in the creditable foreign tax under section 902 even though the actual foreign tax paid has remained the same. The sense of this conclusion should be questioned since the amount ultimately available for dividend distribution will depend on the corporation's earnings and profits as defined under foreign, not United States, law.<sup>73</sup>

The two-tier system (with net operating losses affecting the deemed source of a dividend distribution but not the annual earnings and profits figure used in the denominator of the section 902 fraction) adopted by Revenue Ruling 74-550 makes some sense under the limited circumstances considered in the Ruling.<sup>74</sup> The broader conclusion intimated in the Ruling that a current earnings and profits deficit should never be carried back to affect the earnings and profits denominator in the section 902 fraction, however, seems unwarranted. The Service has deliberately left itself an opportunity to propose a different rule for situations in which the tax provisions of foreign law might allow a recalculation of a previous year's earnings and profits in light of a current earnings and profits deficit. Rather than once again trying to mesh United States and foreign law tax procedures with more complicated and confusing regulations, perhaps the Service could make some small step here towards integration of the United States and foreign tax law practices.<sup>75</sup> Moreover, an adoption of the foreign law carryback rules in this context would have the advantage of allocating losses so that they would offset foreign profits subject to a low or zero rate of foreign taxation.<sup>76</sup> The simplicity and administrability of such a rule might well more than make up for any loss in revenues it might occasion.

John S. Stroebel

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73. Foreign law will determine how much of the corporate assets may be distributed without an impairment of capital.

74. See the argument advanced by Owens and Ball in the text accompanying note 55 *supra*.

75. Recently, the Service has shown a willingness, at least under certain circumstances, to allow a United States taxpayer to use some of the tax procedures mandated by foreign law in the calculation of his § 902 credit. See Rev. Rul. 74-310, 1974 INT. REV. BULL. No. 26, at 13.

76. OWENS & BALL 173.