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IN SEARCH OF THE VANISHING FOREIGN TAX CREDIT: IMPLICATIONS OF REVENUE RULING 76-508*

The United States taxes all domestic and foreign income of its citizens, domestic corporations, and resident aliens.¹ Many foreign countries also tax foreign income of U.S. domestic corporations, citizens, and resident aliens,² raising the possibility that foreign income of U.S. domestic corporations might be taxed twice. Certain sections of the Internal Revenue Code,³ collectively called the foreign tax credit, prevent this potential double taxation⁴ by providing a credit against U.S. income tax liability for certain foreign taxes paid on foreign source income.

The Internal Revenue Service has recently begun to scrutinize this credit provision and has attempted to restrict the availability of the credit.⁵

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1. I.R.C. § 61(a) defines gross income as "all income from whatever source derived." See Jenks, *Taxation of Foreign Income*, 42 GEO. WASH. L. REV. 537, 539 (1974).

2. E. OWENS & G. BALL, *THE INDIRECT CREDIT* 3 (1975).

3. I.R.C. §§ 901-908. Domestic corporations, citizens, and resident aliens may credit foreign income taxes paid or accrued. *Id.* § 901(a)-(b). Taxpayers may also credit foreign "war profits and excess profits taxes paid or accrued." *Id.* Few cases discuss the qualification of these taxes. See E. OWENS, *THE FOREIGN TAX CREDIT* 69 (1961). Domestic corporations owning 10% or more of the voting stock of a foreign corporation may credit part of the foreign company's income tax payments or accruals. I.R.C. § 902(a). For a detailed discussion of the rules of application of this "indirect credit," see E. OWENS & G. BALL, *supra* note 2, at 3-11. See also Rev. Rul. 74-158, 1974-1 C.B. 182. Section 903 provides a credit for payment or accrual of a foreign tax that is "in lieu" of income tax. When Congress added this section in 1942, it intended to enlarge the foreign tax credit provisions to include not only income taxes but other foreign taxes that substitute for income taxes. Note, *The Foreign Tax Credit for American Oil Contractors in Indonesia: An Allocation Approach*, 10 CORNELL INT'L L.J. 307, 312-13 (1977). Section 903's rationale, like that of § 901, is the prevention of double taxation. *Equitable Life Assurance Soc'y v. United States*, 366 F.2d 967, 974 (Ct. Cl. 1966), *cert. denied*, 386 U.S. 1021 (1967). Each of these credits is subject to a ceiling amount under § 904. For a discussion of these limitations, see M. MOORE & R. BAGLEY, *U.S. TAX ASPECTS OF DOING BUSINESS ABROAD* 94-99 (1978). The Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 1031-1037, 90 Stat. 1525 (1976), made significant changes in these rules. See Steinberg & Sisson, *Foreign Tax Credit: How Taxpayers are Affected by New Rules Under TRA 1976*, 46 J. TAX. 250 (1977); Note, *supra*.

4. The rationale for the credit was to eliminate the economic disincentive resulting from double taxation of foreign source income of American corporations. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7-10 (1932).

5. The Service, for example, has severely limited the definition of § 901 "income." See Rev. Rul. 78-61, 1978-8 I.R.B. 11; Rev. Rul. 78-62, 1978-8 I.R.B. 16; Rev. Rul. 78-63, 1978-8

The Service has developed a novel theory that predicates the availability of the credit for foreign tax payments upon stringent procedural requirements. This theory, announced in Revenue Ruling 76-508,⁶ requires that under certain circumstances taxpayers must contest in the foreign country their liability for foreign taxes and must seek review under any available "competent authority" provisions.⁷ Failure to contest or seek review can result in loss of the credit for the foreign tax payment. Revenue Ruling 76-508 will at best cause substantial uncertainty concerning the availability of foreign tax credits, and may at worst deny credits to many taxpayers by creating unrealistic procedural requirements. The motivation for the ruling is unclear,⁸ but the effect could be devastating for all U.S. foreign investment. This Note will describe Revenue Ruling 76-508 and the theory it apparently announces, explore the reach of the ruling, analyze the ruling's basis in law and policy, and suggest a narrowing interpretation of the ruling consistent with Code and policy considerations.

I

CRITERIA FOR FOREIGN TAX CREDITS

In the past, to be eligible for a foreign tax credit, a foreign tax payment has had to meet two requirements.⁹ First, the payment to a government must be a "tax":¹⁰ a governmental levy for the public benefit.¹¹ Second,

I.R.B. 18. The Service requires that a foreign tax must meet the following requirements in order to be considered an "income tax": (1) gain on which the foreign tax is levied must be "realized" in the American sense of the word; (2) the purpose and operation of the foreign tax must be to reach net gain; and (3) the tax must be imposed on receipt of income. Rev. Rul. 78-61, 1978-8 I.R.B. 11, 13-14.

The IRS has also taken a narrow view of the 10-year statute of limitations for amending foreign tax credits. In Rev. Rul. 77-487, the taxpayer contested a tax levy in 1962 and in 1972 paid the contested amount to the foreign government. The IRS ruled that the taxpayer's attempt to carryover the adjustment to amend his 1963 credit was barred by the 10-year statute of limitations, I.R.C. § 6511(d)(3)(A), counting 1962 as the first year. Rev. Rul. 77-487, 1977-52 I.R.B. 21. This denial seems unreasonable in light of the taxpayer's good faith contest and the alteration of the 1963 rather than the 1962 return.

6. 1976-2 C.B. 225, 226.

7. Many tax treaties between the United States and foreign countries establish a grievance procedure for taxpayers to complain about excessive or double taxation in the contracting countries. The "competent authority" is the name given to officials of each contracting country who consult with each other to resolve such taxpayer complaints. See notes 47-48 *infra* and accompanying text.

8. See note 70 *infra* and accompanying text.

9. The textual discussion of the requirements for foreign tax credits refers only to those requirements for § 901 direct credits and § 902 indirect credits that are relevant to this Note's analysis. The other requirements for and limitations on the credit, such as § 904's limitation on the total amount of foreign tax credits available in any given year, are beyond the scope of the Note.

10. I.R.C. § 901 states in part:

(a) [T]he tax imposed by this chapter shall . . . be credited with the amounts pro-

the payment must be in satisfaction of an "income" tax¹² obligation.¹³ With one important exception,¹⁴ Revenue Ruling 76-508 appears substan-

vided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under [section] 902

(b) [including]

(1) In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country

11. Although the only decision defining "tax" for the purpose of the foreign tax credit has been declared obsolete, the language defining tax is still useful:

The word "taxes," in its most enlarged sense, embraces all the regular impositions made by government upon the person, property, privileges, occupations, and enjoyments of the people for the purpose of raising public revenue Fundamentally, a tax is an exaction imposed by a government upon its people *for public purposes*.

I.T. 3768, 1945 C.B. 204, 205, *declared obsolete in* Rev. Rul. 70-293, 1970-1 C.B. 282, 283.

A payment to a government, although termed a "tax," may be a loan. Rev. Rul. 67-187, 1967-1 C.B. 185. In denying a credit, the ruling stated that the "Special Refundable Tax [was] in the nature of a compulsory loan, repayable with interest within a specified time. Refund of the tax is essentially the repayment of a loan . . ." *Id.* at 185. See Rev. Rul. 60-58, 1960-1 C.B. 274 (denying a credit for a "tax" that was really a compulsory refundable loan); Rev. Rul. 59-70, 1959-1 C.B. 186 (denial where tax was to be repaid with interest in six years).

Similarly, a levy for the purpose of regulation is not a tax. See *United States v. Butler*, 297 U.S. 1 (1936) (processing "tax" imposed to defray administrative cost of regulation and payment to benefit certain farmers was not a tax); *Baily v. Drexel Furniture Co.*, 259 U.S. 20 (1922) (levy designated a tax was not a tax, since the exaction was a penalty for violation of regulations).

12. War and excess profits taxes are eligible as well. See note 3 *supra*.

13. *Missouri Pac. R.R. v. United States*, 392 F.2d 592, 597 (Ct. Cl. 1968); *New York & Honduras Rosario Mining Co. v. Commissioner*, 168 F.2d 745, 747 (2d Cir. 1948). The United States Supreme Court, in dictum, has stated:

Section 131 [I.R.C. §§ 901-905] does not say that the meaning of its words is to be determined by foreign taxing statutes and decisions, and there is nothing in its language to suggest that in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterizations and classifications of tax legislation. The phrase "income taxes paid," as used in our own revenue laws, has for most practical purposes a well understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes. It is that meaning which must be attributed to it as used in § 131.

Biddle v. Commissioner, 302 U.S. 573, 578-79 (1938).

A tax based upon gross profits is an "income tax" if levied on "income," computed in such a manner that taxpayers will not have to pay it when they have no net gain. *Bank of America Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 524 (Ct. Cl. 1972), *cert. denied*, 409 U.S. 949 (1973). On the other hand, a tax based solely upon the imputed rental value of land is not an income tax, since the U.S. concept of income does not include imputed value of land. *F.W. Woolworth Co. v. United States*, 91 F.2d 973 (2d Cir. 1937), *rev'g and remanding* 15 F. Supp. 679 (S.D.N.Y. 1936), *cert. denied*, 302 U.S. 768 (1938).

14. Although in nearly all situations Rev. Rul. 76-508 restricts the availability of a foreign tax credit, the ruling appears to broaden that availability in a § 482 setting. For a discussion of I.R.C. § 482, see note 15 *infra*. Prior to Rev. Rul. 76-508, two revenue rulings denied at least direct credits for all foreign tax payments that were based upon income subsequently allocated under § 482 unless the taxpayer corporation could establish that it would still have incurred the foreign tax liability even if it had dealt with the related entity at arm's length.

Revenue Ruling 72-370, 1972-2 C.B. 437, involved a § 482 allocation of income from S, a wholly owned foreign subsidiary, to M, the U.S. parent. Prior to the allocation S had made

tially to restrict the eligibility of foreign tax payments for the foreign tax credit.

The ruling appears to add a new requirement that the taxpayer seeking a foreign tax credit must establish foreign tax liability by both contesting the payment in the foreign country and seeking competent authority assistance. The ruling involved a section 482¹⁵ allocation of income from a foreign subsidiary to a U.S. parent corporation. Neither the parent nor the subsidiary attempted to obtain a refund of the taxes attributable to the allocated income, and the ruling concluded¹⁶ that in order to receive a foreign tax credit, the subsidiary must exhaust "all effective and practicable admin-

foreign tax payments computed from the income subsequently allocated to M. If the transaction that gave rise to the allocation had been conducted at arm's length, neither M nor S would have incurred any foreign tax liability. Under these facts, the Service denied M's claim of a direct credit for the foreign tax payments. In Rev. Rul. 72-371, 1972-2 C.B. 438, M, a U.S. parent, owned 55% of subsidiary P incorporated in foreign country X and 100% of subsidiary S incorporated in foreign country Z. P paid \$100 royalties to S but under the laws of Z had to withhold a \$15 tax. The Service allocated the \$100 royalty income to M under § 482. If the royalty had originally been paid to M, P would have withheld a \$10 tax instead of the \$15. Under these facts, the Service held that M was entitled to a foreign tax credit in the amount of \$10.

The reasoning behind these two rulings appears to be that foreign tax payments based upon income that is subsequently allocated under § 482 will be eligible for a credit only to the extent that the transactions, as recast by the Service, would create foreign tax liability. Although these two rulings deal only with direct credits under § 901, the rationale would seem to apply with equal force to the § 902 indirect credit. E. OWENS & G. BALL, *supra* note 2, at 193-94. Viewed from this perspective, Rev. Rul. 76-508 enlarges the availability of the credit by allowing certain foreign tax payments to be creditable even though no foreign tax liability would have occurred if the transaction had been conducted in an arm's length manner.

15. I.R.C. § 482 states in relevant part:

In any case of two or more . . . businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may . . . allocate gross income, deductions, credits, or allowances between or among such . . . businesses, if he determines that such . . . allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such . . . businesses.

The purpose of § 482 is "to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer"—that is, to ensure that entities under common control deal with one another at prices reflecting the arm's length prices independent entities would charge. Treas. Reg. § 1.482-1(b)(1) (1962). Without this threat of allocation by the Secretary, entities under common control could apportion income so as to minimize or eliminate taxation. *See Commissioner v. First Security Bank of Utah, N.A.*, 405 U.S. 394 (1972).

16. If a taxpayer is put on notice, whether by a proposed adjustment by the Service under section 482 of the Code or otherwise, of the possibility of securing a refund or reduction of foreign income tax liability but fails to pursue its remedies to secure such an adjustment the amounts as to which an adjustment was not sought may be contributions to the foreign government . . .

When as in the instant case income is allocated to a domestic corporation from its foreign subsidiary under section 482 of the Code, a presumption arises that the subsidiary has made a contribution to the foreign government. This presumption will be rebutted if the subsidiary exhausts all effective and practicable administrative remedies in seeking a refund of its foreign income tax liability and if the domestic parent exhausts its rights under the competent authority procedure . . .

Rev. Rul. 76-508, 1976-2 C.B. 225, 226 (citations omitted).

istrative remedies" for obtaining a refund in the foreign country, and the parent must exhaust its rights under the competent authority procedure.¹⁷ Because the company failed to follow these procedures, the IRS denied a credit for the foreign tax payments attributable to the allocated income.¹⁸ The Service argued that the allocation of the foreign subsidiary's income to the domestic parent under section 482 caused the tax previously paid on that income by the subsidiary to the foreign government to become a "contribution," rather than a tax, for the purposes of section 902.¹⁹ Since only "tax" payments are eligible for a foreign tax credit, the characterization of the payment as a "contribution" removed its eligibility for a credit. Under the ruling, the taxpayer could reinstate the payment's status as a "tax" and thereby reestablish its eligibility for a foreign tax credit, if the subsidiary exhausted all effective and practicable administrative remedies and the parent exhausted its remedies under the competent authority.

Although Revenue Ruling 76-508 involved a section 482 allocation, the contribution presumption and the possible procedural rebuttals announced therein appear to be equally applicable to every taxpayer claiming a foreign tax credit. The ruling does not expressly limit the operation of the presumption to reallocations of income,²⁰ and uses broad language to announce the presumption. In addition, the Service's second and at present last word in this area,²¹ Revenue Ruling 77-267,²² points to wide application of the principle. There a foreign branch of a domestic corporation, knowing that a similarly situated taxpayer had obtained a refund, petitioned the foreign administrative agency for a refund and obtained a compromise settlement.²³ The Service explicitly analyzed these facts in light of Revenue Ruling 76-508.²⁴ Apparently the taxpayer's notice of a similarly

17. For a discussion of competent authority, see notes 47-48 *infra* and accompanying text.

18. Rev. Rul. 76-508, 1976-2 C.B. 225, 226.

19. *Id.* See note 16 *supra*; notes 47-48 *infra* and accompanying text.

20. The ruling states that notice of the possibility of a tax reduction or refund may occur by a "proposed adjustment" under § 482 "or otherwise." Rev. Rul. 76-508, 1976-2 C.B. 225, 226.

21. Very recently, the IRS has relied upon Rev. Rul. 76-508 in a letter ruling. Letter Rul. No. 7838063, [1978] IRS LETTER RULING REP. (CCH) (June 22, 1978). This letter ruling confirms that the application of the principles of Rev. Rul. 76-508 will not be limited to § 482 allocations. In the letter ruling, P, a domestic corporation, liquidated its wholly owned subsidiary, S, located in the Virgin Islands. The Virgin Islands tax authorities issued to S a notice of intent to assess a 30% withholding tax on certain liquidation distributions by S. S contested this tax but did not prevail. The Service held that the taxpayer had exhausted all effective and practicable administrative remedies in the foreign country. In addition, since the United States and the Virgin Islands have no competent authority procedures, the Service held that the taxpayer had exhausted all remedies in this regard. Thus, P could claim a foreign tax credit for the withholding tax it paid.

22. Rev. Rul. 77-267, 1977-31 I.R.B. 16.

23. *Id.* at 16-17.

24. *Id.* at 17.

situated taxpayer's refund raised the contribution presumption.²⁵ But the IRS concluded that the taxpayer had successfully rebutted the presumption by petitioning the foreign government and obtaining a compromise settlement, thereby exhausting "in good faith" all effective and practicable administrative remedies.²⁶

Thus, the contribution presumption may be widely applicable, since two disparate events—a section 482 allocation and notice of another's successful refund—both raised the contribution presumption. The description of the principle is broad enough to encompass every payment of foreign taxes for which a taxpayer claims credit.²⁷ In addition, the ruling may have retrospective applicability, affecting payments made even before it was issued.²⁸ The next section will explore the possible reach of the contribution presumption and the procedural burdens involved in rebutting the presumption.

II

POSSIBLE REACH OF REVENUE RULING 76-508

Although the IRS will not necessarily press the language of Revenue Ruling 76-508 to its limits, the potential scope of the ruling plays an important part in assessing its effect on the foreign tax credit. In addition, the rule creates a good deal of uncertainty, underscoring the disadvantages of setting tax policy through the revenue ruling process.

A. CONTRIBUTION PRESUMPTION

Revenue Ruling 76-508 states:

If a taxpayer is put on notice, whether by a proposed adjustment by the Service under section 482 of the Code or otherwise, of the possibility of securing a

25. Although the ruling never expressly held that the contribution presumption was raised, it would not have needed to find that all effective administrative remedies had been exhausted if no presumption had been raised.

26. [S]ince *X* [the taxpayer] in the instant case has, in good faith, exhausted all effective and practicable administrative remedies in seeking refund or adjustment of its foreign income tax liability and since the monetary settlement reached is comparable to a refund obtained in good faith by a similarly situated taxpayer, the portion of the United Kingdom taxes claimed but not returned, if the monetary settlement is accepted by *X*, will constitute creditable taxes for purposes of section 901(b) of the Code, subject to applicable limits.

Rev. Rul. 77-267, 1977-31 I.R.B. 16, 17.

27. The broad language of the ruling could encompass even individual taxpayers. Rev. Rul. 76-508, 1976-2 C.B. 225.

28. In general, revenue rulings apply both retrospectively and prospectively unless the Service states otherwise. Rev. Proc. 72-1, § 6.01(3), 1972-1 C.B. 693. Nevertheless a recent Tax Court case stated that Rev. Rul. 76-508 had only prospective application. *Schering Corp. v. Commissioner*, 69 T.C. No. 46, [1978] TAX. CT. REP. (CCH) ¶ 34,929, at 2250 n.17.

refund or reduction of foreign income tax liability . . . the amounts as to which an adjustment was not sought may be contributions to the foreign government.²⁹

Thus, there must be a possibility of foreign tax refund or reduction in foreign tax liability, and the taxpayer must be on notice of this possibility. If both of these conditions occur, the Service may raise the contribution presumption. This formulation of the conditions for raising the presumption permits the Service to raise it for virtually every payment of foreign income taxes.

1. Possibility of Tax Refund or Reduction

The first requirement of the contribution presumption—"possibility of refund or reduction in tax"—provides no limitation to the applicability of the presumption, because for every foreign tax payment there is some possibility of securing a reduction or refund.³⁰ For example, every taxpayer's decision to include an item in gross income or exclude an item from a deduction raises the "possibility" of a tax refund, since there is rarely one clear result from applying substantive tax law to a specific set of facts. Moreover, the use of the term "reduction of tax liability" in addition to "refund of tax liability" may indicate that the taxpayer must carefully plan in advance to utilize all possibilities of minimizing taxes.³¹ Failure to shape the transaction in the most favorable tax posture could create the "possibility of a reduction of tax liability," even though no refund after the fact would be available.³² Thus, to avoid raising the contribution presumption, the taxpayer may not only have to file a flawless yearly tax return, but may also have to structure transactions carefully in advance to minimize future tax liability.³³ Even a less extreme view would indicate

29. Rev. Rul. 76-508, 1976-2 C.B. 225, 226. See Rev. Rul. 77-267, 1977-31 I.R.B. 16, 17.

30. Possibility is "the character, condition, or fact of being possible," which is defined as "what may be done, occur, be conceived, or be attained . . ." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1771 (1961). One court has defined possibility as "capable of existing or happening, feasible. The word does not mean probability, but denotes extreme improbability without excluding the idea of feasibility." *Reisdorf v. Mayor*, 114 N.J. Super. 562, 570, 227 A.2d 554, 559 (1971). See also *Bump v. Dahl*, 26 Wis. 2d 607, 613, 133 N.W.2d 295, 299 (1965).

31. In the alternative the word "reduction" may merely take into account foreign tax credits based upon accruals of foreign tax liability rather than upon actual payments thereof. In other words, a taxpayer who has accrued a foreign tax liability but who has not paid the liability could not seek a "refund" until after payment is made.

32. This tax planning requirement lacks support in law and policy. See note 64 *infra*.

33. The phrase "possibility of reduction in tax liability" also may require the taxpayer to choose the tax deduction that minimizes the foreign tax payment even if he would have a choice of forms of tax deductions under the foreign law. For example, the English tax statutes allow the taxpayer to choose between the equivalent of straight-line depreciation or accelerated depreciation deductions for certain types of tangible assets. Finance Act, 1971, c. 68, §§ 41(1), 41(3), at 1229-30. Even though either form of deduction is available, Rev. Rul. 76-508

that the taxpayer must be alert to every chance, however slim, of securing even the smallest refund. This could hold true regardless of the cost of seeking such a refund.

2. Notice

The ruling's notice requirement may likewise do little to narrow the scope of the presumption. Because courts have often construed "notice" to include "constructive notice,"³⁴ any event that creates the possibility of a tax refund or reduction may also put the taxpayer on "notice," whether or not the taxpayer actually knew of the possibility. In terms of Revenue Ruling 76-508, if a taxpayer does not deduct a legally deductible expense, there is a possibility of a tax reduction or refund. If the notice requirement is met by constructive notice, the mere existence of such a possibility may satisfy the notice requirement and raise the contribution presumption. Although the Service may not interpret the possibility and notice conditions in such a broad manner, the problems of uncertainty and the potentially all-inclusive standard will remain until the Service refines the criteria for the invocation of the contribution presumption.

The ruling indicates that the Service will not raise the presumption in every case in which the two conditions occur. But its statement that the two conditions "may" raise the presumption³⁵ gives no insight as to what factors will dissuade the Service from doing so. Although the use of the word "may" appears to be a safety valve to mitigate the application of the presumption, it only adds to the taxpayer's uncertainty. Since virtually every tax payment could meet the possibility and notice conditions, the Service could raise the contribution presumption to attack almost any foreign tax payment. Under Revenue Ruling 76-508's standard, a taxpayer attempting to remain eligible for the foreign tax credit has no palatable choices. He can assume that the presumption will be raised in every case and seek the procedural remedies that rebut the presumption, regardless of cost.³⁶ Alternatively, he can take his chances by doing nothing and hoping the Service either does not audit his return or decides not to raise the presumption.

may force the taxpayer to choose accelerated depreciation since the failure to use this method could create the possibility of a reduction in foreign tax liability.

34. "Constructive notice is information or knowledge of a fact imputed by law to a person, . . . because he could have discovered the fact by proper diligence. . . ." BLACK'S LAW DICTIONARY 1210 (4th ed. 1968). See *Baltimore v. Whittington*, 78 Md. 231, 77 A. 984 (1930).

35. Rev. Rul. 76-508, 1976-2 C.B. 225, 226.

36. Although the Service has provided no clear guidelines for invoking the presumption, it appears that the taxpayer involved in a § 482 allocation will automatically be subject to the contribution presumption.

B. PROCEDURAL REBUTTALS

Assuming that the IRS raises the contribution presumption, Revenue Ruling 76-508 states that the taxpayer may rebut the presumption by pursuing its remedies to secure an adjustment of foreign tax liability in two ways. First, the taxpayer must exhaust "all effective and practicable administrative remedies" in the foreign country.³⁷ Second, he must pursue relief through competent authority, if any.³⁸ This second avenue, however, does not appear to be required if foreign administrative proceedings have produced a satisfactory adjustment.³⁹

1. Foreign Administrative Remedies

The extent to which the taxpayer must contest his liability in the foreign country is almost as uncertain as the circumstances that will raise the presumption. The Service, however, has limited the requirement to exhaustion of administrative—as opposed to legal—relief.⁴⁰ But within this limitation, the level of contesting that is required remains unclear. The ruling states that the taxpayer must exhaust all "effective and practicable remedies," but attempts to meet these criteria are fraught with uncertainty. First, the Service does not define "effective" or "practicable." An "effective" remedy appears to be one whose outcome may lead to the desired result.⁴¹ Since all administrative remedies, if successful, will reduce tax liability, the word "effective" seems to provide no assistance in determining whether exhaustion of administrative remedies has occurred. The word "practicable" also provides little assistance in limiting the required administrative steps. Although practicable means capable of being performed, or feasible,⁴² and is thus somewhat more limiting than the word "effective,"

37. See note 16 *supra*.

38. *Id.* For a discussion of competent authority, see notes 47-48 *infra* and accompanying text.

39. In holding that the contribution presumption was rebutted, Rev. Rul. 77-267 did not require exhaustion of competent authority. Alternatively, it could be argued that resort to competent authority is required only when the contribution presumption is raised in a § 482 setting. Since Rev. Rul. 77-267 did not involve a § 482 allocation, no resort to competent authority was required.

40. See note 16 *supra*.

41. One court has defined "effective" to mean "[p]roducing a decided, decisive, or desired effect." *Conroy v. Purcaro*, 42 N.J. 120, 124, 199 A.2d 643, 645 (1964) (per curiam). "Effective" has also been defined as "capable of bringing about an effect: productive of results." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 724 (1961).

42. See *Frey v. Security Ins. Co.*, 331 F. Supp. 140, 143 (W.D. Pa. 1971) (practicable means feasible in the circumstances); *Miller v. State*, 73 Wash. 2d 790, 794-95, 440 P.2d 840, 842-43 (1968) (practicable means possible to practice or perform; capable of being put into practice, done, or accomplished; feasible). Although in the past some courts stated that "practicable" was synonymous with "possible," see *Miller v. Southern Express Co.*, 99 S.C. 333, 340, 83 S.E. 449, 451 (1914), most courts now recognize that "practicable" is a more limiting term than "possible." *Miller v. State*, 73 Wash. 2d 790, 794-95, 440 P.2d 840, 842-43 (1968). See

the application of this definition to specific circumstances does not assist the taxpayer in determining when he has exhausted his administrative remedies. The taxpayer lacks guidance for interpreting the scope of the possible rebuttals to the contribution presumption. Once he decides to contest the foreign tax payment he must either pursue foreign administrative remedies to the highest level or risk a determination that despite his efforts he did not pursue them far enough.

Second, the ruling ignores the realities surrounding the foreign tax credit situation. For example, it is not clear whether the expiration of the foreign statute of limitations for contesting the foreign tax constitutes exhaustion of foreign administrative remedies.⁴³ In addition, when the U.S. taxpayer claims an indirect credit⁴⁴ but does not control the foreign corporation,⁴⁵ he may not be able to convince the foreign subsidiary to contest the foreign tax payment. The ruling provides no guidance as to whether the controlling shareholders' refusal to contest, in itself, meets the exhaustion standard.⁴⁶

2. *Competent Authority*

In addition to seeking foreign administrative remedies, Revenue Ruling 76-508 requires the taxpayer to pursue his remedies under the competent authority procedure. Several tax treaties between the United States and other countries establish this mechanism for resolution of double taxation issues,⁴⁷ under which an aggrieved taxpayer can petition his country's representative for relief.⁴⁸ It is unclear when the taxpayer must petition the

In re Kenilworth Bldg. Corp., 105 F.2d 673, 676 (7th Cir. 1939); *Woody v. South Carolina Power Co.*, 202 S.C. 73, 81, 24 S.E.2d 121, 124 (1943).

43. See text following note 90 for a suggested solution to this problem.

44. I.R.C. § 902.

45. A U.S. shareholder may own as little as 10% of the foreign corporation and remain eligible for an indirect credit under I.R.C. § 902. See note 3 *supra*.

46. See text accompanying note 78 for a suggested solution to this problem.

47. Cole, *Competent Authority Procedure: International Tax Counsel gives his views*, 35 J. TAX. 8, 9 (1971).

48. Prior to 1970, although sixteen tax treaties between the United States and foreign governments gave the Treasury authority to negotiate with foreign countries over the appropriate allocation of a taxpayer's income, there was no definite procedure for the presentation of these claims. Aversa, *International Tax Allocations and Treaty Relief Through Competent Authority Procedures*, 19 TAX EXEC. 15, 17 (1966). In 1970 the Service issued Rev. Proc. 70-18, 1970-2 C.B. 493, which prescribed procedures for invoking competent authority assistance when a § 482 allocation occurred between a U.S. taxpayer and a related person subject to the income tax jurisdiction of a U.S. treaty partner. Rev. Proc. 77-16, 1977-1 C.B. 573, supplements Rev. Proc. 70-18 by outlining the procedures for requesting competent authority assistance when nonallocation issues arise. These "issues involve the availability to a United States taxpayer of credits against foreign tax, exemptions from foreign tax, reduced rates of foreign tax, and other benefits and safeguards provided under income tax treaties." *Id.* at 573.

competent authority if the contribution presumption is raised.⁴⁹ Although Revenue Ruling 76-508 states that the taxpayer must exhaust its remedies under competent authority, in Revenue Ruling 77-267 the taxpayer rebutted the contribution presumption without having resorted to competent authority.⁵⁰ Like the other facets of Revenue Ruling 76-508, failure to establish specific guidelines creates needless uncertainty.

III

BASIS IN LAW AND POLICY OF REVENUE RULING 76-508

Revenue rulings are not law, but rather the Service's interpretation of what the law is.⁵¹ Thus, for a theory advanced in a ruling to be valid, it must have a basis in either law or policy. The Service's theory in Revenue Ruling 76-508 can be broken down into two parts—a standard and an evidentiary rule. The standard may be stated as follows: the Service may find that a payment made to a foreign government pursuant to its tax laws is not a tax if the taxpayer's liability for the tax is less than certain or could have been reduced. To apply this standard, the Service will draw on all material information of which the taxpayer had notice either at the time of or after filing the foreign tax return.⁵² This evidentiary rule has substantial support in the Code and case law,⁵³ but it is more difficult to find support for the expansive standard announced in the ruling.

A. BASIS IN THE CODE

Although Congress could have expressly required that a taxpayer contest uncertain foreign tax liability in order to receive a credit, the Code contains no such provision. Section 904, which places a ceiling on the

49. Under the revenue procedures, the taxpayer can file his request for assistance as soon as the issues are sufficiently developed to permit such assistance. Rev. Proc. 70-18, 1970-2 C.B. 493, supplemented by Rev. Proc. 77-16, 1977-1 C.B. 573; see note 48 *supra*.

50. See note 39 *supra*; note 90 *infra*.

51. Rev. Proc. 72-1, 1972-1 C.B. 693, 694.

52. Although the Service does not expressly state this evidentiary rule, it can be gleaned from the facts of both Rev. Rul. 76-508 and Rev. Rul. 77-267. In both cases, the filing of the tax returns had occurred prior to the "notice" of a possible tax refund.

53. In tax law, the signing of the tax return does not necessarily mark the end of the inquiry as to eligibility for the foreign tax credit. For example, the Code expressly provides for the readjustment of a credit when subsequent events alter the amount of the credit. I.R.C. § 905(c). Similarly, the courts have held that the refund of a foreign tax relates back and alters the credit originally taken for the tax. *United States v. Campbell*, 351 F.2d 336 (2d Cir. 1965), *cert. denied*, 383 U.S. 907 (1966). See *Cuba R.R. Co. v. United States*, 124 F. Supp. 182 (S.D.N.Y. 1954) (credit for contested tax payment, once resolved, relates back to year in which tax would have been paid if there had been no contest); Rev. Rul. 58-55, 1958-1 C.B. 266 (citing *Cuba R.R.* with approval and reasoning that credits should be matched with associated income in order to avoid double taxation).

amount of credit available, is the only limitation on the eligibility of foreign income tax payments.⁵⁴ The ruling, by further limiting the availability of the credit, appears to be inconsistent with the congressional intent embodied in section 904. Furthermore, the ruling does not mesh with the section 905 requirement that credits only be redetermined when a taxpayer receives a refund of foreign tax payments.⁵⁵ Since the Code lacks any language concerning "possible" or "potential" refunds, the mere possibility of a refund should not affect the eligibility of a foreign tax payment for a credit.

Nor does the legislative history of the foreign tax credit provide support for the ruling. The legislative intent behind the foreign tax credit was the elimination of double taxation and its adverse affect upon foreign investment.⁵⁶ Revenue Ruling 76-508, by creating the possibility of double taxation,⁵⁷ establishes an impediment to foreign investment and undermines this legislative intent. In sum, the relevant Code sections and their legislative history provide no support for the ruling's test and, if anything, rebut it.⁵⁸

Although there is no relevant case law interpreting the foreign tax credit provisions, courts have developed a standard for determining when tax payments to state governments are ineligible for a federal tax deduction. The federal tax deduction for a state tax payment⁵⁹ has been denied only if

54. I.R.C. § 904; *see note 3 supra*. Several courts have characterized § 904 as the only limit on the eligibility of a foreign tax payment. *Metropolitan Life Ins. Co. v. United States*, 375 F.2d 835 (Ct. Cl. 1967); *Woodmansee v. Commissioner*, 388 F. Supp. 36 (N.D. Cal. 1975). *See also* Rev. Rul. 54-15, 1954-1 C.B. 129.

55. I.R.C. § 905(c). "If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Secretary or his delegate, who shall redetermine the amount of the tax for the year or years affected." *Id.*

56. The congressional purpose in enacting the foreign tax credit was to relieve domestic taxpayers from the severe burden of double taxation. "With the corresponding high rates imposed by certain foreign countries the taxes levied in such countries in addition to the taxes levied in the United States upon citizens of the United States place a very severe burden upon such citizens." H.R. REP. NO. 767, 65th Cong., 2d Sess. 11 (1918). *See also* *Burnet v. Chicago Portrait Co.*, 285 U.S. 1 (1932).

57. In Rev. Rul. 76-508, the foreign subsidiary has paid a foreign tax on the income allocated to the domestic parent. The parent will also be required to pay a U.S. tax on the income if the procedural remedies are not exhausted.

58. The ruling, however, may be justified insofar as it applies to a § 482 allocation. If the domestic parent automatically receives a credit for the foreign taxes paid by the foreign subsidiary on the income subsequently allocated to the domestic parent, there would be absolutely no penalty for the parent's failure to conduct the transaction at arm's length. *See* E. OWENS & G. BALL, *supra* note 2, at 189-94. Rev. Rul. 76-508 can be justified on the ground that it provides a policing function for § 482. For a discussion of the effect of a § 482 allocation on foreign tax credits, *see note 14 supra*.

59. I.R.C. § 164(a) states in part: "[T]he following taxes shall be allowed as a deduction for the taxable year within which paid or accrued: . . . (3) State and local, and foreign, income . . . taxes."

the taxpayer was under no actual or apparent liability⁶⁰ at the time the taxpayer made it.⁶¹ This standard—no actual or apparent liability—differs significantly from Revenue Ruling 76-508's test for denying a credit for foreign tax payments: liability that is less than certain or could have been reduced. This state tax deduction standard, like the Code and legislative intent discussed above, does not provide support for the Revenue Ruling 76-508 standard. Moreover, unless the state tax deduction can be distinguished from the foreign tax credit, it undermines the validity of the ruling's standard.

B. BASIS IN POLICY

If the Revenue Ruling 76-508 standard is to be more stringent than the domestic tax deduction standard, the foreign tax credit must be distinguished from the domestic tax deduction. Two policy rationales distinguish the foreign tax credit and provide the only basis for a more stringent foreign tax credit standard. They do not, however, support the extreme standard of Revenue Ruling 76-508.

The first policy justification turns on the geographic location of the tax payment. A state tax payment, even though deducted from federal tax liability, remains within the U.S. economy for the benefit and use of the American people. On the other hand, a foreign tax payment neither enters the domestic economy nor benefits U.S. residents. The fiscal policy of retaining money within the United States distinguishes foreign from domestic

60. See *Kenyon Instrument Co. v. Commissioner*, 16 T.C. 732 (1951)(denying deduction for overpayment of taxes when taxpayer knew at time of filing his federal return that he was not liable for the state tax); *Hart Furniture Co. v. Commissioner*, 12 T.C. 1103 (1949), *rev'd on other grounds*, 188 F.2d 968 (5th Cir. 1951) (taxpayer not entitled to deduct under § 164 any portion of excise tax overpaid through taxpayer's error, because taxpayer must be under actual or apparent obligation for the payment at time it is made in order for it to be deductible); *Cooperstown Corp. v. Commissioner*, 144 F.2d 693 (3d Cir. 1944)(denying tax payment deduction where payment indisputably erroneous). See also *Baltimore Transfer Co. v. Commissioner*, 8 T.C. 1, 7 (1947)(allowing deduction for tax payment later refunded and distinguishing *Cooperstown* on ground that taxpayer in *Baltimore Transfer* acted in response to "practical compulsion and prima facie validity which we believe the business man may properly attribute to an administrative notification" of taxes due).

61. *Estate of Frank Cohen*, 29 T.C.M. (CCH) 1221 (1970), held that the payment of state taxes was a valid federal deduction so long as the taxpayer made the payment in good faith. The fact that the taxpayer's liability was later determined to be far less than the payment did not invalidate the deduction. See *Taylor Instrument Cos. v. Commissioner*, 14 T.C. 388 (1950)(allowing tax payment deduction, even though reduction could occur in subsequent years because of ongoing renegotiations of taxable income); *Estate of Lowenstein v. Commissioner*, 12 T.C. 694 (1949), *aff'd sub nom.* *First Nat'l Bank of Mobile v. Commissioner*, 183 F.2d 172 (5th Cir. 1950), *cert. denied*, 340 U.S. 911 (1951)(a good faith payment of taxes for what was then thought to be owed will not be disturbed by later determination that less was owed).

tax payments and supports a more stringent standard for establishing the validity of foreign tax payments.

The second policy rationale differentiates foreign tax credits and state tax deductions on the ground that credits are inherently different from deductions. Whereas a creditable expenditure will not cost the taxpayer any after-tax dollars, an expenditure for which only a tax deduction is available will always cost after-tax dollars. The taxpayer has no incentive to minimize foreign tax payments that are creditable against federal tax liability. In fact, the taxpayer has a disincentive to spend money on such activities since it will cost him money to prepare tax returns carefully or to contest liability, but he will obtain no commensurate gain. Thus, the Service may be justified in imposing a stricter standard of eligibility for the foreign tax credit in order to assure accurate payments.

Although these two policy considerations support a stricter eligibility standard for the foreign tax credit,⁶² they do not justify the possibility that Revenue Ruling 76-508 requires a taxpayer to contest at least some part of every foreign tax payment in order to be eligible for a foreign tax credit. Nor do they support a requirement that a taxpayer must engage in tax planning⁶³ to structure a transaction so as to reduce the foreign tax liability below what it otherwise would be.⁶⁴

62. One could argue that these two policies do not provide an adequate basis for the Rev. Rul. 76-508 standard. Congress made the decision to allow credits for foreign tax payments in 1918. Revenue Act of 1918, ch. 18, §§ 222, 238, 240(c), 40 Stat. 1057 (1919). At that time, as now, there was no incentive to contest foreign tax payments when a credit was available, and the potential effect upon the U.S. Treasury was the same. Nevertheless, Congress has repeatedly reenacted the credit provision without distinguishing between possible and actual refunds. If the credit's disincentive now appears to have an unacceptably adverse effect, Congress, not the Service, should repeal or amend it. For a discussion and listing of the various reenactments of the foreign tax credit, see E. OWENS, *supra* note 3, at 20-21.

63. See text accompanying notes 31-33 *supra*.

64. Any attempt by the Service to require tax planning would also be inconsistent with *Gulf-Puerto Rico Lines, Inc. v. Commissioner*, 61 T.C. 644 (1974). In this case, the Tax Court held that the Service could not require a taxpayer to reduce his foreign tax liability when the taxpayer could elect either to pay Puerto Rican taxes and credit the sums on his U.S. tax return, or to pay U.S. taxes and credit the sums on his Puerto Rican tax returns.

The fact that petitioner could have availed itself more fully of a provision (for a credit) of the Puerto Rico income tax laws to eliminate completely any burden of that country's income tax on United States source income is not a proper concern of the United States taxing authorities. The statute does not purport to authorize the respondent to plumb for the reason that the requisite "connection" exists Section 164(a)(3) refers only to foreign income taxes paid or accrued during the taxable year. Such language precludes a further determination in this instance that the taxes in question need not have been paid.

Id. at 650-51. Similarly, any attempt by the Service to force taxpayers to choose a deduction that minimizes the present foreign tax liability—such as choosing accelerated over straight-line depreciation—when two or more alternative deductions are reasonable, see note 32 *supra*, would also be inconsistent with *Gulf-Puerto Rico Lines*.

IV

SUGGESTED APPROACH

The uncertainty and legal infirmity generated by Revenue Ruling 76-508 indicate that the Service should revoke the ruling and promulgate regulations that provide guidelines for the taxpayer's decision as to when he must utilize procedural rebuttals to the contribution presumption. Use of the Service's rulemaking power⁶⁵ would have several advantages. First, it is legislative in nature and is thus appropriate for resolving a conflict among policy alternatives.⁶⁶ Second, the rulemaking procedure provides a forum for the presentation of diverse solutions by all interested parties,⁶⁷ which will increase the chance of finding the best resolution of the problem. Third, use of this more formal process will force the IRS to be more definite and specific in its resolution of the problems of the foreign tax credit.

A. THEORETICAL ANALYSIS

The problem addressed in Revenue Ruling 76-508 is only one example of a dilemma that often occurs in the administration of tax law: will the Service accept the taxpayer's characterization of an event? Generally, if a taxpayer's action is constrained by competitive market forces and his characterization of an event is consistent with his action, there is no need for the Service to challenge the taxpayer's decision—the taxpayer's self-interest will produce a correct result.⁶⁸ If market forces are not effective, however, the taxpayer's self-interest will not necessarily produce the correct result

65. I.R.C. § 7805.

66. See K. DAVIS, ADMINISTRATIVE LAW TEXT 142 (3d ed. 1972). See generally B. SCHWARTZ, ADMINISTRATIVE LAW 140-65 (1976).

67. See K. DAVIS, *supra* note 66, at 142.

68. Section 162 of the Code provides a good example of this principle. This section permits an employer to deduct a "reasonable allowance" for the salaries of his employees. I.R.C. § 162(a)(1). Theoretically, the Service could require a taxpayer to establish the reasonableness of each salary deduction. In practice, the Service disputes few of these deductions. For the majority of the deductions, the Service can rely upon the employer to pay no more than a "reasonable" salary. The employer's self-interest in maximizing his profit and remaining in business prompts him to give his employee the lowest salary acceptable to the employee. In some situations, however, the employer's self-interest in maximizing his profit may be outweighed by other interests. For example, an employer in a close corporation may wish to run the business at a breakeven point or even a loss and obtain large payments in salary, which are in reality distributions of profit. Here, the Service cannot rely upon the market to produce a reasonable salary, and it must examine the claimed deduction.

Petitioner is a close corporation and the same weight does not attach to salary allowances voted by the directors of such a corporation as attaches in instances where officers have little or no financial interest in the corporation Where a close corporation is involved payments made to stockholder-officers as compensation for services will be carefully scrutinized to determine whether they in fact constitute a distribution of profits.

Builders Steel Co., 8 T.C.M. (CCH) 296, 301 (1949), *rev'd on other grounds*, 179 F.2d 377 (8th

and the Service may have to challenge the taxpayer's characterization, as in a transaction between related entities.⁶⁹ The foreign tax credit creates another situation in which market forces do not provide appropriate constraints for the taxpayer. The taxpayer has no incentive—indeed, has a disincentive—to contest a creditable foreign tax payment, since the combined foreign and domestic tax payment will remain unchanged.⁷⁰ Revenue Ruling 76-508 apparently addresses itself to this failure of the market to provide appropriate incentives.

Of course, the most effective incentive for the taxpayer to contest foreign tax payments would be the abolition of the foreign tax credit and the foreign tax deduction.⁷¹ If the credit and deduction were abolished, the

Cir. 1950) (citations omitted). See also *Capitol-Barg Dry Cleaning Co. v. Commissioner*, 131 F.2d 712, 715 (6th Cir. 1942).

Similarly, the Tax Court, in determining the reasonableness of a salary authorized by a corporation's board of directors, stated:

Where the record establishes [an independent board of directors] . . . , we have been reluctant to substitute our judgment for that of the directors. We do not, however, regard petitioner's board as sufficiently independent to find that the compensation was fixed in an arm's length transaction.

Glenshaw Glass Co., 5 T.C.M. (CCH) 864, 866 (1946), *aff'd per curiam*, 175 F.2d 776 (3rd Cir.), *cert. denied*, 333 U.S. 842 (1947). See also *Kerrigan Iron Works, Inc. v. Commissioner*, 17 T.C. 566 (1951); *L. Schepp Co. v. Commissioner*, 25 B.T.A. 419 (1932).

69. I.R.C. § 482. This section authorizes the Secretary to allocate income between related entities to "prevent evasion of taxes or clearly to reflect the income . . ." See note 15 *supra*. The Secretary must be able to scrutinize the pricing of goods sold between related entities because the price is not determined by competitive market forces.

When the same persons control two or more entities they may cast their transactions between those entities in any form that they desire. *The restraining force of outside interests is absent.* Section 482 is designed "to prevent evasion of taxes" or distortion of income caused by the form that these persons choose in casting their transactions.

South Texas Rice Warehouse v. Commissioner, 366 F.2d 890, 898 n.19 (5th Cir.), *cert. denied*, 386 U.S. 1016 (1966)(emphasis added).

70. For the purposes of this analysis, it is assumed that the taxpayer is risk neutral and considers only the monetary costs and benefits of various actions. Considerations such as establishing a precedent or contesting tax liability out of principle are not, therefore, within the scope of this analysis. Also, the taxpayer is assumed always to attempt to maximize profit. Under these assumptions, a taxpayer will seek a refund if and only if the expected benefits from seeking the refund are greater than the costs. On the benefit side of the equation, expected benefit from seeking a refund is equal to the potential tax refund, R , discounted by the probability of successfully obtaining the refund, p . On the cost side of the equation, a taxpayer who receives a dollar-for-dollar credit for every tax payment has two costs associated with obtaining a refund. First is the out-of-pocket cost, C , associated with contesting the tax liability, including attorney and witness fees. Second is the cost, Cr , associated with the reduction of his credit by an amount equal to the refund, R . Since the taxpayer will incur this credit cost only if he successfully obtains a refund, this cost must also be multiplied by the probability of successfully obtaining the refund, p . The taxpayer will only contest the foreign tax payment if:

$$C + [Cr \cdot p] < R \cdot p.$$

Since Cr is equal to R , and the cost to contest, C , will always be positive, the costs must always exceed the expected benefit. Therefore, the taxpayer will never have an incentive to contest his foreign tax liability.

71. See note 74 *infra*.

taxpayer generally would contest any foreign tax payment so long as the cost of contest remained less than the expected tax savings.⁷² But abolition would also subject the taxpayer to double taxation on all foreign income, clearly an unacceptable outcome.⁷³ Another possible solution would be to abolish the credit but continue to allow a deduction for foreign tax payments.⁷⁴ Unlike a credit, which removes all incentive to contest, a deduction removes only part of the incentive. If only a deduction were available, the taxpayer would generally contest any foreign tax payment so long as the sum of the cost of contest and the cost of losing the deduction are less than tax savings.⁷⁵ But this would still permit double taxation of a portion of the taxpayer's foreign income.⁷⁶

Although the IRS cannot eliminate the foreign tax credit or deduction, it could develop a standard derived from one of these approaches to determine whether a foreign tax payment should be eligible for a credit. For example, the standard for a credit might be the following: a foreign tax payment shall be eligible for a credit if the taxpayer has contested all portions of the payment that he would have contested if only a deduction were available. To receive a foreign tax credit under this standard, the taxpayer

72. This standard assumes that the taxpayer is risk neutral and will consider only the monetary costs and benefits of various actions. See note 70 *supra*. Without a credit cost, the equation in note 70 *supra* becomes:

$$C < R \cdot p.$$

So long as the cost of contest, C , is less than the expected benefit, $R \cdot p$, the taxpayer will gain by attempting to obtain a refund.

73. For example, if the taxpayer earns \$100 in the United Kingdom and is subject to a 20% tax there, he will pay \$20 in U.K. tax. The same \$100 of income is includible in his U.S. taxable income, and if he is in a 50% tax bracket he will pay \$50 in U.S. taxes. This produces double taxation of \$20—the amount by which his total tax payment exceeds his U.S. taxes.

74. The Code does contain a deduction provision for foreign taxes. I.R.C. § 164(a)(3). The taxpayer must elect in each year whether to use the credit or the deduction, but he cannot use both. Generally, the deduction is used only when the business will suffer a net operating loss on its U.S. taxation for the year.

75. The taxpayer receiving a deduction for a foreign tax payment will compare the expected benefit from the tax refund, $R \cdot p$, with the costs of obtaining the refund. The latter include the cost to contest, C , and the cost associated with the loss of a deduction. Since the taxpayer will incur this deduction cost only if he successfully obtains a refund, the amount of the deduction, Dd , must be multiplied by p , the probability of obtaining the refund. The amount of the deduction must also be multiplied by the taxpayer's effective U.S. tax rate, tr , to reflect the actual cost of losing a deduction. Thus, the taxpayer will contest the foreign tax payment if

$$C + tr[Dd \cdot p] < R \cdot p.$$

Since the expected cost of losing the deduction will always be less than the expected refund, and the cost of contest is always positive, there will often, but not always, be an incentive to contest.

76. Taking the same figures and tax rates set out in note 73 *supra*, the taxpayer will receive a \$20 deduction for his tax payment to the United Kingdom. Since his effective U.S. tax rate is 50%, this deduction will reduce his U.S. tax liability by \$10. The taxpayer will pay a total of \$60 in tax—\$40 to the United States and \$20 to the United Kingdom—resulting in double taxation of \$10.

must contest foreign tax liability if the expected benefit is greater than the sum of the costs of contesting the liability and the loss of the deduction.⁷⁷

This standard, however, may be difficult to apply to an individual case. Although the possible tax refund will generally be known with certainty, the other two factors in the equation are not as easily quantified. The Service could alleviate the uncertainty of the "cost to contest" factor by preparing average contesting cost tables for each foreign country. It could minimize uncertainty with regard to the "probability of success" factor by arbitrarily requiring the use of a probability of ten percent unless the Service can demonstrate special factors that would increase the probability. These factors could be enumerated in regulations.⁷⁸

Even under this standard, however, there are two situations in which the taxpayer has sufficient incentive to challenge foreign tax liability. In these cases, there will be no need for the Service to evaluate the taxpayer's decision in light of the deduction standard. The first occurs when a U.S. taxpayer claims a section 902 indirect credit and the foreign corporation is controlled by foreign shareholders. Since these foreign shareholders do not receive a U.S. tax credit for the tax payments, market forces will cause them to contest the liability if the expected benefit is greater than the costs. Second, the IRS can rely upon the taxpayer's decision if his foreign tax payments exceed the section 904 maximum credit.⁷⁹ If the amount of the potential refund is less than the amount of the excess, the taxpayer will have an incentive to contest his foreign tax liability, since he would not in any case receive a credit for the payments. In both of these cases the market provides an adequate incentive for the taxpayer to contest payments; thus, the IRS need not examine the validity of the foreign tax payments.

B. SUGGESTED INTERPRETATION OF REVENUE RULING 76-508

Unless the Service revokes Revenue Ruling 76-508, the contribution

77. Expressed in an equation, this standard is:

$$C + tr [Dd \cdot p] < R \cdot p.$$

See note 75 *supra*. Alternatively, the standard for a credit might be: a foreign tax payment shall be eligible for a credit if the taxpayer has contested all portions of the payment that he would have contested if he had received neither a deduction nor a credit. Under this standard the taxpayer must contest a foreign tax payment if the expected benefit is greater than the cost of contesting:

$$C < R \cdot p.$$

See note 72 *supra*.

78. An example of such a special factor would be a refund from the foreign tax authority obtained by a similarly situated taxpayer. In such a case, the Service might find that the probability of success in obtaining a refund had increased to 90%.

79. This analysis assumes that the taxpayer does not expect to claim a credit in future years for these excess credits. See I.R.C. § 904(c); M. MOORE & R. BAGLEY, *supra* note 3, at 103.

presumption looms over any taxpayer who seeks a foreign tax credit, leaving the taxpayer to determine when the presumption will be raised and what steps he must take to rebut it. The application of the theoretical analysis to Revenue Ruling 76-508 does not provide a simple answer or one that the Service will necessarily follow. It does, however, provide guidance for interpreting the ruling.

1. Contribution Presumption

Revenue Ruling 76-508's two conditions for invoking the contribution presumption—possibility of reduction or refund in tax liability combined with notice—should be interpreted so as to reduce the potential reach of the presumption. First, the notice condition should be deemed met only if the taxpayer has received "actual notice"⁸⁰ of a possible refund or reduction in foreign tax liability. This interpretation is necessary to duplicate the no-credit situation, since even a taxpayer with a high incentive to contest a payment would not do so unless he was aware of the possible refund. The facts of the rulings are consistent with this interpretation. Revenue Ruling 76-508 stated that it was the proposed section 482 allocation letter itself that put the taxpayer on notice, rather than the undertaking of the non-arm's-length transaction. In Revenue Ruling 77-267, the IRS pointed to knowledge of a similarly situated taxpayer's refund, not merely the existence of a potential refund right, as the triggering event.

Second, a "possibility of a refund or reduction of tax liability" should occur only when the taxpayer would have contested the tax liability but for the existence of a credit. Use of the deduction standard⁸¹ would place the taxpayer on the same footing as one seeking a deduction. This standard would provide that a possibility of refund or reduction would occur when the expected tax saving was greater than the sum of the cost to obtain the lowest level of administrative review and the expected loss of the tax benefit provided by a deduction for the foreign tax payment.⁸² Thus, Revenue Ruling 76-508's contribution presumption would become more consistent with considerations of law and policy. The policies of preserving the integrity of the U.S. Treasury and of removing the credit's disincentive to contest⁸³ both support this standard.⁸⁴

80. See note 34 *supra* and accompanying text.

81. See notes 72-77 *supra* and accompanying text.

82. See notes 75 & 77 *supra*.

83. See text accompanying note 62 *supra*.

84. Although the facts of Rev. Rul. 76-508 and Rev. Rul. 77-267 do not specify the amount of the refund, the cost to contest, or the probability of success, it is likely that there would be a large enough expected refund to prompt a taxpayer who receives only a deduction for the tax payment to contest the tax payment. In Rev. Rul. 76-508, the § 482 allocation may create a very high probability of obtaining a refund of the foreign taxes paid on that income.

2. Procedural Rebuttal

Assuming that, using the deduction standard, the contribution presumption seems likely to be raised, the next question is what procedural steps will rebut the presumption. Revenue Ruling 76-508 requires exhaustion of "effective and practicable administrative remedies." Again, using the deduction standard, the exhaustion of effective and practicable⁸⁵ remedies will occur when the expected tax saving is less than the sum of the cost of administrative contest and the expected loss of a tax deduction. The cost of administratively contesting the tax liability should be determined for each level of administrative review.⁸⁶ The taxpayer will have exhausted his administrative remedies when the aggregate cost of proceeding to the next level is greater than or equal to the discounted tax savings.⁸⁷

In addition, to rebut the contribution presumption, the taxpayer may have to exhaust his remedies under the competent authority procedure.⁸⁸

Similarly, in Rev. Rul. 77-267, the very existence of a similarly situated taxpayer who petitioned for and obtained a refund would indicate a high probability of success. It appears, then, that in these two cases the IRS may properly have raised the contribution presumption.

85. The Water Pollution Control Act Amendments of 1972 require the use of "the best practicable control technology currently available." 33 U.S.C. § 1311(b)(1)(A)(1976). In *CPC Int'l, Inc. v. Train*, 540 F.2d 1329 (8th Cir. 1976), the court defined practicable to include the notion of cost. "[T]he term 'practicable' is to limit the use of available technology only where the additional technology necessary to achieve a marginal level of effluent reduction is wholly out of proportion to the cost realized." *Id.* at 1341 (citations omitted).

86. A simple example will illustrate this determination. Assume the following: the amount of tax refund in question is \$5,000; the probability of obtaining a refund is 25%; the taxpayer's effective U.S. tax rate is 50%; and the legal cost of seeking administrative remedies is

Informal request	\$ 50
Private letter ruling	100
Hearing	800
Further review proceedings	1,000

The expected tax refund (amount of tax refund • probability of success) will be (\$5,000) (.25) = \$1,250. Taking into account the effective tax rate of 50%, the cost of the deduction will be (.50)(\$1,250) = \$625.

The taxpayer should pursue his refund until the aggregate cost of the next step is greater than the expected tax refund of \$1,250. In the example, this would occur after the private letter ruling stage, when the aggregate cost of contest (legal costs + cost of deduction) will be \$50 + \$100 + \$625 = \$775. Appealing the private letter ruling would thus produce an aggregate cost of \$1,575, which is greater than the expected tax refund of \$1,250.

87. A recent Tax Court case, *Schering Corp. v. Commissioner*, 69 T.C. No. 46, [1978] TAX CT. REP. (CCH) ¶ 34,929, is consistent with this approach. The IRS wished to deny the taxpayer's foreign tax credit because he had failed to exhaust all effective and practicable administrative remedies in pursuing a reduction of foreign tax liability. The taxpayer had requested and received a foreign government private letter ruling stating that he was liable for the tax. The court held that the receipt of the letter ruling exhausted all practicable and effective administrative remedies, since any further administrative contest would be "futile." *Id.* at 2249-50. Although the court did not quantify its analysis, it appears to have determined in effect that the probability of success was so slight as to make the expected tax refund extremely small.

88. If there is no treaty providing for a competent authority procedure between the United

Resort to competent authority in addition to foreign administrative remedies should be necessary in only two situations. First, if the foreign statute of limitations for contesting tax liability has tolled, administrative relief in the foreign country may not be open to the taxpayer at the time he becomes aware of the reasonable possibility of a tax refund. In such a case, the taxpayer should avail himself of the competent authority procedure if the sum of the cost of petitioning the authority and the expected loss of the tax benefit from the deduction for the foreign tax payment is less than the expected refund. Second, if the taxpayer—after exhausting the administrative relief in the foreign country—is unable to obtain a refund, he should be required to seek the assistance of competent authority only if the additional cost of seeking the assistance, plus the prior costs of administratively contesting and the expected deduction cost, remain less than the expected tax refund.

CONCLUSION

Recent IRS revenue rulings appear to have limited the availability of the foreign tax credit by raising a presumption that the taxpayer has made a contribution rather than a foreign tax payment in certain circumstances. The rulings also point to the methods a taxpayer may use to rebut this presumption. But the Service has failed to provide specific guidelines for determining when it is likely to challenge a payment or when the taxpayer has successfully rebutted the presumption once it is raised. At present, the rulings set requirements that are needlessly uncertain and legally infirm. To cure these defects, the Service should revoke the rulings and promulgate regulations clarifying the circumstances that will raise and rebut this presumption by setting a standard that is both legally sound and easily applicable.

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States and the foreign country where the tax payment was made, the requirement to exhaust remedies under competent authority does not apply. Letter Rul. No. 7838063, [1978] IRS LETTER RULING REP. (CCH) (June 22, 1978).

