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Proposed Multilateral FTC Pooling And U.S. Bilateral Tax Treaties

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The Obama administration's 2009 green book proposed a major change in the indirect foreign tax credit. The proposal probably evolved from the 2007 bill introduced by House Ways and Means Committee Chair Charles B. Rangel, D-N.Y. The proposal is to pool the distributed and undistributed earnings of all foreign affiliates and all the taxes of all foreign countries on those pooled earnings, and then to treat actual distributions by any of the individual affiliates as carrying a share of all foreign taxes on the pooled earnings, rather than a share of the actual taxes paid on the actual earnings of the company paying the dividend.

The pooling basis proposal, whatever its domestic economic or political appeal, appears to conflict with 48 U.S. bilateral tax treaties. Each treaty requires the United States to provide an FTC for that treaty partner's taxes on the profits of companies from that treaty partner when a dividend from that company is taken into income by the U.S. parent company. The United States should first consult with at least its largest treaty partners before turning the bull of righteousness loose in the shop in which the United States has so carefully arranged the china over the past 60 years. How much American china will be broken? Will it be hard to put back on the shelf?

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I. Introduction

The Obama administration's 2009 green book proposed a major change in the indirect foreign tax credit. Under the proposal, the United States would not provide a credit for contracting state taxes on the contracting state company's profits out of which the dividend is paid. Instead, the allowable amount of creditable foreign taxes would be limited to an amount measured by reference to the distributed and undistributed earnings of all foreign

affiliates (not limited to foreign affiliates in the contracting state or even to foreign affiliates in other countries with which the United States has a treaty).

The thesis of this report is that such a change is a square peg that cannot be pounded into the round hole of any bilateral treaty that requires the United States to provide a credit for taxes imposed by the contracting state on the profits out of which the dividend is paid. There are 48 such treaties.

This report is organized around the arguments the author has heard as to why the thesis is wrong and why the United States supposedly has the authority under those 48 treaties to adopt the pooling basis proposal. Those arguments have sometimes taken the form of references to the history of the FTC and the evolution of limitations thereon. The report accordingly examines that history to determine what our treaty partners think the United States agreed to.

The most important point is that even if U.S. tax practitioners agree with the views underlying the proposal, what matters more is whether our treaty partners agree. If we are going to make a major change, we should do so with appropriate courtesy to the affected countries.

A. 2009 Green Book

On May 11, 2009, the Treasury Department issued its ''General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals.''[1] The 2009 green book describes a number of changes under the heading ''Other Revenue Changes and Loophole Closers,''[2] including ''Reform Foreign Tax Credit: Determine the Foreign Tax Credit on a Pooling Basis.''[3] The proposals were followed quickly by a virtually simultaneous endorsement by at least one leading academic advocate of fundamental reform of the U.S. international tax architecture.[4] The report praising the proposals did not, however, address the question of potential conflict with existing U.S. bilateral tax treaties.[5]

This report will examine the tension between the administration's pooling basis proposal for calculating the FTC and each of the 48 U.S. treaties[6] that seek (at least according to their titles) to ''avoid double taxation and to prevent fiscal evasion'' by requiring the United States to provide an FTC for income taxes imposed by the treaty partner (each a contracting state) on the profits of a treaty-resident subsidiary out of which the dividends are paid to the U.S. taxpayer.[7]

The pooling basis proposal is described in the 2009 green book in the following terms:

> Under the proposal, a U.S. taxpayer would determine its deemed paid foreign tax credit on a consolidated basis by determining the aggregate foreign taxes and earnings and profits of all the foreign subsidiaries with respect to which the U.S. taxpayer can claim a deemed paid foreign tax credit

[1]Department of the Treasury, ''General Explanation of the Administration's Fiscal Year 2010 Revenue Proposals'' (May 2009) (the 2009 green book), *Doc 2009-10664, 2009 TNT 89-44*.

[2]*Id.* at 21.

[3]*Id.* at 30.

[4]Reuven Avi-Yonah, ''Obama's International Tax Plan a Major Step Forward,'' *Tax Notes*, May 11, 2009, p. 735, *Doc 2009-10121*, or *2009 TNT 85-6*.

[5]*But see* discussion of some of the issues involved in treaty overrides in Reuven Avi-Yonah, ''International Tax as International Law,'' 57 *Tax L. Rev.* 483 (Summer 2004).

[6](1) Australia 1982 (Art. 22), (2) Austria 1996 (Art. 22), (3) Bangladesh 2006 (Art. 23), (4) Barbados 1984 (Art. 23), (5) Belgium 2006 (Art. 23), (6) Bulgaria 2007 (Art. 22), (7) Canada 1980 (Art. 24), (8) China 1984 (Art. 22), (9) Cyprus 1984 (Art. 5), (10) Denmark 1999 (Art. 23), (11) Egypt 1980 (Art. 25), (12) Estonia 1998 (Art. 23), (13) Finland 1989 (Art. 23), (14) France 1994 (Art. 24), (15) Germany 1989 (Art. 23), (16) Greece 1950 (Art. XIV), (17) Hungary 1979 (Art. 20), (18) Iceland 2007 (Art. 22), (19) India 1989 (Art. 25), (20) Ireland 1997 (Art. 24), (21) Israel 1975 (Art. 26), (22) Italy 1984 (Art. 23), (23) Jamaica 1980 (Footnote continued in next column.) (Art. 24), (24) Japan 2003 (Art. 23), (25) Kazakhstan 1993 (Art. 23), (26) Republic of Korea 1976 (Art. 5), (27) Latvia 1998 (Art. 24), (28) Lithuania 1998 (Art. 24), (29) Luxembourg 2001 (Art. 25), (30) Mexico 1992 (Art. 24), (31) Netherlands 1992 (Arts. 24 and 25), (32) New Zealand 1982 (Art. 22), (33) Norway 1971 (Art. 23), (34) Philippines 1976 (Art. 23), (35) Poland 1974 (Art. 20), (36) Portugal 1994 (Art. 25), (37) Slovenia 1999 (Art. 23), (38) South Africa 1997 (Art. 23), (39) Spain 1990 (Art. 24), (40) Sri Lanka 1985 (Art. 24), (41) Sweden 1994 (Art. 23), (42) Switzerland 1996 (Art. 23), (43) Thailand 1996 (Art. 25), (44) Trinidad and Tobago 1970 (Art. 4), (45) Tunisia 1985 (Art. 23), (46) Turkey 1996 (Art. 23), (47) United Kingdom 2001 (Art. 23), and (48) Venezuela 1999 (Art. 24). Eight treaties entitled as a convention to avoid double taxation do not provide for an indirect credit for foreign taxes on the accumulated profits out of which a dividend might be paid. Those are the treaties with the former East Bloc countries (the Czech Republic, the Republic of Slovakia, Romania, Russia, and Ukraine) with business tax models that did not support, when the treaty was entered into, an indirect credit for local affiliates of a U.S. corporate enterprise, and three jurisdictions (Indonesia, Morocco, and Pakistan) whose treaties did not contemplate indirect credits when the bilateral treaty was entered into. Although further research might explain the atypical provisions, it is likely that the business tax regime in each jurisdiction made an indirect credit unimportant or inappropriate when the treaty was entered into. Also, under the Alma Ata Declaration of December 21, 1991 (regarding agreements of the U.S.S.R.), the U.S.S.R. treaty remains in effect with the following members of the Commonwealth of Independent States (CIS): Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, and Uzbekistan. This treaty (or perhaps, these nine identical treaties) does not provide an indirect credit because it was premised on a business system that would not accommodate such a credit based on the anticipated nature of investment by U.S. enterprises in the Soviet Union. That treaty will remain in effect until new treaties with the individual countries are negotiated and enter into force. *See* IRS Publication 901 (rev. Apr. 2009), *U.S. Tax Treaties*, *Doc 2009-9505, 2009 TNT 81-30*. In sum, most of the cross-border direct investment of the United States is likely covered by a treaty that requires the United States to provide a credit for contracting state taxes on the accumulated profits out of which a dividend is paid by a contracting state company.

[7]The credit against U.S. tax otherwise due for foreign income taxes on the profits of a foreign corporation out of which a dividend is paid is sometimes referred to as the indirect credit or the deemed paid credit. The term ''deemed paid credit'' is based on the language in section 902 that says taxes paid by a foreign corporation on its profits will be ''deemed paid'' by the U.S. corporate shareholder.

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(including lower tier subsidiaries described in section 902(b)). The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year.[8]

The pooling basis calculation of the amount of foreign tax deemed paid and the limitation on the amount thereof that can be credited against U.S. tax otherwise due is at best opaque under the short description in the 2009 green book. The pooling basis proposal may anticipate the use of suspended FTCs at the level of the U.S. shareholder regarding distributions by a foreign affiliate with higher than average tax rates, and it may anticipate a concept of ''previously used FTCs'' for distributions from foreign affiliates with lower than average tax rates.

Alternatively, it would be possible to create a regime to deem distributions made by one affiliate to have been made by different members of the pool out of earnings derived by different members, to deem foreign taxes paid to one country to have been paid to another country, or to attribute all those foreign taxes to an imaginary sovereign that taxes the pool instead of all the real sovereigns that may think they are taxing earnings of real companies. While software writers could no doubt eventually figure out how to automate the tax accounting for such a regime, it seems more likely that the former approach would be followed — shareholder-level accounting for creditable taxes would be deemed paid and deemed not paid without changing the tax books of the individual foreign affiliates.[9]

The administration estimated that the pooling basis would increase federal income tax revenues by $25 billion for the period 2010-2019. The staff of the Joint Committee on Taxation estimated the increase in federal tax revenues for the same period to be $45 billion.[10]

[8]2009 green book, *supra* note 1, at 30.

[9]Either approach will result in essentially the same qualitative pressure on the bilateral-treaty-based indirect credit under article 23 (references herein to article 23 are, unless otherwise specified, used as a proxy for the provisions in each double tax treaty that provides for an indirect FTC, because both the U.S. model and the OECD model contain the indirect credit provision in article 23). The merits of the alternative accounting conventions, aside from the implications under article 23, are beyond the scope of this paper; however, the use of hypothetical reallocations of earnings, dividends, and taxes at the foreign affiliate level would increase employment of accountants and lawyers who will have an opportunity to try to apply, and then creatively mitigate, the application of any such rules. A regime constructed around suspended FTCs deemed paid in excess of the pool average, previously credited FTCs remaining in a foreign corporation as a tax item, and previously deemed distributed taxes not actually paid by the distributing company, might be simpler but will also be labor intensive.

[10]Staff of the JCT, ''Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal as Described by the Department of the Treasury, May 2009,'' JCX-28-09 (June 11, 2009), *Doc 2009-13321, 2009 TNT 111-11*.

B. Article 23 (Relief From Double Taxation)

1. U.S. model income tax convention. Article 23 of the U.S. model income tax convention (2006)[11] provides as follows regarding the obligation of the United States to provide an indirect FTC:

> Article 23. Relief from Double Taxation
>
> 1. ***
>
> 2. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof) the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income applicable to residents and citizens:
>
> a) ***
>
> b) in the case of a United States company owning at least 10 percent of the voting stock of a company that is a resident of _____________ and from which the United States company receives dividends, the income tax paid or accrued to _______________ by or on behalf of the payer with respect to the profits out of which the dividends are paid.

Language similar or identical to the quoted language has been used in 47 of the 48 bilateral tax treaties now in force that provide an indirect or deemed paid FTC for income taxes imposed by the treaty partner on the accumulated profits out of which dividends are paid.[12]

Article 23 states that the United States shall allow a credit to its citizens and residents ''in accordance with and subject to the limitations of the law of the United States.'' Article 23 is not without flexibility. It does permit changes in the ''limitations of the law of the United States'' as of the treaty date, but amendments to existing provisions and limitations are permitted only if they do not change ''the general principle hereof'' (that is, the general principle of article 23 and the associated FTC provisions of U.S. federal income tax law in effect when the deal is struck between the contracting states). Article

[11]United States Model Income Tax Convention (Nov. 15, 2006), reprinted in *Doc 2006-23239, 2006 TNT 221-20*.

[12]The 1950 treaty with Greece refers to section 131 of the Internal Revenue Code of 1939, excerpts of which are set forth in Appendix B. By its terms, the treaty language would preclude any amendment of section 131 as it applies to dividends from a Greek subsidiary (and not merely an amendment inconsistent with the principles of avoiding double taxation of the dividends and underlying profits of a Greek company). Several early post-World War II treaties provided similar relief by reference to section 131. The potential conflict with those treaties was recognized in 1962 when changes were made in the FTC limitation calculation. The conflict was resolved by treaty override in the Revenue Act of 1962. *See* note 52 *infra.* The other 47 treaties now in force that do provide for an indirect credit generally contain the newer caveat that limitations and provisions of U.S. law may be amended if the amendments are not inconsistent with the principles of the treaty in place on the treaty date.

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23 *does not* state that the United States has unilateral discretion to enact whatever provisions or limitations happen to be interesting from time to time after the treaty is signed.

The United States has no current statutory limitations that intentionally preclude a credit for foreign taxes paid to a contracting state for an item of income that is both described in the treaty and subject to tax by the other contracting state in accordance with the treaty (that is, the other contracting state's tax on the profits of a dividend-paying resident of that state). The United States did for a time deliberately impose a double tax in contravention of article 23. That occurred when section 59(a)(2) was enacted as part of the Tax Reform Act of 1986 AMT provisions.[13] At enactment, or soon thereafter, Congress recognized the conflict with article 23's principles and enacted an override in the Technical and Miscellaneous Corrections Act of 1988 (TAMRA).[14] The process of enactment of the conflicting provision, recognition (or denial) of the conflict, legislative override (just in case denial was inadequate),[15] litigation,[16] and academic discourse[17] may be useful in considering whether the proposed pooling basis is in conflict and, if so, what to do about it (and who should do whatever needs to be done). Section 59(a)(2) was repealed in 2004.[18]

As more fully discussed below, there are obvious instances in which the pooling basis would limit the FTC for taxes imposed by the other contracting state ''with respect to the profits out of which the dividends are paid.'' Any new provision or limitation on a credit for income taxes paid to the other contracting state must be tested under article 23 as an amendment that must not result in changing the general principle of relieving double taxation on the relevant profits out of which the dividends are paid.

2. OECD model article 23. The most recent OECD Model Tax Convention on Income and Capital (July 2008) contains two alternative approaches to relieving double taxation of source-country profits of a source-country subsidiary of a residence-country corporate shareholder that is subject to worldwide tax. The alternatives are contained in article 23 of the OECD model. Either alternative, or a combination of both, would be appropriate. Article 23A[19] would require exemption from shareholder-residence-country taxation of dividends. Article 23B[20] would require a credit in terms virtually identical to article 23 of the U.S. model. The virtual identity between the U.S. model article 23 and the provisions of the OECD model is not a fortuitous coincidence. It results from an agreement among the countries that account for the lion's share of global trade and investment regarding the division of taxing jurisdiction over income from businesses participating in the global economy.

The agreement on the indirect FTC has been forged over a period that dates back at least to 1946.[21] It has been built in significant part on the basis of U.S. efforts to work out a stable framework for cross-border trade and cross-border direct investment. However, just because the agreement originated with, or was implemented at the insistence of, the United States does not mean it is supposed to be terminable at will by the United States.

3. Article 23 of the U.S. model and article 23 of the OECD model are intentionally symmetrical. The point is that article 23 of the U.S. model and article 23 of the OECD model are virtually identical because the United States and its treaty partners have been working on this problem together for many years. Relief from double taxation in the way prescribed by both the U.S. model and the OECD model for tax on the accumulated profits out of which a dividend is distributed is not some uniquely American approach to the problem. The substantial identity in language confirms that the OECD will be able to understand the effect of enacting the pooling basis proposal with its attendant (and intended)[22] curtailment of the relief from double taxation prescribed by article 23 under each model convention.

The treaty-based requirement for an indirect credit appears in an article corresponding to article 23 of the U.S. model in each of the 48 (of a total of 58) separate U.S. bilateral treaties for the avoidance of double taxation.[23]

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[13]Tax Reform Act of 1986, section 701(a), P.L. 99-514.

[14]TAMRA, P.L. 100-647, section 1012(aa). *See* note 48 *infra*.

[15]Staff of the JCT, ''Description of the Technical Corrections Act of 1987,'' JCS-15-87 (Jun. 16, 1987).

[16]*See* note 48 *infra*.

[17]Avi-Yonah, ''International Tax as International Law,'' *supra* note 5. *See* Part II.A below.

[18]American Jobs Creation Act of 2004, section 421(a)(1), P.L. 108-357.

[19]The U.S. model is symmetrical with the OECD model in contemplating a territorial exemption alternative along the lines of article 23A if the other contracting states wish to follow that route to relief from double taxation.

[20]Article 23B of the OECD model is symmetrical with the credit approach set out in article 23 of the U.S. model.

[21]The U.K.-U.S. ''Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income,'' entered into April 16, 1945, and June 6, 1946, contained an agreement to extend a credit for U.K. taxes in accordance with section 131 of the code as in effect on January 1, 1945. *See* Convention Between the United States of America and the United Kingdom for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Gains, reprinted at *Doc 94-30292*, *93 TNI 251-115*. Section 131(f) of that code provided the indirect credit for U.K. taxes on the underlying profits of the U.K. company distributing a dividend to a 10 percent U.S. corporate shareholder.

[22]The measure is, after all, lumped with revenue raisers to pay for other government programs.

[23]*See* U.S. bilateral tax treaties listed in note 6 *supra*. The nine exceptions (the treaties with the Czech Republic, Indonesia, Morocco, Pakistan, Romania, Russia, the Slovak Republic, Ukraine, and the CIS remnant countries) are likely the result of peculiarities of the assumptions about limited cross-border direct investment in each of those countries through local company subsidiaries, rather than the result of an intent to subject dividends from source-country subsidiaries to double taxation in the parent company residence country (without the

(Footnote continued on next page.)

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As noted above,[24] we will refer to article 23 as a proxy for articles to the same effect in U.S. bilateral treaties that might number differently the article dealing with relief from double taxation by means of an indirect FTC.

C. Rangel Bill (2007)

The administration's pooling basis proposal appears to have evolved from the FTC proposals in H.R. 3970,[25] introduced on October 25, 2007, by House Ways and Means Committee Chair Charles B. Rangel, D-N.Y. The Rangel bill's FTC proposal[26] is attached hereto as Appendix A. That proposal is broader than the administration's proposal in that it requires aggregation and blending of all direct section 901 credits (for foreign taxes imposed on the income of a U.S. person) and indirect section 902 credits (for foreign taxes imposed on the earnings from which dividends are paid). The pooling basis proposal requires aggregation and blending of indirect credits only.

D. Potential Conflict

Treaty article 23 implicitly requires that the contracting state of shareholder residence provide at least a per-item FTC for taxes imposed by the contracting state (of the dividend-paying company) on the dividends of a contracting state company and the profits out of which the dividend is paid.[27] Under article 23, the United States must provide a credit against its taxes on a dividend from a company that is a resident of the counterparty contracting state. The credit must be provided for both the counterparty state's tax on the dividend *and* its tax on the profits out of which the dividend was paid (that is, the local country corporate income tax).

The pooling basis proposal would not provide an FTC for the contracting state's tax on the resident company's profits out of which the dividend is paid. The allowable amount of FTC would instead be limited to an amount measured by reference to the distributed and undistributed E&P of all foreign subsidiaries (not limited to items comprising the contracting state company's distributed and undistributed E&P) and not limited to foreign subsidiaries located in jurisdictions with which the United States has an income tax treaty.

Although the 2009 green book does not detail the mechanics of the new limitation, it is likely that the pooling basis proposal will operate as a new method to determine the amount of taxes deemed paid under section 902 after first calculating the amount of the dividend actually paid by the particular company, rather than operating as an additional limitation on the amount of U.S. tax that can be offset after the amount of foreign tax deemed paid (on the underlying accumulated profits) has been determined.

From the green book's silence, it can be inferred that the normal rules for distinguishing dividends from other transactions between a company and its shareholders will presumably be applied first. In other words, dividends will be determined by applying the rules of sections 301, 302, 311, 312, 316, and 317 to the amounts distributed by the company making the distribution. Those provisions would not work comfortably on a pooling basis that ignored the E&P of the distributing company or its basis in property distributed. A composite approach could be made to work, but it would be complicated to draft.[28]

It should be noted that depending on how the pooling basis proposal is implemented, it could increase the amount of taxes deemed paid on distributions by affiliates that have earnings subject to foreign tax at a rate below the pool average. Such an increase in foreign taxes deemed paid would reduce U.S. tax, after effecting a credit for the deemed paid foreign taxes. The estimates of this provision's revenue effect predict a large increase in federal income tax collected as a result of projected decreases in the amount of U.S. tax reduced by FTCs.[29] When a decrease occurs, compared with allowing the credit required by the treaty, the potential treaty violation will occur.

However, when taxes in excess of the amount creditable under the requirements of a treaty with one country are allowed as a credit against U.S. taxes otherwise due on *other* dividends, the affected (higher tax) contracting states may argue that two wrongs do not make a right. In that situation the contracting state (whose taxes on its resident companies are disallowed as a credit against U.S. tax on dividends from those resident companies) may contemplate a distortion in possible investment location factors vis-à-vis the lower-taxed state that enjoys a windfall for investment in that lower tax country. It is likely that the location of significant labor-intensive, direct investment is not determined by marginal tax incentives of this sort; however, property ownership by low-tax affiliates might be significantly encouraged by the prospect of FTCs for taxes paid by high-tax companies on undistributed profits of those companies in other countries. It may also encourage research on efficient base and

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benefit of a credit for source-country tax on the dividends and on the accumulated profits from which dividends might be paid).

[24]*See* note 9 *supra*.

[25]Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong., (2007) (the Rangel bill).

[26]Section 3201 of the Rangel bill would have added new subpart H (new sections 975, 976, and 977 of the code). Section 976 is the portion effecting the potential dilution of the indirect FTC by a form of pooling of foreign-source income and foreign income taxes thereon.

[27]While a per-item FTC system is the most precise method of ensuring the elimination of double taxation, it has generally been unappealing because it might be impossible to administer.

[28]The occasion for complexity would include the consequences of partial ownership by more than one U.S. 10 percent corporate shareholder of a foreign corporation the E&P of which may be aggregated with many other foreign corporations related to only one of the U.S. 10 percent corporate shareholders. It would also include the consequences of changes of ownership in taxable and tax-free reorganizations (i.e., the consequences of the movement or nonmovement of corporate tax attributes) and the consequences of preaffiliation foreign tax payments. Those are the first few that come to mind.

[29]As indicated in note 10 *supra*, the administration estimated a revenue increase of $25 billion for the period 2010-2019, while the JCT's estimate was $45 billion.

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timing differences (tax arbitrage) among various non-U.S. tax systems, but it is too soon to start that planning.

Thus, the distributing company distribution, once distinguished from other transactions involving payments to a related U.S. corporate taxpayer (such as payment of principal or interest on shareholder-held debt, or payments for goods and services) would likely then be tested as a dividend or as a return of capital by reference to the distributing company's E&P account, and not by reference to the E&P of some other companies occasionally sharing a level of common ownership with the distributing company and its U.S. corporate shareholder (directly or indirectly).

This approach is symmetrical with the statutory architecture of the Rangel bill. The amount and character of distributions as dividends in that proposal would first be determined under the normal company-by-company rules. Once the amount of dividend has been determined at the level of the actual distributing company, the next step would be to determine how much foreign tax would be treated as deemed paid by the shareholder on the accumulated profits included in the dividend. The new provisions would then further adjust the ordinary operation of section 902(b) to limit the amount of foreign tax deemed to be associated with the dividend by a particular company for purposes of section 902(b) and for purposes of determining the section 78 gross-up.[30]

As discussed below, if a U.S. corporate shareholder has two wholly owned subsidiaries, one in Germany and one in Ireland, and if the German subsidiary distributes 100 percent of its income (taxed at a high rate) while the Irish subsidiary distributes none of its income (taxed at a low rate), the pooling basis proposal would not allow a credit for all the German taxes imposed on the German company's profits out of which the dividend (to be taxed by the United States) will have been paid. The actual dividend from the German subsidiary would carry an FTC for only a portion of the German taxes paid on the profits of the German company — effectively diluting the treaty-mandated credit — even though all the German profits (distributed as a dividend and grossed up for the diluted amount of German taxes deemed paid under section 902(b)) would be subjected to U.S. tax as the contracting state (of which the U.S. shareholder is a resident subject to worldwide tax).

Under this assumption, in the converse case, in which the Irish company distributes all its E&P and the German company distributes none, a dividend by the Irish company would give rise to a deemed-paid credit for some of the German tax on the German company (that is, to bring the amount deemed paid on the Irish dividend up to the average amount of the combined foreign affiliate E&P pool tax rate). Under section 902(b), as adjusted by the new provisions, the Irish company tax plus some of the German company tax would then be taken into account as taxes deemed paid by the U.S. shareholder, effectively enhancing the treaty-mandated credit. The German tax taken into account would then have to be parked in something like a "previously credited tax" account.[31]

E. The Core Question Regarding Article 23

Although the administration's proposal and Rangel's bill have some differences, both present the same conceptual issue: Is determination of the FTC on the proposed pooling basis consistent with the United States' existing treaty obligations to provide relief from double taxation by granting an FTC for foreign income taxes imposed by the treaty partner on the dividends paid and on the underlying profits of the foreign corporation from which the dividends are paid? The pooling basis proposal appears to be in direct conflict with the United States' separate obligations to each of the treaty partners under each of the 48 separate bilateral treaties that provide for an indirect FTC (for taxes on the accumulated profits out of which *the* dividend is paid).

Bilateral treaties are not merely cogs in a multifaceted, multilateral treaty mechanism under which each contracting state seeks to avoid double taxation of its resident companies' income viewed in combination with the income and taxes of all other companies owned by a U.S. shareholder (in some amount at or above 10 percent). Moreover, bilateral treaties do not even address the issue of allowing credits for one country's tax as an offset against the residence-country tax on other income from the same country.[32]

It seems likely that squeezing the pooling basis proposal into a bilateral treaty network will never quite work. It may be possible to implement a multilateral compact that deems taxes paid to any member of the community of like-minded states to be fungible, or even to discard altogether treaty-based relief from double taxation by means of the indirect credit (even though the provision was likely put in place at the insistence of the United States and consistently pursued as U.S. tax policy for more than seven decades).[33] The pooling basis proposal may be ahead of its time.

F. U.S. Power to Override a Treaty

It is true that Congress can, by subsequent legislation, override any treaty to which the United States is a party. That is not the subject of this article, and it has been extensively addressed in other contexts. The question U.S. tax policymakers must address regarding the pooling basis proposal is how best to reconcile the United States' interests in increasing funding for healthcare reform or in lowering the basic corporate income tax[34] (or some other worthy purpose, such as reducing budget

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[30]Section 78 provides for the addition (to the amount of a dividend received from a foreign affiliate) of the amount of foreign taxes deemed paid under section 902 on the dividend received. The amount added back is the section 78 gross-up.

[31]The account approximates an inverted version of "previously taxed income" accounts under subpart F (section 959).

[32]*See* discussion below at Part II.C.1.

[33]The indirect credit was initially enacted by the Revenue Act of 1921, ch. 136, section 238(e) (see Appendix B). The 50 percent ownership threshold was later reduced to 10 percent in 1951, where it has remained for the past 58 years. *See* Appendix B for excerpts of applicable statutory provisions in force since enactment of the Revenue Act of 1921.

[34]*See* Meg Shreve, "Obama's International Proposals Will Go to Tax Reform, Not Healthcare, Rangel Says," *Doc 2009-13935,*

(Footnote continued on next page.)

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deficits to a level the nation's creditors may consider sustainable) with the United States' interests in retaining (and expanding) the benefits it seeks in entering into bilateral tax treaties.[35] Before overriding the treaties, explicitly or implicitly, U.S. tax policymakers should decide that they really want to do this, regardless of the cost to American interests in maintaining or even expanding the existing bilateral treaty network; that they care about those costs but find them acceptable; or that there will be no cost because our treaty partners do not really care about this aspect of treaty-based relief from double taxation and have just been humoring the United States in providing for an indirect FTC since the United States first implemented the idea in the 1920s.[36]

The treaties in question are each entitled ''Conventions for the Avoidance of Double Taxation and Prevention of Fiscal Evasion,'' or something to that effect. Each treaty's indirect FTC provision is set forth under an article with the heading ''Relief from Double Taxation'' or something similar. Still, tax policymakers may prefer to conclude that the pooling basis proposal is entirely consistent with each of the tax treaties that require the United States to provide an indirect credit. As suggested below, that conclusion seems questionable, at least sufficiently so that consultation with treaty partners would be prudent.

G. The Proviso to the Proviso in Article 23

Every FTC provision in each double taxation treaty contains a specific proviso to the effect that domestic U.S. tax law will apply existing ''limitations'' under that law on the benefit of an FTC for taxes imposed by the treaty counterparty country on dividends from companies resident in that country (and on the profits out of which the dividends are paid).[37] That proviso is further qualified by another proviso in article 23 that any changes in those treaty-date limitations must be consistent with the principles of avoiding double taxation resulting from residence-country tax on income taxable by the country that is entitled to tax the dividend-paying company.

As will be discussed below, the U.S. cross-crediting limitations that existed when the treaties were entered into are fully consistent with the principle of avoiding the kind of double taxation that each treaty requires be avoided. The limitations on the use of an FTC to reduce the alternative minimum tax were perhaps inconsistent with the avoidance of double taxation, but they were either limitations in force on the relevant treaty date or were specifically authorized by the override in TAMRA.[38]

H. The General Saving Clause in Article 1

Each of the tax treaties that require an indirect FTC also retains a general saving clause that corresponds to the saving clause in article 1(4) of the U.S. model.[39] The saving clause provides that the treaty shall not affect the taxation by the United States of its own citizens and residents, as if the treaty had not come into effect. If one were to read only through article 1(4), article 1(4) might support the view that the treaty does not require the United States to grant any relief in the taxation of its citizens and residents regarding any foreign tax those citizens or residents might pay or be deemed to pay. Under that reading, article 23 would be only hortatory — an aspiration of the parties to reduce double taxation if that happened to be domestically popular at any moment after the treaty enters in force.

The next paragraph of each treaty contains a clear limitation on the United States' ability to deal as it pleases with the taxation of its citizens and residents. Article 1(5) of the U.S. model provides that the provisions of article 1, paragraph 4 shall not affect ''the benefits conferred by a Contracting State under . . . Article 23 (Relief From Double Taxation).''

I. Humpty Dumpty's Definition of 'Limitations'

Article 23(2) refers to the ''provisions'' and ''limitations of the law of the United States.'' A U.S.-centric view of the term ''amendments consistent with the general principle'' of article 23 might lead supporters of the pooling basis proposal to argue that only limitations of the sort set out in section 904 are proscribed. Under that

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2009 TNT 116-3. ('''No, that's for tax reform,' Rangel said when asked by a reporter whether international provisions could be part of the financing side of a healthcare reform package.'')

[35]*See* H. David Rosenbloom and Stanley I. Langbein, ''United States Tax Treaty Policy: An Overview,'' 19 *Colum. J. Transnat'l L.* 359 (1981).

[36]*See* Revenue Act of 1921, ch. 136, section 238(e). (See Appendix B.)

[37]Some have argued that the word ''existing'' appears nowhere in the U.S. model or the OECD model. The concept of ''limitations'' and ''provisions'' in the same sentence as ''as it may be amended from time to time'' implies the concept of ''existing'' as the starting point.

[38]TAMRA, section 1012(aa). The limitations on the use of FTCs to offset the AMT were somewhat inconsistent with the concept of requiring, at a minimum, relief from double taxation on the same items. The problem of a potential conflict with article 23 was recognized in the period following the enactment of TRA 1986, and the possible inconsistency with existing treaties was addressed by a treaty override. *See* Staff of the JCT, ''Description of the Technical Corrections Act of 1987,'' JCS-15-87 (June 16, 1987), at 322. (''The bill provides that the following provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986): section 1201 of the Act, amending the foreign tax credit limitation, and section 701 of the Act (as it relates to the limitation on use of foreign tax credits against minimum tax liability'').) The role of the explicit override, the implicit adaptation to address postoverride treaty protocols, and the policy implications of all those are addressed in several cases and in at least one academic comment. *See* note 48 *infra* and discussion of the commentary at Part III.F.

[39]Some argued that it is settled law that the United States is not constrained by treaties in taxing its citizens and residents. They allude to the AMT litigation as support for this broad thesis. As discussed below, the AMT litigation turned on a specific override of existing treaties and on existing provisions of U.S. law to which the treaty was later subject. *See* discussion below at Part I.K.2. The cases did not depend on the general saving clause, in contrast with *Xilinx Inc. v. Commissioner*, 567 F.3d 482 (9th Cir. 2009), *Doc 2009-11943*, *2009 TNT 100-9*.

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reading, a reduction in the amount of foreign taxes deemed paid would not be subject to challenge as inconsistent with the general principle because there would be no change in the limitation.

Still, a reduction in the amount of contracting state foreign tax that can be credited against U.S. tax on dividends from a contracting state company (resulting from the inability to access the credit, perhaps forever) is likely to be treated as an amended limitation in the common understanding of the word, and is likely to be treated as inconsistent with the general principle of avoiding double taxation of the profits out of which the dividend is paid.[40] For example, if the United States were to reduce the amount of FTC allowed by repealing section 902 altogether but leaving section 904 unchanged, presumably no one would argue that the elimination of all FTCs for taxes deemed paid by the U.S. corporate shareholder would not be an amendment of the ''provisions'' and ''limitations'' within the meaning of the terms used in article 23.[41] Similarly, if the mechanical approach to limiting the creditable amount of contracting state tax on contracting state company dividends will be to refer to the income of entities other than the dividend payer, that is just a limitation by another name. Saying that ''limitations'' or ''general principles'' are only what the United States chooses them to mean, and to contend that the reduction in the amount deemed paid is not a limitation or a reduction that conflicts with general principles, is similar to Humpty Dumpty's definition of ''glory.''[42] It might lead to a nice knock-down argument.

J. An FTC Delayed Is Not an FTC Denied?

It may also be argued that the pooling basis proposal does not fail to *allow* the required FTC, but instead merely *postpones* the allowance of the credit until all the corresponding (expanded grouping) income items (pooled earnings) are taken into account for U.S. federal income tax purposes (worldwide income of all present or future affiliates now and forever). It is requiring, in effect, cross-crediting against U.S. tax on corporate profits of other companies from other countries when and if those profits are ever taken into account for U.S. tax purposes. In other words, in our Germany-Ireland example above, the argument might be that a dividend that walks and quacks like a German-source dividend from a German company may properly be treated as a composite dividend coming partly from the German company that paid it out of accumulated profits derived by the German company and subject to German tax, and partly from the Irish company that did not, but could have, paid some of the dividend out of the Irish accumulated profits that were not subject to German tax.[43]

The argument might be that if the Irish company distributes a sufficient amount in a subsequent year, the German tax would be creditable against the U.S. tax otherwise due on the Irish-source dividend income. In theory, everything will work out in the great by-and-by when the Irish company (or its present or future siblings) distributes its earnings.[44] The current version of article 23 does not contemplate the contingency that the credit for taxes imposed on accumulated profits out of which a dividend is paid be deferred until other dividends are paid out of accumulated profits not even subject to German tax. Germany may well wonder how it might ascertain compliance by the United States with the obligation under article 23 when, in addition to inquiring about the actual dividends and actual accumulated profits of the German company, Germany is required to inquire into the past, present, and future taxes imposed by several, or dozens, or even more than 100 other countries, on the accumulated profits of several, or dozens, or perhaps hundreds of other companies, in which each 10 percent or greater U.S. shareholder of a German company may also own for some period a 10 percent or greater interest, either now or in the future.

It may be possible to imagine a world in which disembodied taxes can be accounted for in a way that might make the effect on the required U.S. credit for German tax on the German company a timing issue, at least facially. It would be nice to know whether the German treaty partner concurs that the imaginary world is sufficient to convert the new limitation into a mere timing issue. It would also be nice to know that there is a mere timing issue gloss on permissible future amendments to the permissible limitations and, if so, that a mere timing issue that may extend into infinity conforms to what the Germans think article 23 is supposed to accomplish.

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[40]Article 23 is generally entitled ''Relief from Double Taxation.''

[41]It is worth remembering that even the relatively minor limitation on the double taxation article in 1986 — regarding a 90 percent cap on the AMT that could be reduced — was greeted with some hostility by treaty partners. *See* discussion at Part III.E below.

[42]*See* Lewis Carroll, *Through the Looking Glass and What Alice Found There*, ch. 6, in which the following version of this argument appears:

> ''I don't know what you mean by 'glory,''' said Alice.
>
> Humpty Dumpty smiled contemptuously. ''Of course you don't — til I tell you. I meant 'there's a nice knock-down argument for you!'''
>
> ''But 'glory' doesn't mean 'a nice knock-down argument,''' Alice objected.
>
> ''When I use a word,'' Humpty Dumpty said in a rather scornful tone, ''it means just what I choose it to mean — neither more nor less.''
>
> ''The question is,'' said Alice, ''whether you can make words mean so many different things.''
>
> ''The question is,'' said Humpty Dumpty, ''which is to be master — that's all.''

[43]This report does not address the various potential taxpayer responses to enactment of the pooling basis proposal. Taxpayers have supposedly commenced modeling the effect of forgoing all or substantially all distributions out of earnings that have been taxed at a rate in excess of the pool average rate.

[44]A strategy based on trying to convince each of our treaty partners that this is ''only timing'' may be ineffective in maintaining a working set of bilateral tax treaties. The relationship between time and space is beyond the scope of this report, but it is probably true that there is a convergence between time and substance and that never is too long to be mere timing.

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K. Remedies in Case of Conflict With Treaties

1. Treaty partners. One important question, apart from Humpty Dumpty's view of what is important, is whether legislative changes to implement the pooling basis proposal are consistent with the understanding on the part of our treaty partners as to what principles are supposed to apply in accommodating future (post-treaty-date) changes in the FTC limitations by amendment of U.S. tax law governing the FTC. Whatever one's views of the untrammeled right of a free people to tax themselves, their residents, and their corporations, it would be prudent to explore with our treaty partners whether they[45] think some interest of theirs is also at stake, and what they might do in response to the United States' exercise of its unquestioned right to do whatever it wants to in dealing with its own citizens and residents.[46]

2. U.S. taxpayers. This report will not explore what remedies (if any) might be available to affected U.S. taxpayers in the event of a perceived conflict with article 23 in determining tax due on dividends from contracting state affiliates. Section 7852(d) recites a general rule that neither a revenue law nor a treaty shall have precedence by virtue of being a law or treaty. The other general rule is that the last in time will prevail and that inconsistent treaty provisions in place immediately before enactment will be overridden by enactment.[47] The issue will likely be resolved, as it was when section 7852(d) was added to the code by TAMRA,[48] by a specific "just in case" override that will be accompanied by a recital of the reverence the United States has for its solemn commitments under treaties.[49]

II. The Indirect FTC Under Article 23

The treaty-based requirement for the indirect FTC is set out in article 23 of the U.S. model (quoted above) and in article 23B of the OECD model. Article 23A of the OECD model is a suggested alternative approach to relieving double taxation: an exemption of dividends received by a resident of a contracting state from a company resident in the other contracting state. That alternative also appears in the U.S. model.

The United States was one of the original members of the OECD and remains active in its tax policy operations. The United States is not a mere observer on whom article 23B was imposed in the nature of an adhesion contract; indeed, it was most likely the chief proponent of the indirect credit provision in the OECD model and its predecessors.[50] The possible conflict may be a matter of indifference to some or all our treaty partners. But even if we now wish to repudiate the gospel we have brought to the world, it is still worth confirming that we will not offend those whom we previously evangelized.

A. Statutory FTC: Overview

The indirect FTC provided under the code was originally adopted by Congress as a unilateral measure to relieve double taxation.[51] The scope of the domestic provisions is somewhat different from, and generally provides more relief from double taxation than, article 23

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[45]That consultation should at least include some significant subset of all the countries that would include "important" treaty partners whose taxes might lose the benefit of the indirect credit permanently or for a period of time that could have a material and adverse effect on the global economy. *See* discussion below at Part III.A concerning the OECD's stated interest in avoiding recurrent corporate taxation of corporate profits out of which dividends may be paid.

[46]*See* OECD Committee on Fiscal Affairs, "Report on Treaty Override," 1989, No. 7. *See* below at Part III.E.

[47]*Whitney v. Robertson*, 124 U.S. 190 (1888); *see* note 38 *supra*.

[48]Several cases have addressed the application of article 23 to the AMT. The disallowance of part of the credit against the AMT was a direct repudiation of the principle of avoiding double taxation otherwise required under article 23. As noted in those cases, the repudiation, to the extent necessary to accommodate the AMT, was addressed by Congress and all affected treaties were overridden by TAMRA section 1012(aa). *See Kappus v. Commissioner*, 83 T.C.M. (CCH) 1203 (2002), *Doc 2002-3456, 2002 TNT 28-5*, *aff'd*, 337 F.3d 1053 (D.C. Cir. 2003), *Doc 2003-18423, 2003 TNT 154-40*; *Haver v. Commissioner*, T.C. Memo. 2005-137, *Doc 2005-12835, 2005 TNT 113-6*, *aff'd*, 444 F.3d 656 (D.C. Cir. 2006), *Doc 2006-6949, 2006 TNT 70-9*; *Jamieson v. Commissioner*, T.C. Memo. 2008-118, *Doc 2008-9551, 2008 TNT 84-10*. In *Kappus*, the Tax Court stated:

> Petitioners urge us to find a conflict between section 59(a)(2) and Article XXIV of the [Canadian] treaty based upon the Third and Fourth Protocols, but they fail to address the effect of the enactment of section 1012(aa) of TAMRA. As discussed above in section 1012(aa)(2) of TAMRA, Congress provided that section 701 of the Tax Reform Act of 1986, including section 59(a)(2), would apply "notwithstanding any treaty obligation of the United States in effect on the date of the enactment of the Reform Act." The Third and Fourth Protocols on which petitioners rely, became effective after Congress enacted section 59(a)(2) of the Code and section 1012(aa)(2) of TAMRA.

(Footnote continued in next column.)

Kappus, 83 TCM at 1216-1217. The Tax Court rejected the argument because the later-in-time third and fourth protocols were by then subject to existing provisions and limitations of U.S. law by virtue of the third protocol's reference to the Internal Revenue Code of 1986. The Tax Court in 2008 applied the same analysis in *Jamieson*, and relied on the D.C. Circuit Court decision in *Kappus.*

[49]The JCT staff, in "Description of the Technical Corrections Act of 1988," JCS-10-888 (Mar. 31, 1988), explained what Congress thought it was doing in the various treaty override provisions that were enacted by TAMRA:

> The bill provides that the following provisions of the 1986 Act will apply notwithstanding any treaty provision in effect on the date of enactment of the 1986 Act (October 22, 1986). . . . Except for cases that have been identified in the bill or in [TRA 1986], no cases are known where a harmonious reading of the Act is not possible. Congress intended harmonious construction of the Act and U.S. income tax treaties to the extent possible.

JCS-10-88, at 322.

[50]The intended operation and the history of the United States' unilateral development of its FTC, and of the spreading of that gospel, is described in Michael J. Graetz and Michael M. O'Hear, "The Original Intent of U.S. International Taxation," 47 *Duke L.J.* 1021 (Mar. 1997). *See also* Pamela B. Gann, "The Concept of an Independent Treaty Foreign Tax Credit," 38 *Tax L. Rev.* 1 (Fall 1982).

[51]*See* Revenue Act of 1921, ch. 136, section 238(e). (See Appendix B.)

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of any of the existing bilateral tax treaties.[52] Under section 902, a deemed paid or indirect credit is provided for all foreign income taxes imposed on the profits from which a dividend might be paid by a foreign corporation to a U.S. corporate shareholder that holds 10 percent or more of the voting stock of the foreign corporation.

There is no requirement under section 902[53] that the potentially creditable foreign income tax be imposed by the country of which the foreign corporation is a tax resident (that is, the country in which the company is incorporated or, in some cases, managed and controlled). In contrast, as discussed below, article 23 of any U.S. bilateral tax treaty will only require the United States to provide a credit for taxes of the other contracting state on dividends (and on the profits out of which dividends are distributed) of a company that is a tax resident of that other contracting state.

In almost all cases, however, in addition to whatever third-country taxes might be imposed on profits of a contracting state corporation, there will also be taxes imposed by the other contracting state (for example, Germany) on profits derived by a company resident in that contracting state (for example, a German corporation). Article 23 requires the United States to reduce U.S. tax on dividends paid by a resident of the other contracting state (for example, a German company) out of profits taxed by that contracting state (for example, Germany) by the amount of tax paid to that other contracting state (Germany) by the locally resident company (for example, the German company).

B. Architecture of the Statutory 'Indirect' FTC

1. FTC formula: The 'limitations.' To understand the intended meaning of the article 23 reference to existing U.S. provisions and limitations on the required FTC for foreign taxes, it may be helpful to review existing basic limits of the U.S. statutory FTC. The basic formula for providing an FTC is relatively simple. A U.S. taxpayer first must determine its worldwide income that will in any tax year be subject to U.S. federal income tax. This amount is then multiplied by the applicable U.S. federal income tax rate to determine the U.S. federal income tax due (the tentative U.S. tax). Foreign income taxes taken into account in that year (paid or accrued) can be deducted from the tentative U.S. tax (that is, credited), subject to a maximum limitation on the total amount of U.S. tax that can be reduced. The maximum amount that can be reduced by a credit (the limitation) is determined by multiplying the tentative U.S. tax on worldwide income by a fraction, the numerator of which is foreign-source income and the denominator of which is worldwide income. The basic limitation was designed in 1921 to prevent deducting foreign taxes from U.S. taxes otherwise due on U.S.-source income.[54]

A simple example illustrates the basic operation of domestic U.S. tax law and of article 23. The simplified facts involve a U.S. corporation with all its foreign direct investment business in one foreign country and all its foreign-source income arising only in that same foreign country:

Example 1. Statutory direct FTC: Foreign branch of U.S. corporation.

> USCO has U.S. operations that give rise to 300 units of U.S.-source taxable income (before taking into account interest expense). USCO has a branch in Ruritania. The Ruritanian branch has 200 units of Ruritanian-source income (before taking into account USCO's interest expense). Ruritania is one of the original members of the OECD, and there is a tax treaty between the United States and Ruritania that is identical to the U.S. model. The treaty provides for a zero rate of tax on dividends from subsidiaries in the dividend-paying state to a ______ percent corporate shareholder in the residence state of that shareholder.
>
> The U.S. corporate tax rate is 35 percent. The Ruritanian corporate tax rate is 35 percent.
>
> USCO has outstanding general obligation debt that it issued to finance the acquisition of equipment used in (and secured by) its textile mill in Lowell, Mass.[55] Interest expense on the debt is 150. The tax basis of USCO's assets in the United States is precisely equal to the tax basis of its assets in Ruritania.

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[52]The existing treaty with Greece requires that the United States provide a credit as provided under section 131 of the Internal Revenue Code of 1939, which included an indirect credit. *See* Appendix B. The Greek treaty, which was similar to several other treaties entered into immediately after World War II, provided no authority for the United States to amend the provisions and limitations then in section 131. Congress specifically overrode conflicting treaties in the Revenue Act of 1962 to avoid legal challenge to changes in the limitations in that legislation. *See* Staff of the JCT, ''Description of the Technical Corrections Act of 1987,'' note 38 *supra*, at 320. ('''In the interest of forestalling any possible litigation,' the Revenue Act of 1962 expressly provided that it took precedence over any prior treaty obligation (citations omitted). One major conflict between that Act and treaties, not identified in the legislative history of that Act, was the conflict between the Act's separate foreign tax credit limitation for interest income and treaties that (at least literally) required the United States to retain the foreign tax credit limitation rules it had used at some earlier date.'')

[53]There is also no limitation, under the companion provisions governing the FTC, to only those taxes that are imposed by the country of incorporation on the corporation's profits out of which dividends are paid by the foreign corporation. *See* sections 901 through 907.

[54]*See* Graetz and O'Hear, ''The Original Intent of U.S. International Taxation,'' note 50 *supra*, at 1055-1056.

[55]A stated goal of the proposed treatment of income from cross-border trade and investment is to bring jobs back to the United States. Lowell, Mass., was a foundation location for the American industrial revolution (textile mills based on Francis Lowell's memorized designs of English mills), and it seems fitting that Lowell should get some of the new investment encouraged by the proposals. If the mills later migrate to North Carolina, that seems to be a matter of indifference to the stated federal tax policy, although this may not be the case for creating or retaining jobs in all industries.

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No portion of the interest expense on the special purpose financing of the Lowell facility is deductible for purposes of determining the income of the Ruritanian branch for Ruritanian tax purposes. For U.S. federal income tax purposes, however, 60 (150 x 200/500) of the interest expense is allocated against the foreign-source income to determine the limitation on the maximum amount of Ruritanian tax that can be deducted from (credited against) USCO's federal income tax liability.

USCO will pay U.S. tax of 122.50 (35 percent x (500 minus 150 of interest expense) on its worldwide income; USCO will be entitled to deduct from the U.S. tax (as a credit against the tax) a portion of the Ruritanian tax, calculated as follows:

U.S. tax tentatively due:		122.50
Foreign-source income:		
200	foreign-source dividend income before interest	
<60>	allocable interest expense (=150X (200/500))	
140	net foreign-source income	
Limitation on credit		
122.50 x 140/350		49 (limit credit of < 70)
Ruritanian tax (35% x 200)		70
U.S. tax due (after credit):		73.50 (122.50 minus lesser of 70 as actual Ruritanian tax or 49.00, as the U.S. limit on the credit.)
Combined U.S. and Ruritanian tax on 350:		143.50 (70 plus 73.50 U.S. tax)
"Excess FTC":		21 (70 deemed paid minus 49 allowed)

The excess FTC in this case is equal to 35 percent of the 75 of interest expense allocated to foreign-source income but not deductible in Ruritania (since under Ruritanian tax principles the interest expense is not related to the production of Ruritanian taxable income because it was invested in USCO's Lowell production facilities).

At various times in the FTC's history the tentative U.S. tax and the maximum limitation amount have been calculated separately for different categories (baskets) of foreign-source income. The deconstruction into categories is intended to prevent cross-crediting (or credit averaging) of foreign taxes that may have been imposed by a foreign country on one category of foreign-source income against U.S. taxes otherwise due on another category of foreign-source income.

With the exception of the limitation on the amount of AMT that could be offset by foreign taxes,[56] there has not been any limitation on the amount of U.S. tax otherwise due on an item of foreign income that can be offset by same-country foreign taxes on the same item from the same country. Since 1921 the limitations under U.S. federal income tax law have been designed to prevent offsetting U.S. tax on *other income* (that is, domestic-source income or low-taxed foreign-source income treated for federal income tax purposes as derived from another foreign provenance).

The cross-crediting limitation of U.S. federal income tax law for the past 60 years (in all its different iterations) is what each pair of contracting states (the United States and each treaty partner) had before it when referring to the right of the United States to apply present law[57] provisions and limitations to the credit for foreign income taxes paid to the other contracting state. The reference to changes in the provisions and limitations under U.S. law was not intended to confer a general license to ignore the obligation to provide a credit for income taxes paid to the other contracting state on income treated by both countries as income arising from sources in the same country and subject to primary tax by that same country.[58] The ability to change the provisions and limitations is expressly limited — any changes must be consistent with the general principle of avoiding double taxation.

2. The 'indirect' FTC. The indirect FTC is intended to avoid double taxation of dividend income by taking into account foreign income taxes paid by the foreign dividend-paying company in calculating the U.S. tax on the dividend recipient.

As with the basic FTC provisions for a direct credit, the formula is fairly simple. Example 2 is a simplified illustration of how the domestic section 902 formula works, as well as how article 23 would apply. For distributed income, the core architecture replicates the treatment of foreign branch income described in example 1. As in example 1, all foreign-source income is derived by a single foreign corporation subject to foreign income tax only in the country of incorporation.

Example 2. Statutory indirect FTC: Foreign subsidiary.

The facts are the same as in Example 1, except that the Ruritanian branch has been incorporated as a 100 percent owned Ruritanian subsidiary (RuriCo). USCO derives 300 units of U.S.-source income (before interest expense of 150). RuriCo derives 200 units of Ruritanian-source income and has no interest expense. The USCO basis in its RuriCo stock is precisely equal to the tax basis of its U.S.-situs assets.

RuriCo will pay Ruritanian corporate income tax of 70 (35 percent x 200). USCO will pay no Ruritanian tax on the dividend payment. If RuriCo distributes all its after-tax income as a dividend, USCO will have taxable income of 350:

As in the branch model, the excess FTC corresponds, in economic effect, to the loss of a deduction in any country for interest expense allocated under the U.S. FTC limitations formula to foreign-source income. This effect

[56]*See* note 48 *supra*. The conflict caused by the enactment of section 59(a) was recognized and dealt with as such.

[57]Present law provisions are those in effect when the treaty was entered into.

[58]*See* article 23(2)(b) of the U.S. model.

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RuriCo dividend:	130.00 (200 minus 70)
Section 78 gross-up 200 x 35%	70.00[a]
Includable dividend (before interest)	200.00
U.S. operations income (before interest)	300.00
Interest expense	<150.00>
Taxable income	350.00
U.S. tax tentatively due 350 x 35%	122.50
Foreign-source income net of allocable interest 200 minus (150 x 200/500)	140.00
Limitation on credit (122.50 x 140/350)	49.00 (limit < credit 70)
U.S. tax (after credit) 122.50 minus 49 Ruritanian tax	73.50
Combined U.S. and Ruritanian tax on 350: 70 + 73.50	143.50
"Excess FTC" 70 deemed paid minus 49 limit used	21.00

[a]The section 78 gross-up for foreign taxes deemed paid is applied *before* the operation of the section 904 limitations that might reduce the amount of U.S. tax on foreign dividend income that can be offset by foreign income tax. The Pooling Basis limitation on the amount of foreign taxes deemed paid should limit the amount of section 78 gross up to the amount deemed paid under the Pooling Basis calculation of taxes includible based on the aggregate of *distributed* and *undistributed* accumulated (earnings and) profits. This difference in mechanics should not convert the reduction in the amount of credit into something not subject to Article 23. *See* discussion at Part I.I ("Reducing the Amount of Foreign Tax Deemed Paid Is A Change in the "Limitation" Even If It Is Not In Section 904").

occurs when the allocation under the limiting fraction results in a loss of FTC against U.S. tax tentatively due.

The basic limitation is intended to prevent a reduction in U.S. tax otherwise due on the income from U.S. operations. The allocation of interest to all income, rather than only to income from the source that was actually financed by the proceeds of the borrowing, reflects the position generally taken by the United States that money is fungible and that tracing the actual application of the proceeds of general obligation debt does not accurately measure the U.S.- and foreign-source return on deployment of total enterprise capital obtained by a U.S. taxpayer from all sources (debt issuance, equity issuance, or retained earnings).

The U.S. corporate shareholder will be deemed to have paid the proportion of foreign income tax paid by the foreign dividend-paying company, which is determined by multiplying total foreign taxes paid by the foreign corporation on its earnings by a fraction, the numerator of which is the amount of the dividend paid and the denominator of which is total foreign earnings. The resulting amount of foreign taxes is carried with the dividend and is deemed to have been paid by the shareholder for purposes of then claiming the FTC, subject to the limitations described above.

In calculating the amount of U.S. tax on the dividend when a shareholder elects to claim an FTC, the deemed paid amount (of foreign taxes that will be carried with the dividend) is added to the U.S. tax base (the section 78 gross-up). The section 78 gross-up is a mathematical device necessary to avoid overstating the early-year FTC for taxes on profits out of which a dividend is distributed and correspondingly understating the later year FTC.[59]

The limitations under section 904 on the FTC apply after the calculation of the aggregate foreign taxes paid and deemed paid. The deemed-paid credit provisions themselves (section 902) have no built-in limitations on the amount of foreign taxes deemed paid on the E&P out of which a dividend is paid.[60] The limitations are applied after the amount of the dividend and the amount of tax deemed paid have been determined under sections 902 and 78.

During the period 1987-2002, the indirect FTC was subject to a special limitation. There was a separate category or basket for income consisting of dividends from each foreign corporation in which the U.S. shareholder owned at least 10 percent and not more than 50 percent of the voting stock (the 10/50 basket).

As with all other limitations, the creation of a separate, per-company basket to which the limitation formula applied prevented the cross-crediting of foreign income taxes on dividends from one 10/50 company against any other income (whether U.S. or foreign source) of the taxpayer. The limitation was not intended to limit the credit for foreign income taxes borne by the particular

[59]*See American Chicle Co. v. United States*, 316 U.S. 450 (1942). In *American Chicle* the Supreme Court held that the amount of dividend subject to federal income tax was limited to the actual dividend received (before reduction by withholding tax at the source). That net amount of includable dividend was thus the profits of the distributing company out of which the dividend was paid, reduced by the amount of foreign taxes paid by the distributing company on those profits. That reduction from profit for taxes became known as the *American Chicle* reduction. The amount of foreign tax deemed paid for purposes of the indirect credit in the analog to current section 902 was determined as a portion of those foreign taxes on the accumulated profits equal to the portion of after-tax profits represented by the dividend. In effect, the corporate shareholder had the benefit of a deduction for foreign taxes paid (in determining the amount of the dividend includable in U.S. gross income), as well as a credit for some portion of that foreign tax against the U.S. tax otherwise due on the (reduced) amount of the dividend. This was only a timing difference, because eventually the total amount of the credit could not exceed 100 percent of the foreign tax paid. A timing difference that might last for a very long time (forever?) could result in a permanent tax benefit. The *American Chicle* reduction was eventually eliminated for developed-country dividends by the enactment of section 78 in the Revenue Act of 1962, section 9(b), P.L. 87-834. The *American Chicle* reduction was retained for dividends from "less developed country corporations" until eliminated by the Tax Reform Act of 1976, section 1033(e), P.L. 94-455.

[60]Thus, section 78 includes the amount determined under section 902 before the application of limitations under section 904.

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10/50 company against U.S. federal income tax otherwise due on the dividend from the same 10/50 company (that is, the minimum per-item FTC relief required by article 23).

C. Differences Between Indirect FTC and Article 23

It is worth noting some important differences between the existing domestic statutory indirect credit provisions and the article 23 obligations imposed on the United States under bilateral treaties. The current domestic statutory provisions are significantly broader (more generous) than what is required by article 23.

U.S. domestic law provides an indirect FTC for *all* foreign income taxes paid by a dividend-paying company on the equivalent of "profits out of which the dividends are paid," subject to various statutory limitations on cross-crediting. Section 902 would provide an FTC (subject to quantitative limitations designed to prevent reducing U.S. tax on U.S.-source income and on passive foreign-source income) for non-German (for example, French) taxes paid by a German company on profits out of which a dividend would be distributed by the German company to a 10 percent U.S. corporate shareholder.

Article 23 of the Germany-U.S. treaty, in contrast, would not require the United States to provide an FTC for French taxes imposed on the profits out of which the German company distributes dividends, because the French taxes are not imposed by Germany. Moreover, the identically worded article 24 of the France-U.S. treaty would not require the United States to provide a credit for French taxes imposed on the profits of a German company because the taxes are not imposed on the profits of a company that is a resident of France, but are instead imposed on a resident of another country (Germany).[61] The bilateral structure of each of the treaties that follow the U.S. and OECD models simply does not accommodate indifference to the country that taxes the company that pays the tax on the profits out of which the dividend is paid.

The core architecture further provides credit averaging to take into account overall foreign income taxes imposed by multiple foreign taxing sovereigns on overall business income taxable to a U.S. multinational. (Or if reducing U.S. tax by foreign taxes paid is thought to be objectionable, the pejorative term "cross-crediting" is often used.[62]) There is no requirement under domestic law that the taxes be paid to the country of which the dividend-paying company is a resident.

Thus, if a German company pays income taxes to countries other than Germany, U.S. domestic law provides for a credit against U.S. tax on income comprising dividends from that German company.[63] Similarly, if the U.S. corporate shareholder derives business income directly or through subsidiary operations in any country (including Germany), domestic law provides that the German tax on the dividend-paying company's income can be credited against U.S. tax otherwise due on that other income.[64] Article 23 does not compel the cross-crediting that is provided under the domestic statutory regime.

1. Cross-crediting against U.S. tax on other items of income. Example 3 illustrates the operation of domestic U.S. law regarding the credit for tax on an item of income other than the dividend or the profits from which the dividend may be paid. In the example, the country imposing the tax on a different income item is Ruritania, the same country that has taxed the dividend and the profits out of which the dividend has been paid.

Example 3. U.S. provisions and limitations: Cross-crediting.

> The facts are the same as in Example 2, except that USCO has interest income (from a loan to RuriCo) in the amount of 75. This interest expense of RuriCo, although deductible in Ruritania, only reduces RuriCo's income to 200.[65] We will assume that the related-party loan does not change the ratio of foreign assets to U.S. assets, so that 40 percent of the USCO interest expense continues to be allocable to foreign-source income.[66] Ruritania imposes no withholding tax or other income tax on interest paid to USCO (either as a result of its domestic law or because article 11 of the Ruritania-U.S. treaty provides for zero withholding tax on Ruritanian-source interest paid to a U.S. resident).

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[61]A French branch of a German company would not be a qualified resident of France under the terms of the France-U.S. treaty. *See* article 4 of the U.S. model for the typical definition of resident for purposes of determining potential eligibility for the benefits of a bilateral tax treaty.

[62]The author prefers the connotations of the term "credit averaging" because of the frequent convergence of taxes imposed by multiple taxing sovereigns on components of income derived from activities (often related to each other) in many countries. *See* Robert H. Dilworth, "Tax Reform: International Tax Issues and Some Proposals," 35 *Int'l Tax J.* 5, at 54-55 (Jan.-Feb. 2009). To avoid a distraction based on an argument over the shape of the table, future references will be to "cross-crediting."

[63]The United States has occasionally provided per-country limitations to preclude cross-crediting on a multinational basis. It has not done so since 1976.

[64]Other than the dividend.

[65]RuriCo's income before interest is 275, and its income before income tax is 200.

[66]This simplifying assumption is made to avoid a long digression into the formula for allocation of interest expense based on the asset-based calculation prescribed in reg. section 1.861-9T and related provisions.

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RuriCo dividend:	130.00
Section 78 gross-up	70.00
Includable dividend	200.00
Related party Interest income	75.00
Foreign-source income (before interest expense)	275.00
U.S. operations income (before interest expense)	300.00
Interest expense	<150.00>
Taxable income	425.00
U.S. tax tentatively due (425 x 35%)	148.75
Foreign income net of interest expense (275 minus (150 x 200/500))	215.00
Limitation on credit 148.75 x (215/425)	75.25 (70 deemed paid < limit)
U.S. tax (after credit) 148.75 minus 70	78.75
Combined U.S. and Ruritanian tax on 425:	148.75
"Excess FTC" (70 deemed paid minus 70 FTCs used)	-0-
"Excess FTC limitation" (70 deemed paid minus 70 limit used)	-0-

USCO has increased its U.S. taxable income by 125 (from 350 to 425), but the increase in its final U.S. federal income tax was only 5.25 (78.75 minus 73.50 (the U.S. tax due in example 2)).[67] The excess FTC in example 2 has been absorbed by reducing federal income tax otherwise due on 75 units of other items of income subject to either no or very low foreign income tax.[68]

This result would not be compelled by article 23. Although there is no current U.S. domestic statutory limitation on cross-crediting Ruritanian tax on the dividend against U.S. tax on the interest income from RuriCo, the treaty by its terms would not appear to prevent an amendment of U.S. domestic law to change the limitations to prevent crediting Ruritanian tax on RuriCo's profits out of which it paid dividends against other items of income (the related-party Ruritanian-source interest income that has been subject to no or low Ruritanian tax).[69]

The result is that all income derived from sources in countries with a 35 percent tax rate by taxpayers resident in countries with a 35 percent tax rate will be taxed at a combined 35 percent tax rate.

2. Cross-crediting of multiple country taxes against a realized pool of income (dividends and other U.S. taxable foreign-source income). Example 4 illustrates the operation of domestic U.S. law regarding the credit for a different country tax (Auretania) on the profits out of which the Ruritanian dividends are paid. In the example, Ruritanian-source income is commingled with Auretanian-source income, and no differentiation is made by the United States in allowing a credit for foreign taxes deemed paid by USCO when RuriCo remits a dividend. As a result, a full credit is allowed by the United States against U.S. tax otherwise due on the Ruritanian dividends for both Ruritanian and Auretanian tax imposed on the Ruritanian resident.

Example 4. U.S. 'provision and limitations': Foreign country income taxes imposed by another country.

The facts are the same as in Example 3, except that RuriCo derives a portion (75) of its 200 units of income from Auretania. USCO's interest expense continues to be allocable 60 percent to U.S.-source income and 40 percent to foreign-source income. Auretania is one of the original members of the OECD and is a party to the Auretania-U.S. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion (the Auretania-U.S. treaty). The Auretania-U.S. treaty is identical to the U.S. model and also provides for zero withholding tax on parent-subsidiary dividends. Auretania imposes tax at the rate of 35 percent on RuriCo's Auretania-source income. Ruritania provides a credit against Ruritanian tax otherwise due on Auretanian income taxes imposed on RuriCo's Auretanian-source income. The Ruritanian FTC architecture is identical to the domestic U.S. provisions of sections 901 through 907.

[67]Absent cross-crediting, the increase in income (75 units of interest) would have been subject to U.S. tax of 26.25, but the 26.25 has been reduced by 21 of otherwise "excess" credit in example 2.

[68]Other general limitation foreign-source income that is typically subject to low foreign tax includes not only interest but also royalties and export sales profit (to the extent treated as foreign-source income). *See* note 72 *infra*.

[69]The imposition of myriad new baskets to limit cross-crediting was apparently thought by Congress at the time to be consistent with existing tax treaties. In 1988, however, Congress adopted a treaty override to validate the basketing, just in case there might be a treaty-based challenge. TAMRA, section 1012(aa), *supra* note 38. Various stakeholders may have wished to avoid the appearance of intentionally overriding a treaty (perhaps the State Department was concerned), while others may have wished to defend the important role of the House of Representatives in originating tax legislation (albeit excluded from a role in the review of tax treaties, which is the exclusive responsibility of the Senate). Yet others may have wanted to avoid the risk of a successful taxpayer challenge to the statutory regime. The result seems to have something for everyone. It might be an approach that would work again.

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RuriCo dividend:	130.00
Section 78 amount	
Ruritania 43.75 (70 x 125/200)	
Auretania 26.25 (70 x 75/200)	70.00
Includable dividend	200.00
Related party foreign-source interest income	75.00
Foreign-source income (before interest expense)	275.00
U.S. operations income (before interest expense)	300.00
Interest expense	<150.00>
Taxable income	425.00
U.S. tax tentatively due 425 x 35%	148.75
Foreign income tax	
Ruritanian tax	43.75
Auretanian tax	26.25
	70.00
Foreign-source income net of interest	
Ruritanian-source dividend 125 minus 27.28 (60 x (125/257)) allocable interest	97.72
Auretanian-source dividend 75 minus 16.36 (60 x (75/275)) allocable interest	58.64
Interest income 75 minus 16.36 (60 x (75/275)) allocable interest	58.64
	215.00
Limitation on credit	
148.75 x (215/425)	75.25 (70 deemed paid < limit)
U.S. tax (after credit) 148.75 minus 70	78.75
Combined U.S., Ruritanian, and Auretanian tax (70 + 78.75)	148.75
"Excess FTC" (70 deemed paid minus 70 used)	-0-
"Excess FTC limitation" (70 limit minus 70 limit used)	-0-

Under U.S. domestic statutory provisions and limitations, the substitution of Auretania as the taxing country has no effect on the calculation of USCO's FTC. Because U.S. domestic statutory provisions and limitations provide a credit for all foreign income taxes on all foreign business income, the end result is that all income derived in countries with a 35 percent rate by taxpayers resident in countries with a 35 percent tax rate will be taxed at a 35 percent tax rate.

3. Article 23 minimum requirements: Same items taxed by each contracting state under each treaty.

a. Article 23 does not require a U.S. credit for third-country tax. If the existing U.S. domestic statutory limitations were conformed to provide no more than the exact minimum requirement of article 23 (that is, to provide an FTC only to the extent of the United States' obligation under article 23(2) to its counterparty under each bilateral tax treaty), USCO would not be entitled to a credit for Auretanian tax imposed on the Ruritanian company under either the Ruritania-U.S. treaty or the Auretania-U.S. treaty. The Auretanian tax would, however, be taken into account as a deduction in calculating the amount of RuriCo profits out of which RuriCo pays dividends and the corresponding amount of the section 78 gross-up.

The combined U.S. and foreign income tax on the 75 units of income taxed by Auretania rather than by Ruritania will bear a combined tax of 43.81 (95.81 minus 78.75, from example 4) (Auretanian tax of 26.25) plus incremental U.S. tax of 17.06 compared with the amount of U.S. tax if a credit is allowed for the Auretanian tax), which is an effective rate of about 58 percent ((26.25 + 17.06)/75) on income derived by a taxpayer operating in three different countries, each of which imposes tax at the identical rate of 35 percent.

Example 5. Disallowance of FTC for taxes by another country on company resident in other contracting state.

RuriCo dividend:	130.00
Ruritania	43.75 (70 x (125/200))
Auretania	0 (0 x (75/200))
Includable dividend	173.75
Related party interest income	75.00
Foreign-source income (before interest expense)	248.75
U.S. operations income (before interest expense)	300.00
Interest expense	<150.00>
Taxable income	398.75
U.S. tax tentatively due 398.75 x 35%	139.56
Foreign-source dividend income, net of interest	
Ruritanian-source dividend 173.75 minus 41.91 (60 x (173.75/248.75)) allocated interest	131.84
Foreign-source interest income, net of expense	
75 minus 18.09 (60 x (75/248.75))	56.91
allocated interest	188.75
Limitation on credit	
139.56 x (188.75 / 398.75)	66.06 (43.75 deemed paid < limit)
U.S. tax (after credit) (139.56 minus 43.75)	95.81
Combined U.S., Ruritanian, and Auretanian tax on 398.75:	
U.S.	95.81
Ruritania	43.75
Auretania	26.25
	165.81

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While such double taxation of the Auretanian-source income may be undesirable from the perspective of those tax policy theoreticians who worry about a potential adverse effect of double taxation on the global economy and thus on the United States, the bilateral tax treaties do not individually seek to achieve a global blended tax rate on an aggregate pool of income derived from multiple direct investments in companies throughout the community. Instead, bilateral tax treaties are by their terms intended to avoid double taxation of income derived by treaty residents only to the extent of the tax imposed by the particular contracting state of which the dividend-paying company is a resident as defined in the applicable treaty.

b. Article 23 does not require U.S. credit for contracting state tax on other items of income. If the existing U.S. domestic statutory limitations were amended to disallow an indirect FTC for taxes paid to the contracting state, on dividends or on profits out of which the dividend is paid, against U.S. tax otherwise due on other income, or other income from the same contracting state, that would not violate article 23. Thus, even closely related items of income derived by the U.S. corporate shareholder, such as interest or royalties received from the dividend-paying contracting state company, could be taxed without providing a credit for the taxes on items other than the dividend and the profits out of which the dividend was paid.

Article 23 only requires the United States to provide a credit against U.S. federal income tax for host country (Ruritania) taxes paid on the income out of which dividends are paid by the Ruritanian company. None of the bilateral tax treaties requires the United States to provide a credit for taxes of other countries imposed on the dividend-paying company, even if the dividend-paying company pays income taxes to countries with which the United States has a tax treaty.[70] None of the bilateral treaties now requires the United States to provide a credit for the dividend and corporate-level tax against U.S. tax otherwise due on different items of income from the country that taxes the dividend and the accumulated profits out of which the dividend is paid. Thus, in example 6, article 23 would not require the United States to provide a credit against U.S. tax otherwise due on Ruritanian interest income for even Ruritanian tax on the Ruritanian company dividends on the Ruritanian company profits out of which the dividend is paid.

Example 6. Disallowance of FTC for taxes on other items of foreign-source income.

The facts are the same as in Example 3. USCO's interest expense continues to be allocable 60 percent to U.S.-source income and 40 percent to foreign-source income. In this case, however, U.S. domestic statutory law has been amended to provide that Ruritanian tax on accumulated profits of a foreign subsidiary cannot offset U.S. tax otherwise due on active business foreign income other than dividends (that is, interest, rents, or royalties).[71] The Ruritanian tax would be allowed as a credit against U.S. tax otherwise due on the dividend from RuriCo, but not against U.S. tax otherwise due on the interest income from RuriCo.

RuriCo dividend:	130.00
Section 78 amount	70.00
Includable dividend	200.00
Interest income	75.00
Foreign-source income (before interest expense)	275.00
U.S. operations income (before interest expense)	300.00
Interest expense	<150.00>
Taxable income	425.00
U.S. tax tentatively due	148.75
Foreign income, net of interest	
Ruritanian-source dividend 200 minus 43.65 (60 x (200/275)) allocated interest	156.36
Limitation on credit	
148.75 x (156.36/425)	54.73 (deemed paid < credit of 70)
U.S. tax (after credit) 148.75 minus 54.73	94.02
Combined U.S. and Ruritanian tax on 425:	
U.S.	94.02
Ruritania	70.00
	164.02

In this case, 15.27 units of Ruritanian tax (70 minus 54.73) have been converted into unusable excess credit (because of the allocation of interest to reduce the amount of Ruritanian dividend income recognized for U.S. tax purposes). The excess credit cannot be used to offset U.S. tax otherwise due on Ruritanian-source related-party interest income, even from sources in Ruritania, because article 23 does not impose a minimum mandatory FTC for all Ruritanian tax on a pool consisting of all Ruritanian-source income. Instead, the minimum mandatory credit is for Ruritanian taxes on an item comprising

[70]Language in some of the older treaties could be construed to require the United States to retain its cross-crediting in effect when the treaty was entered into. Constraints on limiting the FTC on a basket basis to minimize cross-crediting were recognized by Congress as being potentially in conflict with treaties entered into before TRA 1986. Section 1012(aa) of TAMRA specifically overrode any such treaties. *See* note 48 *supra*.

[71]Such a goal may have been part of the simplified income tax proposed by the President's Advisory Panel on Federal Tax Reform in its report delivered November 1, 2005 (*Doc 2005-22112*, *2005 TNT 211-14*). U.S. proposals for a territorial system usually include as one of the desired benefits an end to cross-crediting of credits for taxes deemed paid under section 902 against other income such as mobile income. Mobile income in turn includes interest, rents, and royalties — even when received by a U.S. corporate taxpayer from the same or related business enterprises. The pooling basis proposal probably drew its revenue goals from the earlier proposals to reduce the FTC.

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Ruritanian company dividends (and on the profits out of which the dividend is paid), to be offset against U.S. tax otherwise due on the same item. As a result, the aggregate effective rate on 215 units of Ruritanian-source dividend and interest income (275 minus 60 of USCO's allocable interest expense) would be 40 percent ((70 + 15.27)/215).

c. Article 23 does require at least a per-item credit. As illustrated by the prior examples, existing U.S. domestic law provides for an FTC determined on a pooling basis — but a pooling basis in which only income from various sources actually taken into account by the U.S. taxpayer for U.S. tax purposes is included in the pool. Example 7 below illustrates the case in which article 23 *would* appear to require a credit that domestic statutory U.S. law would not provide, if the green book pooling basis proposal were implemented by amending domestic statutory U.S. law. Article 23 compels at least a per-item credit for the "item" consisting of the dividend and the accumulated profits out of which the dividend is paid. Article 23 has no occasion to be tested if the United States provides a credit that is broad enough to safeguard a per-item credit under a system that also permits even broader cross-crediting.

Under the current pooling system, which permits cross-crediting among various kinds of foreign-source business income,[72] the bare minimum per-item credit requirement under article 23 does not have an opportunity to operate. The item consisting of the dividend (even if grossed up under section 78 for foreign taxes allowed as a credit) will not be subject to U.S. income tax (without a credit for source-country taxes on the dividend and the profits from which it is paid) because of the treatment of other items of income under U.S. law.

The various provisions and limitations of current U.S. domestic law that might limit the credit are all designed to prevent crediting of the source-country tax against U.S. tax otherwise due on income other than the dividend. That other income may be domestic-source income, foreign-source income from other countries, or even foreign-source income items from the same country that is the contracting state that taxes a contracting-state company dividend or the profits out of which the dividend is paid. The existing limitations do not preclude a credit against U.S. tax otherwise due on the same item (the dividend).

The pooling basis proposal would, however, deny (or limit) the credit for contracting state tax on a dividend (and the contracting state tax on the profits out of which the dividend is paid) whenever the U.S. corporate taxpayer has 10 percent or greater equity ownership interest in one or more foreign corporations in the same country or countries other than the contracting state[73] and the tax burden borne by those other companies is lower than the effective rate of the contracting state on the accumulated profits[74] of the contracting state company that pays a dividend.

An example may illustrate the intended operation of the pooling basis proposal. To simplify the analysis, we will assume that USCO has no allocable interest expense and that its investment in RuriCo is wholly in equity (that is, USCO has no business-related interest income or business expense). That is an oversimplification but it is necessary in order to illustrate the effect of the pooling basis proposal on crediting foreign taxes allowable after giving effect to the existing apparatus for limiting cross-crediting against other income, whether U.S.-source or foreign-source.

The example illustrates the model that the pooling basis proposal is aimed at: distribution by high-taxed affiliates and little or no distribution by low-taxed affiliates.

If current law were applied, even with a complete prohibition on cross-crediting against other income (permissible under article 23), the foreign tax deemed paid would be 26.25 and the dividend (for U.S. tax purposes) would be 75. The U.S. tax on that 75 of Ruritanian-source dividend income would be zero, rather than 8.67 ((61.66 x 35 percent) minus 12.91 creditable Ruritania tax) as determined under the pooling basis. The United States will thus have denied a credit for 33 percent (8.67/26.25) of Ruritanian taxes on the accumulated profits out of which the Ruritanian company (RuriCo) dividend has been paid. As a result, the effective rate of tax on RuriCo's earnings is 46.6 percent ((26.25 plus 8.67)/75).

Example 7. Pooling of distributed and undistributed earnings: High-tax affiliate dividends.

> As in Example 1, USCO has U.S. operations that give rise to 300 units of U.S.-source taxable income. USCO is neither a borrower nor a lender. USCO has a wholly owned first-tier Ruritanian subsidiary (RuriCo) and a wholly owned first-tier Irritanian subsidiary (IrriCo). RuriCo derives 75 units of income from sources outside the United States. RuriCo is subject to Ruritanian tax at the rate of 35 percent. IrriCo derives 125 units of income from sources outside the United States. IrriCo is subject to Irritanian tax at the rate of 12.5 percent. In year 1, RuriCo distributes all its after-tax earnings (48.75) (75 minus (75 x 35 percent)). IrriCo distributes none of its after-tax earnings (109.38) (125 minus (125 x 12.5 percent)). Ruritania and Irritania are among the original members of the League of Nations, the organization now entitled the OECD, and each is party to a bilateral tax treaty that is identical to the U.S. model. Under the Ruritania-U.S. treaty, the

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[72]This system, in place from 1921 through 1986, was suspended from 1986 to 2004 and reinstated in 2004. Again, a digression into the tortuous history can be deferred to another day.

[73]The pooling basis proposal would also deny credits for foreign taxes paid by one contracting state on its profits out of which it pays a dividend, even if the low-taxed affiliate was in the same contracting state.

[74]Determined in accordance with U.S. tax accounting principles.

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term "taxes" is defined by reference to Ruritanian taxes and not by reference to third-country taxes (even other members of the OECD). Under the Irritania-U.S. treaty, the term "taxes" is defined by reference to Irritanian taxes and not by reference to Ruritanian taxes.

RuriCo income	75.00
Ruritania tax at 35%	26.25
IrriCo income	125.00
Irritania tax at 12.5%	15.62
Aggregate RuriCo and IrriCo pre-tax E&P	200.00
Aggregate RuriCo and IrriCo taxes	
Ruritania	26.25
Irritania	15.62
	41.87
Accumulated E&P	158.13
RuriCo cash dividend (75 minus 26.25 Ruritanian tax)	48.75
Deemed paid FTC 41.88 x (48.75/158.13)	12.91
Includable dividend	61.66
U.S. operations income (before interest expense)	300.00
Taxable income	361.66
Limitation on credit	
126.58 x (61.66/361.66)	21.58 (credit of 12.91 < limit)
U.S. tax (after credit) 126.58 minus 12.91	113.67
Combined U.S. and Ruritanian tax on 361.66:	
U.S.	113.67
Ruritania	26.25
	139.92
"Excess FTC"	
12.91 deemed paid minus	
12.91 Ruritanian FTCs used	-0-

Although there is no excess FTC in this example, there is some sort of suspended uncredited creditable foreign tax account to be maintained by USCO. That suspended amount will be available to offset future distributions by future members of the USCO foreign affiliates (from time to time in the future). For example, IrriCo could distribute some or all of its Irritanian accumulated profits to enable USCO to cross-credit the suspended Ruritanian tax on RuriCo accumulated profits. That, presumably, is the point of the exercise.[75]

This issue is not merely academic, nor is it limited to our treaty partners with the highest tax rates (Japan and Germany). If we substitute the United Kingdom (with its 28 percent tax rate) for Ruritania and Ireland for Irritania in example 7 under a pooling basis regime, the United States would deny (the proponents would argue "delay, perhaps forever") a credit for 52.5 percent (11.03/21) of U.K. taxes on the accumulated profits out of which the UKCo dividend has been paid. As a result, the effective tax rate on the U.K. company's earnings would be 42.7 percent ((21 U.K. plus 11.03 U.S.)/75). In contrast, if current law were applied (even with a complete prohibition on cross-crediting against other income as is otherwise permissible under Article 23), the foreign tax deemed paid would be 21 and the dividend (for U.S. tax purposes) would be 75. The U.S. tax on that 75 of U.K.-source dividend income would be 5.25, rather than 11.03 ((66.11 x 35 percent) minus 12.11 creditable U.K. tax) — as determined under the pooling basis. The doubling of residual U.S. tax (from 5.25 to 11.03) may strike the U.K. as a significant repudiation of the United States' commitment.

Example 8. Pooling of distributed and undistributed earnings: Moderate-tax affiliate dividends.

As in Example 1, USCO has U.S. operations that give rise to 300 units of U.S.-source taxable income. USCO is neither a borrower nor a lender. USCO has a wholly owned first-tier U.K. subsidiary (UKCo) and a wholly owned first-tier Irish subsidiary (IreCo). UKCo derives 75 units of income from sources outside the United States. UKCo is subject to U.K. tax at the rate of 28 percent. IreCo derives 125 units of income from sources outside the United States. IreCo is subject to Irish tax at the rate of 12.5 percent. In year 1, UKCo distributes all its after-tax earnings, 54.00 (75 minus (75 x 28 percent)). IreCo distributes none of its after-tax earnings, 109.38 (125 minus (125 x 12.5 percent)).

[75]Ruritania has a long history with Irritania. That history has included two world wars in which they happened to be on opposite sides, and frequent alliances and skirmishes between and among the various communities aggregated in the two nations (since the dissolution of the Roman empire). As members of the OECD, and as parties to various compacts of eternal friendship, commerce, and navigation, they have reached a condition of perpetual peace (to which they aspired at the end of the first world war but were unable to achieve). Nonetheless, even after each adopted the euro as a common currency, each has decided to retain the sovereign right to determine what to tax, when to tax, who to tax, and how much to tax. Ruritania thus may not be satisfied that one-third of the agreed credit (33 percent (8.67/26.25 of the applicable Ruritanian tax) in this example) under article 23 for its taxes on RuriCo accumulated profits will be restored only if and when IrriCo, an Irritanian company, is able to, and does, distribute from accumulated profits (that Ruritania cannot tax). Ruritania may be particularly piqued if, in that future, IrriCo has suffered reverses (perhaps caused by Irritania's ill-advised economic policies and a toleration for excessive inflation notwithstanding its Maastricht promises made when joining the Euro zone), and if IrriCo cannot make a future catch-up distribution to restore the credit for Ruritanian tax marooned, perhaps forever, in USCO's suspense account.

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UKCo income	75.00
U.K. tax at 35%	21.00
IreCo income	125.00
Ireland tax at 12.5%	15.63
Aggregate UKCo and IreCo pre-tax E&P	200.00
Aggregate UKCo and IreCo taxes	
U.K.	21.00
Ireland	15.63
	36.63
Accumulated E&P	163.37
UKCo dividend (75 minus 21 U.K. tax)	54.00
Potential FTC: 36.63 x (54 (Div.)/ 163.37 (Total E&P))	12.11
Section 78 gross-up	12.11
Total grossed-up foreign dividend 54 plus 12.10	66.11
Total foreign-source income	66.11
U.S. operations income (before interest expense)	300.00
Taxable income	366.11
U.S. tax tentatively due 366.11 x 35%	128.14
Limited on credit 128.14 x (66.11/366.11)	23.14 (12.11 deemed paid < limit)
U.S. tax (after credit) (128.14 minus 12.11)	116.03
Combined U.S. and U.K. tax on 75 U.K. earnings:	
U.S.	11.03
U.K.	21.00
	32.03
"Excess FTC" (U.K. taxes deemed paid (12.11) minus U.K. taxes credited against U.S. tax (12.11))	-0-
U.K. credits denied per pooling basis (21.00 minus 12.11)	8.89
Additional U.S. tax (32.03 (pooling)) minus 26.25 (full credit)	5.78

III. OECD Model Convention

A. Historical Antecedents for Article 23

The OECD is the successor organization to the Organization for European Economic Cooperation (OEEC),[76] formed immediately after World War II. The OEEC in turn assumed the responsibility for a treaty-based approach to avoiding double taxation of income from global trade and investment previously borne by the League of Nations.

The historical antecedents of the OECD model tax convention on income and capital are described briefly in the introduction to the most recent OECD model:
A. Historical background

* * *

> 4. Progress had already been made towards the elimination of double taxation through bilateral conventions or unilateral measures when the Council of the Organisation for European Economic Co-operation (OEEC) adopted its first Recommendation concerning double taxation on 25 February 1955. At that time, 70 bilateral general conventions had been signed between countries that are now Members of the OECD. This was to a large extent due to the work commenced in 1921 by the League of Nations. This work led to the drawing up in 1928 of the first model bilateral convention and, finally, to the Model Conventions of Mexico (1943) and London (1946), the principles of which were followed with certain variants in many of the bilateral conventions concluded or revised during the following decade. Neither of these Model Conventions, however, was fully and unanimously accepted. Moreover, in respect of several essential questions, they presented considerable dissimilarities and certain gaps.
>
> 5. The increasing economic interdependence and co-operation of the Member countries of the OEEC in the post-war period showed increasingly clearly the importance of measures for preventing international double taxation. The need was recognised for extending the network of bilateral tax conventions to all Member countries of the OEEC, and subsequently of the OECD, several of which had so far concluded only very few conventions and some none at all. At the same time, harmonization of these conventions in accordance with uniform principles, definitions, rules, and methods, and agreement on a common interpretation, became increasingly desirable.
>
> 6. It was against this new background that the Fiscal Committee set to work in 1956 to establish a draft convention that would effectively resolve the double taxation problems existing between OECD Member countries and that would be acceptable to all member countries. From 1958 to 1961, the Fiscal Committee prepared four interim Reports, before submitting in 1963 its final Report entitled "Draft Double Taxation Convention on Income and Capital." The Council of the OECD adopted, on 30 July 1963, a Recommendation concerning the avoidance of double taxation and called upon the Governments of Member countries, when concluding or revising bilateral conventions between them, to conform to that Draft Convention.
>
> * * *
>
> 10. Because the influence of the Model Convention had extended far beyond the OECD Member countries, the Committee also decided that the revision process should be opened up to benefit from the input of non-Member countries, other international

[76]Established April 16, 1948, the OEEC's original members were Austria, Belgium, Denmark, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey, the United Kingdom, and West Germany.

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> organisations and other interested parties. It was felt that such outside contributions would assist the Committee on Fiscal Affairs in its continuing task of updating the Model Convention to conform to the evolution of international tax rules and principles.
>
> 11. This led to the publication in 1992 of the Model Convention in a loose-leaf format. Unlike the 1963 Draft Convention and the 1977 Model Convention, the revised Model was not the culmination of a comprehensive revision, but rather the first step on an ongoing revision process intended to produce periodic updates and thereby ensure that the Model Convention continues to reflect accurately the views of Member countries at any point in time.[77]

The history confirms that the problem of double taxation and the desirability of relieving it on a bilateral basis have been generally agreed on for a long time. Of course, the mere fact that this goal has been pursued for a long time by the United States and other OECD members, and by nonmembers that are encouraged to do so by the OECD members, is no reason to resist fresh insights into how the global economy should operate and be taxed in the modern era.[78] At the same time, it is worth bearing in mind that the slate has not been blank for many decades. Some of our treaty partners may be thinking about the pooling basis proposal as informed by that history and may perceive it to be another treaty override by the United States.[79]

The commentary to article 23 in the first OECD model tax convention (1963) did not include a recommendation to provide relief from double taxation for the tax imposed on profits out of which a dividend might be distributed. That model tax convention did, however, anticipate that such an indirect credit provision could be included.[80] After all, the relevant fiscal affairs committees had U.S. representatives, and the U.S. policymakers were likely influenced by T.S. Adams, who had long advocated relief from double taxation that could result from corporate tax on the accumulated profits out of which a dividend is paid.

The United States entered into a number of double tax treaties immediately following World War II and before the issuance of the 1963 OECD model. Some of those early treaties provided an indirect credit. The treaty with the United Kingdom (1945/1946) provided for the indirect credit, while the treaty with the Netherlands (1948) did not. The treaties that did provide for an indirect credit did so by requiring the United States to provide a credit for the other contracting state's income taxes in accordance with section 131 of the Internal Revenue Code in effect when the treaty was entered into (or some specified date proximate thereto). Section 131(f) at that time provided for the indirect credit.[81]

The first major revision of the OECD model tax convention was produced by the OECD in 1977. By that time, the general desirability of the indirect FTC had been incorporated into the official commentary to article 23B (most likely because of persistent advocacy by the United States). Paragraphs 49-54 of the 1977 commentary to article 23(B) explain that the fiscal affairs committee had given serious consideration to a proposal to incorporate a standard indirect credit provision in the recommended text of article 23 but that the effort to achieve a unified solution collapsed under the weight of too many good ideas on the best way to reach the desired end. The description is worth reviewing, if only to understand that the OECD member countries have grasped the role of the indirect credit and have encouraged (even if perhaps only at the prodding of the United States) some variant to be used to reduce the drag on the global economy caused by "recurrent corporation taxation."[82]

> Dividends from substantial holdings by a company.
>
> 49. The combined effect of paragraphs 1 and 2 of Article 10 and Article 23 (Article 23A and 23B as appropriate) is that the State of residence of the shareholder is allowed to tax dividends arising in the other State, but that it must credit against its own tax on such dividends the tax which has been collected by the State where the dividends arise at a rate fixed under paragraph 2 of Article 10. This regime equally applies when the recipient of the dividends is a parent company receiving dividends from a subsidiary; in this case, the tax withheld in the State of the subsidiary — and credit in the State of the parent company — is limited to 5 per cent of the gross amount of the dividends by the application of sub-paragraph a) of paragraph 2 of Article 10.
>
> 50. These provisions effectively avoid the juridical double taxation of dividends but they do not prevent *recurrent corporate taxation* on the profits distributed to the parent company: first at the level of the subsidiary and again at the level of the parent

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[77]Committee on Fiscal Affairs, "Introduction to the OECD Model Tax Convention on Income and Capital," at 6-8 (Jul. 17, 2008), *Doc 2008-18813*. The quoted language is similar to comparable statements in the fiscal committee report that accompanied the OECD model recommended by the OECD in 1977, as well as the introduction to each of the revised versions issued in 2000, 2003, and 2005.

[78]The "modern era" often seems to commence when one casts one's first vote for president.

[79]*See* Part III.E. for a brief discussion of the reaction of the OECD in 1989 to the U.S. 1986-1988 treaty overrides affecting article 23.

[80]OECD Model (1963), "Commentary on Articles 23(A) and 23(B) concerning Methods for Avoidance of Double Taxation," para. 52. ("Certain States wishing to apply the credit method in their Conventions, in respect of dividends from companies in other States, credit, not only for the amount of tax directly levied on the dividends in those other States, but also for that part of the companies' tax which is appropriate to the dividends. Member States applying this method are left free to do so.")

[81]*See* Appendix B for the text of the indirect credit in former section 131.

[82]"Recurrent corporate taxation" is the term used in OECD commentaries addressing the problem of double taxation that can be relieved either by an exemption of dividends or a credit for host country tax on the accumulated profits out of which a dividend is paid.

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> company. Such recurrent taxation creates a very important obstacle to the development of international investment. Many States have recognised this and have inserted in their domestic laws provisions designed to avoid this obstacle. Moreover, provisions to this end are frequently inserted in double taxation conventions.
>
> 51. The Committee on Fiscal Affairs has considered whether it would be appropriate to modify Article 23 of the Convention in order to settle this question. *Although many States favoured the insertion of such a provision in the Model Convention this met with many difficulties, resulting from the diverse opinions of States and the variety of possible solutions.* Some States, fearing tax evasion, preferred to maintain their freedom of action and to settle the question only in their domestic laws.
>
> 52. In the end, it appeared preferable to leave States free to choose their own solution to the problem. For States preferring to solve the problem in their conventions, the solutions would most frequently follow one of the principles below:
>
> b) *Credit for underlying taxes*
>
> As regards dividends received from the subsidiary, the State of which the parent company is a resident gives credit as provided for in paragraph 2 of Article 23A or in paragraph 1 of Article 23B, as appropriate, not only for the tax on dividends as such, but also for the tax paid by the subsidiary on the profits distributed (such a provision will frequently be favoured by States applying as a general rule the credit method specified in Article 23B).
>
> 53. When the State of the parent company levies taxes on capital, a similar solution should also be applied to such taxes.
>
> 54. Moreover, States are free to fix the limits and methods of application of these provisions (definition and minimum duration of holding of the shares, proportion of the dividends deemed to be taken up by administrative or financial expenses) or to make the relief granted under the special regime subject to the condition that the subsidiary is carrying out a genuine economic activity in the State of which it is a resident, or that it derives the major part of its income from that State or that it is subject to a substantial taxation on profits therein.[83]

Similar explanations appear in each subsequent commentary to article 23(B). The idea of dealing with recurrent corporate taxation has not somehow receded under the pressure of evolving insights into how best to tax income from cross-border investment in subsidiaries. Those subsequent commentaries (each in paragraphs 49-54, entitled ''Dividends From Substantial Holdings by a Company'') explain the revised OECD model tax conventions issued in 1997, 2000, 2003, 2005, and 2008.

As listed in footnote 6 of this article, as of 2009, 48 countries are parties to double tax treaties with the United States, treaties whose provisions include a requirement that the United States provide an indirect credit. Most of the indirect credit provisions in those treaties closely track the OECD approach to elimination of the ''recurrent corporate taxation'' flavor of double taxation that otherwise results from unmitigated shareholder country tax on dividends from a treaty partner company or on the profits out of which the dividend is distributed. In other words, the language in the 2006 U.S. model — the means chosen by the United States to relieve double taxation on underlying profits of contracting-state companies that distribute dividends to U.S. corporate shareholders — is precisely what the OECD commentary to article 23B is talking about.

B. Once Included, Compliance Is Not Optional

Once the contracting states have decided to deal by treaty with the problem of recurrent corporate taxation on operating profits, the OECD commentaries address it as an agreed-on ''deal,'' not an exhortation for each contracting state to contend with the problem unilaterally (if, as, and when either contracting state can fit the commitment into its other tax or budget priorities). States that want to retain the flexibility to pursue more important tax goals (preventing tax evasion, or funding healthcare, for example) are supposed to take the course prescribed in commentary paragraph 51: Leave the indirect credit out of the bilateral tax treaties to which that state is a party and deal with recurrent corporate taxation solely under domestic law. The United States has decided to include the indirect credit in 48 treaties and has chosen not to take the route left open to it in commentary paragraph 51.

C. Domestic Laws

The OECD commentaries to article 23B suggest intimate familiarity by the OECD member countries with the concepts expressed in article 23 of the U.S. model as to the function of domestic law and with the U.S. model's reference to the provisions and limitations to which the allowance of a credit may be subject. The pertinent commentary suggests that the assumption of the fiscal committee (at least) is that Humpty Dumpty's definition of glory is not what the fiscal committee (and the OECD member states) has in mind. Instead, the commentary explains that the perception is that the provisions of domestic law should be consistent with the *principle* laid down in article 23B:

> 60. Article 23B sets out the main rules of the credit method, but does not give detailed rules on the computation and operation of the credit. This is consistent with the general pattern of the Convention. Experience has shown that many problems may arise. Some of them are dealt with in the following paragraphs. In many States, detailed rules on credit for foreign tax already exist in their domestic laws. A number of conventions, therefore, contain a reference to the domestic laws of the

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[83]OECD Model (2008), Commentaries on the Articles of the Model Tax Convention, at 275 (emphasis added), *Doc 2008-18813*.

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> contracting states *and further provide that such domestic rules shall not affect the principle laid down in Article 23B*.[84]

The experience mentioned in this statement appears to refer only to the problems in implementing a credit, not to the problems of a fiscal crisis in the contracting state of the parent company or of a new good idea on how to use international taxation rules as an instrument of economic change. Instead, the problems have to do with adequately dealing with double taxation (including, if applicable, the indirect tax burden caused by recurrent corporate taxation of operating profits that fund a dividend), avoiding double nontaxation, and perhaps even limiting unintended cross-crediting. The concept of consistency with principles is clearly expressed; nothing suggests that the OECD fiscal committee has assumed that limitations can be imposed or changed without regard to the purpose of avoiding recurrent corporate taxation.

D. 'Mere Timing Problems' Not Exempt

Nothing in the commentaries to article 23 of the OECD model suggests that contracting state tax measures that only temporarily subject a parent company to double taxation of dividends from a contracting-state affiliate are somehow not supposed to be constrained by article 23. On the contrary, the opposite inference seems to be required by the language in commentary paragraph 32.8:

> F. Timing mismatch
>
> 32.8 The provisions of the Convention that allow the State of source to tax particular items of income or capital do not provide any restriction as to when such tax is to be levied (see, for instance, paragraph 2.2 of the Commentary on Article 15). Since both Articles 23 A and 23 B require that relief be granted where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention, it follows that such relief must be provided regardless of when the tax is levied by the State of source. The State of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the State of source taxes it in an earlier or later year. Some States, however, do not follow the wording of Article 23 A or 23 B in their bilateral conventions and link the relief of double taxation that they give under tax conventions to what is provided under their domestic laws. *These countries, however, would be expected to seek other ways (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in a different taxation year.*[85]

The problem is recurrent corporate taxation when both countries tax the dividend (including the underlying profits out of which a dividend is paid). At the least, some effort to relieve even a timing-difference "recurrent corporate taxation" burden is contemplated: "(the mutual agreement procedure, for example)." That same concern seems present when the other contracting state has taxed the underlying profits out of which the dividend has been paid, but the United States wants to postpone relief from recurrent corporate taxation for reasons entirely extrinsic to the bilateral relationship covered by the applicable treaty.

E. The OECD Has Objected to Treaty Overrides

Perhaps in response to the override experience in the United States following the enactment of the TRA 1986 and the TAMRA override in 1988,[86] the OECD fiscal affairs committee in 1989 issued a report on treaty override.[87] In that report, later adopted by the OECD council on October 2, 1989, the committee suggested that overrides of treaties were a matter of grave concern. The report recognized that an override can result from deliberate acts as well as from the adoption of inconsistent legislation in countries that do not adhere to the principle of *pacta sunt servanda*.

The pooling basis proposal puts at least as much pressure on the existing deal under article 23-type provisions as TRA 1986 did in introducing measures to prevent or limit cross-crediting of contracting state tax against *other* income (whether domestic or foreign-source), and it is comparable to the direct conflict caused by the enactment of section 59(a)(2) (the direct limitation on the amount of AMT that could be offset by an FTC). If the TAMRA treaty override was offensive, the pooling basis proposal would be an even more direct conflict with both the letter and the spirit of article 23.

The OECD fiscal affairs report described "the problem":

> 1. Double taxation agreements (tax treaties) are an essential element in facilitating economic relations between States and encouraging flows of capital and labour. They form a firm and reliable basis for tax relations between States. They limit and regulate the taxing jurisdiction of the States entering into them so as to ensure the orderly application of the domestic tax laws of what are often quite different systems. Their importance is underlined by the large numbers that are currently in force and the fact that international organisations and the business community repeatedly recommend the enlargement and improvement of the treaty network.
>
> 2. *The certainty that tax treaties bring to international tax matters has, in the past few years, been called into question, and to some extent undermined, by the tendency in certain States for domestic legislation to be passed or proposed which may override provisions of tax treaties*. In this note, which looks at the consequences of such action by national legislatures, the term "treaty override" refers to a situation where

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[84] *Id.* at 277 (emphasis added).
[85] *Id.* at 268 (emphasis added).

[86] *See* notes 48-49 *supra*.
[87] OECD Committee on Fiscal Affairs, "Report on Treaty Override," 1989, No. 8.

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> the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State. Legislation may take the form of a provision that treaty provisions are to be disregarded in certain circumstances (e.g. in cases of treaty shopping or other forms of abuse). Legislation can also have the effect of overriding treaties, even where no reference is made in the legislation to treaty provisions as such, because the domestic interpretation of the effect of that legislation in relation to treaty provisions has the same effect in practice. Some hypothetical examples of treaty override are given in Section IV of this note.[88]

The report went on to make several points that may well come up again in a renewed examination of the role of treaties in implementing American international tax policy if the United States proceeds to adopt a pooling basis limitation on the amount of foreign taxes deemed paid, and thus on the amount of contracting state tax that can be credited against U.S. tax otherwise due on the same income:

> 4. At the outset . . . the kind of treaty override primarily addressed in this note should be distinguished from other situations, which either involve or are similar to treaty override and may have the same effects. Three of these situations are described below and comments are made on them either below or later in this note.
>
> a) A State may legislate to reverse the effect of a court decision which deviates from the common interpretation, explicitly accepted or tacitly implied by the treaty partners, of a provision based on the text of the treaty. In this case, it is not considered that any injury is done to the basis of international tax relations if the competent legislative and administrative organs of the States concerned are in agreement that the court decision is contrary to their intentions. Indeed it is the Court's decision in the first place which may be seen as overriding the treaty;
>
> b) A State may change the definition of a term used in its domestic legislation which is also used in treaty provisions but which is not specifically defined for the purposes of the treaty. In this case there is no override where the treaty contains a provision essentially similar to that embodied in Article 3, paragraph 2, of the 1977 OECD Model Double Taxation Convention which provides that, as regards the application of a treaty by a contracting state, any term not defined in the treaty shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the treaty applies. It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law provided such changes were compatible with the context of the treaty;
>
> c) Finally, newly adopted domestic legislation may be incompatible with a treaty provision, without the competent organs intending, or even being aware of, such an effect.[89]
>
> 5. In summary, the type of treaty override primarily addressed in this note is the enactment of domestic legislation *intended by the legislature to have effects in clear contradiction to international treaty obligations*.[90]
>
> 15. In this respect, OECD Member countries find themselves in different positions. . . . On the other hand, the United States has chosen, in accordance with Article VI, paragraph 2, of its Constitution, to give treaty obligations equal rank with domestic law and thus to make such obligations subject to the ''*lex posterior*'' rule in the case of irreconcilable conflicts.
>
> 17. If a constitutional system does not exclude the adoption of legislation contrary to the State's international obligations, this does not mean that those international obligations are considered as having no importance. If they have such power, the legislative organs must consider carefully whether or not to exercise it. In some States, the outcome of such reflexion may almost always be in favour of respecting those international obligations. *In others, legislators may, in occasional cases, consider certain national interests as of such overwhelming importance that the State has no other choice but to override its treaty obligations.*
>
> 18. In summary, the rank of treaty obligations depends on each State's legal system. The latter may allow for derogation, under domestic law, from those obligations. Such derogation is internally perfectly valid, and binding on a State's organs and citizens. It does not, however, alter the obligations of the State towards other States under international law.[91]

The committee report confirms that the various issues associated with carving back the article 23 indirect credit are not new in terms of tax policy. The United States may reach a different conclusion, but it would not be doing so on a blank slate.

> The OECD council went on to adopt a recommendation:
>
> Recommendation of the council concerning tax treaty override
>
> (Adopted by the Council on 2 October 1989)

[88]*Id.* (emphasis added).

[89]*Id.* These three kinds of potential conflict are more benign, at least in lack of intent to override an existing treaty regarding its intended scope.

[90]*Id.* (emphasis added). A resolution of the conflict between the pooling basis proposal and article 23 would probably be of this type: A direct contradiction is intended and is one in which legislation is to control and treaties are to recede.

[91]*Id.* (emphasis added).

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> THE COUNCIL,
>
> Having regard to Article 5 b) of the Convention of the Organisation for Economic Co-operation and Development of 14th December 1960;
>
> Having regard to the Recommendation of the Council of 11th April 1977 concerning the avoidance of double taxation;
>
> Having regard to the Recommendation of the Council of 3rd June 1982 concerning the avoidance of double taxation with respect to taxes on estates and inheritances and on gifts;
>
> Having regard to the report of the Committee on Fiscal Affairs of 29th June, 1989 on Tax Treaty Override;
>
> Considering that double taxation conventions contribute to the removal of obstacles to the free movement of goods, services, capital and manpower between Member countries of the OECD and that the network of conventions brings certainty into international tax matters;
>
> Considering that such certainty has been called into question, and to some extent undermined, by the enactment of legislation which is intended to nullify unilaterally the application of international treaty obligations;
>
> Considering that bilateral or multilateral consultations are the first course of action in dealing with problems arising from conflicts between domestic legislation and treaty provisions;
>
> I. RECOMMENDS Member countries:
>
> 1. To undertake promptly bilateral or multilateral consultations to address problems connected with tax treaty provisions, whether arising in their own country or raised by countries with which they have tax treaties;
>
> 2. To avoid enacting legislation which is intended to have effects in clear contradiction to international treaty obligations.
>
> II. INSTRUCTS the Committee on Fiscal Affairs to follow developments in this area and to bring to the attention of the Council any action which would constitute a material breach of Member countries' international treaty obligations.[92]

That report (including the recommendation) is now 20 years old. The compilation of such reports is accompanied by cautionary language to the effect that the various reports on the list may be out of date. That said, it seems likely that article 23 is still an article to be eviscerated with some caution if the views of the OECD are an area of potential concern.

F. Article 23 Overrides

The concern expressed by the OECD council in 1989 is not peculiar to treaty policy concerns on the part of international bureaucrats or other ''foreigners.'' An interesting analysis of the relationship between tax treaties and ordinary treaties was published in 2004.[93] That analysis included an expressed concern about the propriety of overriding the double taxation provisions of a bilateral tax treaty, as distinguished from the more acceptable override of treaty provisions that might be applied in a way to accomplish an effect unintended by the contracting states. The discussion poses questions and positions we must consider in the context of the much larger (quantitative) conflict raised by the pooling basis proposal than by the partial override for the AMT:

> But the interesting question is, when does the United States resort to treaty overrides? The answer is rarely, and when it does so deliberately, an argument can be made that it is justified in doing so. Consider three recent cases from the period 1986-1997: the branch profits tax, the earnings stripping rule and the reverse hybrid rule (citing sections 884, 163(j) and 894(c)).
>
> In each of these [three] cases I think an override was justified. The reality is that tax law and practice change too fast to wait for treaties to be renegotiated. Still, overrides should be used sparingly and only when consistent with the underlying purpose of the treaty. *And there are unjustified examples, such as the provision of the alternative minimum tax that limits the foreign tax credit to 90%* (citing section 59(a)(2)). *That leads directly to double taxation and is not justifiable in the treaty context*, but courts (including recently the D.C. Circuit (citing *Kappus v. Commissioner*, *supra*, note 49) have accepted it as a valid override (even though Congress did not explicitly designate it as such[94]).[95]

The unjustified example would presumably be just as unjustified if Congress had more clearly stated that it really wanted to override the provisions of the Canadian treaty that correspond to article 23. In the case of the pooling basis proposal, the conflict is equally direct and may well be viewed as being just as unjustified as the conflict in the AMT context to which the quoted language was addressed.[96]

IV. Bilateral Network Is Not Multilateral

The existing treaty network was not put together to achieve a harmonious multilateral tax burden on global

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[92] *Id.*

[93] *See* Avi-Yonah, note 5 *supra*, at 496.

[94] *Id.* In the current case, we may end up in a similar situation: If the administration chooses to treat the pooling basis as consistent with its understanding of the permitted changes under the 48 treaties rather than seek an explicit override, the question may devolve to applying the later-in-time rule confirmed by the enactment of section 7852(d) in 1986. Treaty-partner reaction will then inform the next step (the Humpty Dumpty problem).

[95] *Id.* (emphasis added) note 5 *supra*. *See also* Richard L. Doernberg, ''Overriding Tax Treaties: The U.S. Perspective,'' 9 *Emory Int'l L. Rev.* 71 (Spring 1995).

[96] The perception of similitude in the desired application of the policy against overriding article 23 in the case of section 59(a)(2), and a consistent opposition to overriding or ignoring article 23 in the case of the pooling basis, may be nothing more than the hobgoblin of a small mind.

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business. Instead, from the very beginning up through the most recent OECD model convention (2008), it has been recognized that bilateral treaties are the best we can do.

Again, the deals that were struck were reached in full awareness that the bilateral treaty, in requiring credit for taxes only of the other contracting state, was imperfect in terms of global tax efficiency but was compelled by the practical needs of each contracting state:

> Report and Resolutions submitted by the Technical Experts to the Financial Committee of the League of Nations, ''Double Taxation and Tax Evasion'' (Feb. 7, 1925) at p. 17:
>
>> We have realized how difficult it is to establish a hard and fast principle. In such matters, general economic considerations (need of ensuring the free flow of capital), the difference between the financial and commercial policy of States (need for a State, according to circumstances, to seek or reject pecuniary assistance from foreign investors) and finally the absolute necessity of obtaining the balancing of the budget by means of appropriate fiscal arrangements are elements in the problem which cannot, in the present troubled state of the general European economic situation, be reconciled, unless we take the view that bilateral agreements will supply a corrective to the unduly rigid character of general principle and make it possible to harmonize the various competing interests.

It is not particularly important that in 2009 we agree that the holy grail of perfect taxation (exclusive residence-based taxation) is unattainable.[97] It *is* important that the context in which all the bilateral tax treaties to which the United States is now a party are based is the assumption that recognizing the differing needs of each contracting state were on the table when each deal was struck. The first antecedent version of article 23 was article 10 of the model tax convention that was attached in an appendix to the 1925 report. That version was directly connected with the quoted understanding of the point of entering into tax treaties rather than trying to work out uniform laws. Uniform laws might ''correctly'' implement some truth about the best form of multinational taxation of income and capital or the best blended rate to be borne by the productive business sector to fund government services in the modern world, but agreement was then, and probably still remains, elusive.

Each OECD model tax treaty has reflected the core assumption that a multilateral reconciliation of the various distinct fiscal preferences of the several sovereigns that oversee global trade and investment is a chimera. The most recent OECD statement appears in the introduction to the 2008 OECD model tax treaty:

> Multilateral convention
>
> 37. When preparing the 1963 Draft Convention and the 1977 Model Convention, the Committee on Fiscal Affairs considered whether the conclusion of a multilateral tax convention would be feasible and came to the conclusion that this would meet with great difficulties. It recognized, however, that it might be possible for certain groups of Member countries to study the possibility of concluding such a convention among themselves on the basis of the Model Convention, subject to certain adaptations they might consider necessary to suit their particular purposes.
>
> 38. The Nordic Convention on Income and Capital entered into by Denmark, Finland, Iceland, Norway and Sweden, which was concluded in 1983 and replaced in 1987, 1989 and 1996, provides a practical example of such a multilateral convention between a group of Member countries and follows closely the provisions of the Model Convention.
>
> 39. Also relevant is the Convention on Mutual Administrative Assistance in Tax Matters, which was drawn up within the Council of Europe on the basis of a first draft prepared by the Committee on Fiscal Affairs. This Convention entered into force on 1 April 1995.
>
> 40. Despite these two conventions, there are no reasons to believe that the conclusion of a multilateral tax convention involving all Member countries could now be considered practicable. The Committee therefore considers that bilateral conventions

[97]*See* ''Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp,'' League of Nations, Part II, Section I.A (The Basis of Taxation the Principle of Ability to Pay), Doc. E.F.S. 73F 19. Professor Seligman asserted in the 1923 report that residence country taxation in lieu of source country taxation was necessary to preserve the progressivity of the income tax, because only the residence country could take into account any particular taxpayer's aggregate ability to pay. The same view has been advanced regularly by public finance economists during the past 86 years but has not been implemented (perhaps because of vigorous resistance by source countries). *See* David F. Bradford, *Blueprints for Basic Tax Reform* (2d ed). The United States is both a source and a residence country and may wish to preserve its ability to tax on a source basis as it becomes more dependent on foreign direct investment in the United States. In deciding to eliminate the indirect credit for source country taxes on foreign subsidiary income, some thought might be given to the implications if countries, such as Italy, follow our lead and deny Fiat relief from double taxation on Chrysler's future profits (admittedly, a problem we would all love to wrestle with). The United States may find itself between a rock and a hard place: great political demands from valued constituents of the body politic to turn Chrysler around (and to save U.S. jobs) and to have it attract foreign capital to assist in that effort, while trying to increase tax revenue from U.S. multinational corporation investments in Italy by denying the Italian fisc the benefits of the **(Footnote continued in next column.)** source country tax primacy we had agreed to give. A goal of international tax reform may be to bring jobs back to America by increasing the U.S. tax burden on business in those countries. If those countries respond by similar measures, the appeal of the United States for foreign direct investment capital may diminish (the goose and gander problem).

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are still a more appropriate way to ensure the elimination of double taxation at the international level.[98]

The difficulty noted by the technical experts in the 1925 report is clearly not peculiar to early 20th-century nationalism, nor is it attributable to automatic replication by the OECD fiscal affairs committee word processing software used when the updated model treaty was issued in 2008.

As recently as June 2009 the European Council found it necessary to reassure Ireland that Irish accession to the Treaty of Lisbon[99] would not ''make any change of any kind, for any Member State, to the extent or operation of the competence of the European Union in relation to taxation.''[100] If the European Union has such difficulty with members of its union, it is likely that the difficulties will be even greater in achieving multinational accord on what to tax, when to tax, who to tax, and how much to tax, when the sovereigns do not even aspire to ''union'' with each other.

However, now may be a suitable time to start the process again. The place to start is a multilateral convention, perhaps sponsored by the OECD. The wrong place to start is to override 48 bilateral treaties and then see what can be done to establish a new world order.

V. Conclusion

For the sake of discussion, I suggest the following course of action. There is more than one wrong answer to be found to the question, ''What should be done?''

1. Determine the reaction of the 10 largest treaty partners (measured by reference to amount of bilateral cross-border direct investment) to the partial override of article 23. A first step would be to raise the question with the OECD.

2. If the preservation of article 23 treaty-based relief is politically unpalatable, Congress should override any of the treaties to the extent necessary (the TAMRA section 1012(aa) solution). This would forestall unnecessary confusion and the need to apply the last-in-time rule in litigation. Private litigation is an inappropriate platform from which to conduct U.S. foreign policy.

3. Propose amendments to the U.S. model article 23 and invite public comment thereon.

4. Add the proposal to the other items that the United States routinely seeks (for example, enhanced limitation on benefits) in its renegotiation and updating of treaties.

5. Explore treaty-legal alternatives, such as permissible limitations on cross-crediting; review why such limitations were adopted in 1986 and then modified or discarded over the ensuing 20 years.

6. Convene a conference of like-minded countries (among the G-9 or the G-20) to again consider moving to a multilateral apportionment of income and taxing jurisdiction among those countries.[101]

Appendix A

Rangel Bill

SECTION 976. AMOUNT OF FOREIGN TAXES COMPUTED ON OVERALL BASIS.

(a) CURRENT YEAR ALLOWANCE. — For purposes of this chapter, the amount taken into account as foreign income taxes for any taxable year shall be an amount which bears the same ratio to the total foreign income taxes for that taxable year as —

(1) the currently-taxed foreign income for such taxable year, bears to

(2) the sum of the currently-taxed foreign income and deferred foreign income for such year.

The portion of the total foreign income taxes for any taxable year not taken into account under the preceding sentence for a taxable year shall only be taken into account as provided in subsection (b) (and shall not be taken into account for purposes of applying sections 902 and 960).

(b) ALLOWANCE RELATED TO REPATRIATED DEFERRED FOREIGN INCOME. —

(1) IN GENERAL. — If there is repatriated foreign income for any taxable year, the portion of the previously deferred foreign income taxes paid or accrued during such taxable year shall be taken into account for the taxable year as foreign taxes paid or accrued. Any such taxes so taken into account shall not be included in foreign income taxes for purposes of applying subsection (a) to such taxable year.

(2) PORTION OF PREVIOUSLY DEFERRED FOREIGN INCOME TAXES. — For purposes of paragraph(1), the portion of the previously deferred foreign income taxes allocated to repatriated deferred foreign income is —

---

[98]Commentaries on OECD Model (2008), *supra* note 83, at 15. Similar statements appear in various reports and introductions to the various model conventions recommended by the OECD fiscal committee since 1963. Of course, different views may emerge from a fundamental change in U.S. tax policy.

[99]The Treaty of Lisbon was signed at Lisbon, Portugal, December 13, 2007. The Treaty of Lisbon seeks enhanced coherence in the functioning of the EU and is a less ambitious effort to integrate the EU than the attempt to adopt a European constitution that was unsuccessful after rejection by French and Dutch voters in 2005.

[100]Annex 1, Presidency Conclusions No. 2, Brussels European Council (June 19, 2009), reprinted in *Doc 2009-14038, 2009 WTD 117-18*.

[101]Do not invite anyone who wants *only* the best, rather than just a good, system. Attendance by private sector or academic enthusiasts should be permitted but the important speaking parts should be limited to representatives of the finance ministries of participating countries.

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(A) the amount which bears the same proportion to such taxes, as

(B) the repatriated deferred income bears to the previously deferred foreign income.

(c) DEFINITIONS AND SPECIAL RULE. — For purposes of this section —

(1) PREVIOUSLY DEFERRED FOREIGN INCOME TAXES. — The term ''previously deferred foreign income taxes'' means the aggregate amount of total foreign income taxes not taken into account under subsection (a) for all prior taxable years (determined as of the beginning of the taxable year), reduced by any amounts taken into account under subsection (b) for such prior taxable years.

(2) TOTAL FOREIGN INCOME TAXES. — The term ''total foreign income taxes'' means the sum of foreign income taxes paid or accrued during the taxable year (determined without regard to section 904(c)) plus the increase in foreign income taxes that would be paid or accrued during the taxable year under sections 902 and 960 if —

(A) all controlled foreign corporations were treated as one controlled foreign corporation, and

(B) all earnings and profits of all controlled foreign corporations were subpart F income (as defined in section 952).

(3) FOREIGN INCOME TAXES. — The term ''foreign income taxes'' means any income, war profits, or excess profits taxes paid by the taxpayer to any foreign country or possession of the United States.

(4) CURRENTLY-TAXED FOREIGN INCOME AND DEFERRED FOREIGN INCOME. — The terms ''currently-taxed foreign income'' and ''deferred foreign income'' have the meanings given such terms by section 975(c)).

H.R. 3970, 110th Cong., 1st Sess. (Oct. 25, 2007) (the Rangel bill).

Appendix B

Excerpts From Various Statutory Indirect Credit Provisions

REVENUE ACT OF 1921:

SECTION 238. CREDIT FOR TAXES IN CASE OF CORPORATIONS.

(e) For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under section 234) in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided*, That the credit allowed to any domestic corporation under this subdivision shall in no case exceed the same proportion of the taxes against which it is credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term ''accumulated profits'' when used in this subdivision in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income.

INTERNAL REVENUE CODE OF 1939:

SECTION 131. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

(f) Taxes Of Foreign Subsidiary. — For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war-profits or excess-profits taxes paid by such corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided*, That the amount of tax deemed to have been paid under this subsection shall in no case exceed the same proportion of the tax against which credit is taken which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term ''accumulated profits'' when used in this subsection in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income.

REVENUE ACT OF 1951:

SECTION 332. CREDIT FOR TAXES OF FOREIGN CORPORATIONS.

(a) Foreign Subsidiary of a Domestic Corporation. — Effective with respect to dividends received by a domestic corporation from a foreign corporation during taxable years beginning after December 31, 1950, the first sentence of section 131 (f) (1) is hereby amended by striking out ''a majority'' and inserting in lieu thereof ''at least 10 per centum.''

INTERNAL REVENUE CODE OF 1954:

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

(a) Allowance of Credit. — If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus,

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in the case of a corporation, the taxes deemed to have been paid under section 902.

SECTION 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

(a) Treatment of Taxes Paid by Foreign Corporation. — For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits.

REVENUE ACT OF 1962:

SECTION 9. DOMESTIC CORPORATIONS RECEIVING DIVIDENDS FROM FOREIGN CORPORATIONS.

(a) Foreign Taxes Deemed Paid by Domestic Corporations. — Section 902 (relating to credit for corporate stockholders in foreign corporations) is amended to read as follows:

SECTION 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

(a) Treatment of Taxes Paid by Foreign Corporation. — For purposes of this subpart, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall —

> (1) to the extent such dividends are paid by such foreign corporation out of accumulated profits (as defined in subsection(c)(1)(A)) of a year for which such foreign corporation is not a less developed country corporation, be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States on or with respect to such accumulated profits, which the amount of such dividends determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profit taxes (other than those deemed paid).

SECTION 78. DIVIDENDS RECEIVED FROM CERTAIN FOREIGN CORPORATIONS BY DOMESTIC CORPORATIONS CHOOSING FOREIGN TAX CREDIT.

If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under section 902(a)(1) (relating to credit for corporate stockholder in foreign corporation) or under section 960(a) (1) (C) (relating to taxes paid by foreign corporation) for such taxable year shall be treated for purposes of this title (other than section 245) as a dividend received by such domestic corporation from the foreign corporation.

SECTION 10. SEPARATE LIMITATION ON FOREIGN TAX CREDIT WITH RESPECT TO CERTAIN INTEREST INCOME.

(a) Limitation on Foreign Tax Credit. — Section 904 relating to limitations on foreign tax credit) is amended by redesignating subsection (f) as subsection (g) and by inserting after subsection (e) the following new subsection:

> ''(f) Application of Section in case of Certain Interest Income. —
>
> > ''(1) In General.— The provisions of subsections (a), (c), (d), and (e) of this section shall be applied separately with respect to —
> >
> > > ''(A) the interest income described in paragraph (2), and
> > >
> > > ''(B) income other than the interest income described in paragraph (2).

TAX REFORM ACT OF 1986:

SECTION 1202. DEEMED PAID CREDIT UNDER SECTIONS 902 AND 960 DETERMINED ON ACCUMULATED BASIS.

(a) General Rule. — Section 902 (relating to credit for corporate stockholder in foreign corporation) is amended to read as follows:

> ''SECTION 902. DEEMED PAID CREDIT WHERE DOMESTIC CORPORATION OWNS 10 PERCENT OR MORE OF VOTING STOCK OF FOREIGN CORPORATION.
>
> > ''(a) Taxes Paid by Foreign Corporation Treated as Paid by Domestic Corporation. — For purposes of this subpart, a domestic corporation which owns 10 percent or more of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of such foreign corporation's post-1986 foreign income taxes as —
> >
> > > ''(1) the amount of such dividends (determined without regard to section 78), bears to
> > >
> > > ''(2) such foreign corporation's post-1986 undistributed earnings.''

CURRENT LAW SECTIONS 902 AND 904:

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

(a) Taxes paid by foreign corporation treated as paid by domestic corporation. For purposes of this subpart, a domestic corporation which owns 10 percent or more of the voting stock of a foreign corporation from which it receives dividends in any

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taxable year shall be deemed to have paid the same proportion of such foreign corporation's post-1986 foreign income taxes as —

(1) the amount of such dividends (determined without regard to section 78), bears to

(2) such foreign corporation's post-1986 undistributed earnings.

SECTION 904. LIMITATION ON CREDIT.

(a) Limitation.

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

* * *

(d) Separate application of section with respect to certain categories of income.

(1) In general. The provisions of subsections (a), (b), and (c) and section 902, 907, and 960 shall be applied separately with respect —

(A) passive category income, and

(B) general category income.

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