

1/4 HISTORY OF FOREIGN TAX CREDIT

Until 1918, all foreign taxes were treated as deductible expenses under United States income tax law. It appears that the foreign tax credit provisions were adopted in that year in response to the sharp increase in income tax rates both at home and abroad during World War I. While one or two countries had used the tax credit device prior to that time for taxes paid to their colonies, the United States was the first country to apply the foreign tax credit on a world-wide basis as a means of relieving international double taxation of income.⁸⁰ The original tax credit legislation⁸¹ restricted the credit to foreign income, excess profits, and war profits taxes, and this group of taxes still constitutes the major category of creditable taxes. The 1918 law also provided an indirect credit for taxes paid by foreign subsidiaries, but otherwise the structure of the tax credit mechanism as it now exists was substantially established in the Revenue Act of 1921. Although there have been many technical amendments to the tax credit law since that time,⁸² the most important amendments reflecting policy changes are those related to the progressive extension of the indirect credit provisions, to changes in the character of the limitation on the amount of tax credit, and to the category of creditable taxes. The one addition to the category of creditable taxes occurred in 1942 when the provision allowing a credit for foreign taxes paid in lieu of taxes on income, excess profits, and war profits, was enacted.⁸³

In the 1918 Revenue Act, the indirect credit for taxes imposed on foreign corporations, now provided for in section 902 of the Code, was granted to domestic corporations which owned the majority of the voting shares of foreign subsidiaries for taxes paid by those subsidiaries. In 1942, the indirect credit was extended to include taxes paid by foreign sub-sub-

certain conditions, the application of either the per-country or the over-all limitation on the tax credit. The factors relevant to this choice between alternative limitations are discussed in Appendix I where the provisions of H.R. 10087 are described. See also 4/1 and 4/7.

⁸⁰ At the present time several countries grant tax credit relief on a world-wide basis under provisions which are similar to the United States tax credit provisions. Major countries granting unilateral tax credit relief against their income taxes are: Canada, Greece, India, Israeli, Japan, Mexico, Pakistan, the Philippines, Turkey, the United Kingdom, and West Germany. In addition, some countries grant a foreign tax credit for taxes paid to countries with which they have income tax treaties. For example, in the treaties to which the United States is a party, the foreign signatory country often agrees to grant a tax credit to its residents for income taxes paid to the United States. See International Chamber of Commerce, Commission on Taxation, *Avoidance of Double Taxation*; and Lachmann, "International Tax Treaties and Their Effect on Double Taxation," *The Taxation of Business Income from Foreign Operations* 183 (American Management Association, Management Report Number 2) (1958).

⁸¹ R.A. 1918, §§ 222, 238, 240(c).

⁸² Many of these amendments are referred to in subsequent chapters where the technical provisions are discussed.

⁸³ R.A. 1942, § 158(f).

aries which were wholly owned by a subsidiary the majority of whose voting stock was held by a domestic corporation.⁸⁴ The present requirements with respect to stock ownership, i.e., 10% or more of voting stock at the subsidiary level and 50% or more of voting stock at the sub-subsidiary level, were adopted in 1951.⁸⁵ The provision allowing a credit to be taken when royalties are received in lieu of dividends by a domestic corporation from a wholly owned foreign subsidiary was enacted in 1954.⁸⁶

A limitation on the maximum amount of credit which could be taken by a taxpayer was first adopted in 1921.⁸⁷ This was an over-all limitation under which the amount of credit for aggregate creditable taxes paid to all foreign countries in any year was limited to the United States tax on aggregate foreign source income in that year. The per-country limitation, limiting the amount of the credit for taxes paid to any one country in any year to the United States tax on income from sources in that country, was adopted in 1932.⁸⁸ Between 1932 and 1954, both of these limitations were in effect and the maximum amount of credit which could be taken was the lesser of the over-all limitation or the sum of the per-country limitations. The over-all limitation was repealed by the 1954 Code, leaving only the per-country limitation in operation between 1954 and 1961. The provision for the carry-over and carry-back of excess taxes, which in effect results in the application of the limitation over an eight-year period rather than on an annual basis, was enacted in 1958.⁸⁹ H.R. 10087, the provisions of which are briefly described at 1/2C2, was enacted in 1960 and allows a taxpayer to use either the per-country or over-all limitation for taxable years beginning after December 31, 1960.

1/5 EXTENT OF PRESENT USE OF FOREIGN TAX CREDIT

The most recent statistical data⁴⁰ published on the foreign tax credit show that the total amount of credit taken in relation to total taxes paid by individuals is very small, but is a substantial amount in relation to total taxes paid by corporations. For the tax year 1957, credit was claimed in only 76.9 thousand out of 59.8 million individual returns filed, and the

⁸⁴ R.A. 1942, § 158(c).

⁸⁵ R.A. 1951, §§ 332(a), 332(b).

⁸⁶ § 902(d). For most recent change in provisions relating to the indirect credit, see Appendix I.

⁸⁷ R.A. 1921, §§ 222(a)(5), 238(a).

⁸⁸ R.A. 1932, § 131(b).

⁸⁹ Technical Amendments Act of 1958, § 42.

⁴⁰ See U.S. Treasury Department, Internal Revenue Service, *Statistics of Income . . . 1956-57, Corporation Income Tax Returns*, Pub. No. 16 (3-59), particularly Tables 23, 24, and 25; and U.S. Treasury Department, Internal Revenue Service, *Statistics of Income . . . 1957, Individual Income Tax Returns*, Pub. No. 79 (9-59).

Statistics of income for corporations for 1957-1958 have been published but they do not include some detailed data on the tax credit included in the report for 1956-1957. Consequently, the corporate figures used in the text are for 1956-1957.