

CREDIT FOR FOREIGN TAXES PAID BY CERTAIN
FOREIGN CORPORATIONS

DECEMBER 30 (legislative day, DECEMBER 28), 1970.—Ordered to be printed

Mr. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 18549]

The Committee on Finance, to which was referred the bill (H.R. 18549) to amend sections 902(b) and 902(c) of the Internal Revenue Code of 1954 to reduce the 50-percent requirement to 10 percent between first and second levels and to include third-level foreign corporations in the tax credit structure if the 10 percent test is met, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

I. SUMMARY

H.R. 18549 modifies in two respects the indirect foreign tax credit presently allowed domestic corporations for foreign income taxes paid by a first-tier or second-tier foreign corporations on earnings which are distributed to the domestic corporation. First, the indirect foreign tax credit is to be available for foreign income taxes paid by a third-tier foreign corporation in which the second-tier foreign corporation has at least a 10-percent ownership interest. Second, the required ownership of a first-tier foreign corporation in the second-tier foreign corporation also is reduced from 50 percent to 10 percent. A credit is not to be available in either of these situations, however, unless the domestic corporation has at least a 5 percent indirect ownership interest in the second- and third-tier foreign corporations.

The Treasury Department has indicated that it does not oppose the enactment of this bill.

II. REASONS FOR THE BILL

Under present law, U.S. taxpayers are allowed a credit against the tax on their foreign income for foreign income taxes paid by them with respect to that income. In addition, a domestic corporation is

allowed a foreign tax credit against its U.S. tax for foreign taxes paid on income earned by a foreign corporation which in turn is paid as a dividend to the domestic corporation. This type of credit is referred to here as an indirect credit. In order to claim an indirect credit on dividends received, a domestic corporation must own at least 10 percent of a foreign corporation. An indirect foreign tax credit is also allowed for foreign income taxes paid by a second-tier foreign corporation which is at least 50 percent owned by the first-tier foreign corporation in those cases where its earnings are distributed through the first-tier corporation to the domestic corporation.

In the past it has not been clear why the credit has not been available in the case of third-tier corporations except possibly because of the manner in which the provisions developed. In 1918 when the foreign tax credit was first adopted, a domestic corporation was permitted the indirect credit for taxes paid by first-tier foreign subsidiaries. In 1942 the indirect credit was first permitted for second-tier foreign corporations but at that time the second-tier foreign subsidiary had to be wholly owned by the first-tier foreign corporation. In 1951 this 100 percent requirement for ownership of the second-tier corporation was reduced to 50 percent. At that time it was stated "on administrative grounds there is a basis for requiring majority ownership but not complete ownership."

It has become increasingly common for U.S. taxpayers to engage in joint ventures at the second-tier level in foreign countries where there is not a 50-percent ownership between the first- and second-tier levels. In addition, foreign law often requires a substantial degree of local ownership so that it may be difficult for a first-tier foreign subsidiary to have a 50-percent ownership in a second-tier foreign subsidiary. Moreover, it has become increasingly common (and at times necessary) for U.S. taxpayers to engage in business in foreign countries through foreign subsidiaries at the third-tier level. The committee agrees with the House that the principle of allowing an indirect foreign tax credit in these situations is the same as in the case of the indirect credit allowed under present law. The extension of the indirect credit to these situations also would conform the tax law with current business practices. Moreover, the committee does not believe that allowing the credit in these cases would present significant administrative difficulties for the Treasury Department in auditing claimed foreign tax credits for two reasons: First, extensive information reporting requirements are presently imposed on U.S. taxpayers with respect to foreign corporations in which they have an ownership interest. Second, under present law, a taxpayer is not allowed a foreign tax credit unless the taxpayer has established to the satisfaction of the Treasury Department the amount of the tax for which a credit is claimed and all other information which is necessary to verify and compute the foreign tax credit.

The Treasury Department indicated that it believes there are a number of other problems in our present tax laws as they relate to the taxation of foreign income. In this regard it should be made clear that by taking action on this bill at this time the committee does not intend to foreclose the future consideration of other problems involving U.S. taxation of foreign income which may be presented to it.

III. EXPLANATION OF BILL

For the reasons discussed above, the bill extends the indirect foreign tax credit to foreign income taxes paid by third-tier foreign corporations in which the second-tier foreign corporation has at least a 10 percent ownership interest (determined by voting power).

The bill also reduces the required ownership for allowance of the indirect foreign tax credit between first- and second-tier foreign corporations from 50 percent to 10 percent. The indirect credit is to be allowed for foreign income taxes paid by a second- or third-tier foreign corporation, however, only where the domestic corporate shareholder has an indirect ownership interest (determined by voting power) of at least 5 percent in the second- and third-tier foreign corporation. This continues what is, in effect, the 5 percent indirect ownership requirement under present law with respect to second-tier foreign corporations (under present law this indirect ownership requirement arises as a result of the requirement that the domestic corporation own at least 10 percent of the first-tier foreign corporation and that it own at least 50 percent of the second-tier foreign corporation).

The amendments made by this bill are to apply to taxable years of domestic corporations ending after the date of enactment of the bill, but only with respect to dividends which are paid by one corporation in a chain to another corporation in the chain after the date of enactment. Thus, a domestic corporation is to be allowed an indirect foreign tax credit for foreign income taxes paid by a third-tier foreign corporation which meets the ownership tests provided by the bill only to the extent the taxes were paid with respect to earnings which are distributed as a dividend to the second-tier foreign corporation by the third-tier foreign corporation after the date of enactment of the bill. Similarly, foreign income taxes paid by a second-tier foreign corporation, which meets the ownership tests provided by the bill but which is less than 50 percent owned by the first-tier foreign corporation, are to be eligible for a foreign tax credit (when subsequently distributed to the domestic corporation) only when the distribution occurs after the date of enactment of the bill.

IV. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in *italic*, existing law in which no change is proposed is shown in roman) :

SECTION 902 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 902. CREDIT FOR CORPORATE STOCKHOLDER IN FOREIGN CORPORATION.

* * * * *

[(b) FOREIGN SUBSIDIARY OF FOREIGN CORPORATION.—If such foreign corporation owns 50 percent or more of the voting stock of another foreign corporation from which it receives dividends in any taxable

year, it shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid by such other foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of the corporation from which such dividends were paid which—

[(1) for purposes of applying subsection (a) (1), the amount of such dividends bears to the amount of the accumulated profits (as defined in subsection (c) (1) (A)) of such other foreign corporation from which such dividends were paid in excess of such income, war profits, and excess profits taxes, or

[(2) for purposes of applying subsection (a) (2), the amount of such dividends bears to the amount of the accumulated profits (as defined in subsection (c) (1) (B)) of such other foreign corporation from which such dividends were paid.]

(b) *FOREIGN SUBSIDIARY OF FIRST AND SECOND FOREIGN CORPORATION.*—

(1) *If the foreign corporation described in subsection (a) (hereinafter in this subsection referred to as the "first foreign corporation") owns 10 percent or more of the voting stock of a second foreign corporation from which it receives dividends in any taxable year, it 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 second foreign corporation to any foreign country or to any possession of the United States on or with respect to the accumulated profits of the corporation from which such dividends were paid which—*

(A) for purposes of applying subsection (a) (1), the amount of such dividends bears to the amount of the accumulated profits (as defined in subsection (c) (1) (A)) of such second foreign corporation from which such dividends were paid in excess of such income, war profits, and excess profits, taxes or

(B) for purposes of applying subsection (a) (2), the amount of such dividends bears to the amount of the accumulated profits (as defined in subsection (c) (1) (B)) of such second foreign corporation from which such dividends were paid.

(2) *If such first foreign corporation owns 10 percent or more of the voting stock of a second foreign corporation which, in turn, owns 10 percent or more of the voting stock of a third foreign corporation from which the second foreign corporation receives dividends in any taxable year, the second foreign corporation shall be deemed to have paid the same proportion of any income, war profits, or excess profits paid by such third foreign corporation to any foreign country or to any possession of the United States on or with respect to the accumulated profits of the corporation from which such dividends were paid which—*

(A) for purposes of applying subsection (a) (1), the amount of such dividends bears to the amount of the accumulated profits (as defined in subsection (c) (1) (A)) of such third foreign corporation from which such dividends were paid in excess of such income, war profits, and excess profits taxes, or

(B) for purposes of applying subsection (a)(2), the amount of such dividends bears to the amount of the accumulated profits (as defined in subsection (c)(1)(B)) of such third foreign corporation from which such dividends were paid.

(3) For purposes of this subpart, subsection (b)(1) shall apply unless the percentage of voting stock owned by the domestic corporation in the first foreign corporation and the percentage of voting stock owned by the first foreign corporation in the second foreign corporation when multiplied together equal at least 5 percent, and for purposes of this subpart, subsection (b)(2) shall not apply unless the percentage arrived at for purposes of applying subsection (b)(1) when multiplied by the percentage of voting stock owned by the second foreign corporation in the third foreign corporation is equal to at least 5 percent.

(c) APPLICABLE RULES.—

(1) ACCUMULATED PROFITS DEFINED.—For purposes of this section, the term “accumulated profits” means with respect to any foreign corporation—

(A) for purposes of [subsections (a)(1) and (b)(1),] subsections (a)(1), (b)(1)(A), and (b)(2)(A), the amount of its gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income by any foreign country or any possession of the United States; and

(B) for purposes of [subsections (a)(2) and (b)(2),] subsections (a)(2), (b)(1)(B), and (b)(2)(B), the amount of its gains, profits, or income in excess of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income.

The Secretary or his delegate shall have full power to determine from the accumulated profits of what year or years such dividends were paid, treating dividends paid in the first 60 days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings.

(2) ACCOUNTING PERIODS.—In the case of a foreign corporation, the income, war profits, and excess profits taxes of which are determined on the basis of an accounting period of less than 1 year, the word “year” as used in this subsection shall be construed to mean such accounting period.

