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## Taxation of International Activity: Over Relief from Double Taxation under the U.S. Tax System

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# Taxation of International Activity: Over Relief from Double Taxation Under the U.S. Tax System

by  
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I.

INTRODUCTION

Two major income tax issues raised by transnational transactions are (a) which country (or countries) has jurisdiction to impose a tax liability on a taxpayer and (b) how to prevent, or at least to reduce, international double taxation in situations where more than one country has jurisdiction to tax.

In general, a country will not attempt to assert jurisdiction to tax where it has no connection with either the income to be taxed or the taxpayer. Two types of connections are accepted as being sufficient to create the jurisdiction to tax: territorial and personal.<sup>1</sup> The territorial connection is the most commonly asserted basis of jurisdiction and gives the country in which the income is produced (the "host country") the jurisdiction to tax that income regardless of the taxpayer's country of citizenship or residence.<sup>2</sup> The personal connection is the second connection that may create jurisdiction to tax and provides that the country of which the taxpayer is a citizen or a resident (the "home country") may exercise jurisdiction to tax all of that taxpayer's income, regardless of where the income is produced.<sup>3</sup>

International double taxation occurs when more than one country has and exercises jurisdiction to impose an income tax on the same income. A pure double taxation exists when precisely the same income is subject to more than one tax system. For example, suppose a taxpayer who is a U.S. citizen produces income in a foreign country. The gross income is 1,000 and the only deduction allowed under each tax system equals 100. Therefore, the taxpayer pays a tax to both the United States and to the foreign country on the same 900. The total taxes paid may become an extremely heavy burden and, in an extreme case, the taxes due may even equal or exceed the income earned. It is clear that this taxpayer should be accorded some relief from this

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1. Commentators have suggested that the concept of jurisdiction in the context of transnational transactions is not meaningful and that the only "connection" required is whatever is needed to enable the taxing country to collect the tax. J. ISENBERGH, *INTERNATIONAL TAXATION* 13 (1990). See generally Norr, *Jurisdiction to Tax and International Income*, 17 *TAX L. REV.* 431 (1962). For a detailed analysis and examples of the imposition of taxes where there is no personal or territorial connection, see R. MARTHA, *THE JURISDICTION TO TAX IN INTERNATIONAL LAW* 156-79 (1989).

2. The host country is justified in taxing the income sourced within it because that country has made production of the income possible and it is reasonable for the recipient of that income to help pay the source country's expenses. See D. TILLINGHAST, *TAX ASPECTS OF INTERNATIONAL TRANSACTIONS* 5-6 (1978).

3. The home country is justified in taxing a resident's or citizen's income, even though it may not make the production of the income possible (if the income is sourced outside of the home country), because that country offers benefits and protection to that person. If the taxpayer is a resident of the home country, the home country will normally make the investment or consumption of income possible and will provide benefits and services to the taxpayer. If the taxpayer is a citizen but not a resident of the home country, that country offers protection to the taxpayer. He has the continuing right to return to that country and to seek the protection of its government. See *Cook v. Tait*, 265 U.S. 47, 55-56 (1924).

double taxation in order to avoid substantial deterrence of foreign trade and fundamental unfairness.<sup>4</sup>

International double taxation results most often when one country has jurisdiction because of a personal connection, while a second country has jurisdiction because of a territorial connection.<sup>5</sup> Double taxation also may occur when countries employ different rules concerning what constitutes a territorial or personal connection. Thus, using different standards, each of two countries may determine that it has a territorial connection to the same income, thereby subjecting the taxpayer to double taxation.<sup>6</sup> Finally, double taxation may occur when a taxpayer maintains a personal connection with more than one country, such as where a taxpayer is a citizen of one country and a resident of another.<sup>7</sup>

An external solution to the problem of double taxation can be achieved through agreements among nations. All nations may adopt a tax system containing a built-in mechanism for the avoidance of double taxation, such as taxing only income sourced within a country,<sup>8</sup> or two or more countries may agree to a tax treaty that divides the tax jurisdiction.<sup>9</sup>

When an external solution is not possible, an internal solution to the problem of double taxation is necessary. Thus, a country hoping to alleviate any double taxation of its domestic taxpayers may unilaterally enact relief provisions. In formulating such relief, the domestic country has two options. One is to consider the taxes imposed by foreign countries and enact different relief provisions depending upon which particular foreign country is involved. The other option is to enact relief provisions that apply regardless of which foreign country is involved. In order to formulate such relief, the country assumes that the tax systems of all foreign countries are mirror images of its own; that is, that all foreign countries tax both their domestic and foreign taxpayers in the same manner as the domestic country taxes its domestic and

4. The first U.S. foreign tax credit was enacted in 1918 after the First World War brought a sharp increase in income tax rates. Prior to 1918, tax rates were low enough that a deduction for foreign income taxes paid was viewed as sufficient relief from the burden of double taxation. J. ISENBERGH, *supra* note 1, at 472-73.

5. See generally B. SPITZ, *INTERNATIONAL TAX PLANNING* 13-26 (2d ed. 1983); M. PIRES, *INTERNATIONAL JURIDICAL DOUBLE TAXATION OF INCOME* 65-72 (1990).

6. International law does not define basic jurisdictional terms such as "residence" or "territorial connection." Therefore, countries are free to define those terms and may broaden their jurisdiction to tax without violating international law. See R. MARTHA, *supra* note 1, at 151-52.

7. This may occur when a U.S. citizen resides outside of the United States since the United States taxes all of its citizens on their worldwide income. See *Cook v. Tait*, 265 U.S. at 53-56.

8. An example of this approach can be found in the value-added tax imposed by many countries (but not the United States) wherein each country imposes the value-added tax only when it is the destination country. Since only the destination country imposes the tax, international double taxation is eliminated. For a discussion of the destination principle, see *TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH, THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT* 3, 11-12 (1984).

9. For example, see Draft U.S. Model Income Tax Treaty, June 16, 1981, *reprinted in* 5 *INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS (MB)* § 93 (1987).

foreign taxpayers. This assumption is made merely to enable the domestic country to unilaterally formulate logical solutions to the problem of double taxation. No reciprocal treatment by the foreign country is needed.

This article deals with internal solutions to the problem of double taxation.<sup>10</sup> It analyzes the U.S. provisions granting relief from international double taxation, points out where the relief offered is overly generous, and offers suggestions for improvements.

## II. FIRST BITE TO THE HOST COUNTRY

The analysis of double taxation must begin with the question of which country should have priority with respect to taxation. If double taxation is to be avoided, one country must recognize the other country's priority to tax (commonly referred to as the right to the first tax bite) and therefore forego part or all of the tax to which it would be ordinarily entitled. The established answer to the question of which country gets the first bite is that the country with a territorial connection (the "host country") has priority over the country with a personal connection (the "home country").<sup>11</sup> Therefore, the host country should be entitled to its full tax revenue despite the fact that the home country also has jurisdiction to tax. Any relief from double taxation should come from the home country.

The rule that the host country should be accorded the first bite is long standing. One explanation for it can be found in the "Report on Double Taxation" submitted to the League of Nations in 1923:

A survey of the whole field of recent taxation shows how completely the Governments are dominated by the desire to tax the foreigner. It seems to be clearly instinctive in laying down general principles to treat "origin" as of *first* importance, and residence as of "secondary" importance; *i.e.*, if the origin and source of income are within a country's borders, it is assumed that that country has the *prime* right of taxation on that income, although it goes to some person abroad. There are a few modifications, but this is the *main* instinctive principle. From this flows the consequence that, when double taxation is involved, Governments would be prepared to give up residence rather than origin as establishing the prime right.<sup>12</sup>

An additional rationale for this rule can be derived from the fact that although modern governments tend to tax persons and not income, income remains the *sine qua non* for the income tax. A resident or a citizen without income cannot produce tax revenue; only the creation of the income creates

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10. Thus, it deals only with those situations where there is neither a mechanism built into the tax system that eliminates the possibility of double taxation nor an agreement between the domestic and foreign countries that divides tax jurisdiction.

11. J. ADAMS & J. WHALLEY, *THE INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES IN DEVELOPED COUNTRIES* 53 (1977).

12. League of Nations Doc. 341.014(00) IIA (1923). See generally E. SELIGMAN, *ESSAYS IN TAXATION* 100-25 (8th ed. 1913).

revenue. This is true even though the income is defined by saving and consumption; since such saving and consumption can take place only if income is produced, the location of these components is enough to establish jurisdiction to tax. Thus, if we must rank the importance of the location where income is produced (the country of source), where it is saved or consumed (the country of residence), and where the taxpayer enjoys public goods and services (the country of residence or perhaps citizenship), it seems quite natural to assign the highest priority to the country of origin of the income.<sup>13</sup>

Accepting the principle that the host country is entitled to the first bite provides one method of evaluating the effectiveness of the U.S. provisions granting relief from double taxation. For provisions to be effective, they should grant relief to the taxpayer only when the United States is the home country (taxing because of a personal connection) and the foreign country is the host country (taxing because of a territorial connection).

### III.

#### MECHANISMS FOR RELIEF FROM DOUBLE TAXATION

There are three primary mechanisms available for formulating an internal solution to double taxation: (a) a tax exemption for foreign source income; (b) a foreign tax credit; and (c) a deduction for foreign taxes paid. Each of these mechanisms advances tax neutrality.<sup>14</sup> However, in the international context, there are several different types of neutrality and each of these mechanisms embraces a distinct type of neutrality.

##### A. Tax Exemption

If a country exempts from taxation all income that is not produced within that country, international double taxation is largely eliminated.<sup>15</sup> Since such a country taxes income only when there is a territorial connection, it taxes only when it is the host country and thus entitled to the first tax bite. Therefore, in most instances, it needs no further mechanism to eliminate or mitigate double taxation. If any income is subject to the tax jurisdiction of a

13. The principle of first bite to the host country is generally accepted by both developed and developing countries, although they apply the principle in different ways. Most developed countries tax their residents and domestic corporations on their worldwide income and make an allowance for the foreign income tax paid on foreign source income. Shoup, *Effects of United States Tax Laws on the Tax Systems of Developing Countries*, in UNITED STATES TAXATION AND DEVELOPING COUNTRIES 194-95 (R. Hellawell ed. 1980). Developing countries generally tax only income sourced within their borders. *Id.* See also D. TILLINGHAST, *supra* note 2, at 8.

14. Tax neutrality is frequently a goal of tax policymakers. In general, it calls for a tax system that has as little impact as possible upon the allocation of resources within an economy. Thus, when tax neutrality is obtained, the government is able to raise required revenue with a minimum distortion upon the economic decisions of taxpayers. INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, INTERNATIONAL TAX GLOSSARY 188 (1988); Kay, *Faith in Market Forces*, in TAX POLICY IN THE TWENTY-FIRST CENTURY 210 (H. Stein ed. 1988).

15. Despite an exemption from tax of all foreign source income, double taxation could still occur if the countries involved employed different standards to determine what constitutes a territorial connection.

second country, that country would generally have jurisdiction because of a personal connection. Thus, any relief from double taxation should emanate from the second country.

The goal of the exemption from tax of foreign source income is capital-import neutrality. This is achieved when all firms operating in a particular industry and country are subject to identical tax treatment, regardless of the nationality of the firms. For example, pure capital-import neutrality would be achieved if all firms, both domestic and foreign, operating within Country A were taxed in the same manner by Country A and if the foreign firms were not taxed by their home countries on profits derived from within Country A. All firms operating within Country A would be able to compete on an equal tax basis regardless of national origin, which would promote the efficient use of the host country's resources.<sup>16</sup>

Although granting a tax exemption for all foreign source income completely eliminates double taxation in most cases and has the advantage of being fairly simple to implement, the home country is foregoing more revenue than is necessary to merely eliminate double taxation. For example, Country A, which taxes at a rate of 40%, exempts from tax all income its residents earn outside the country.<sup>17</sup> A citizen and resident of Country A earns interest income in Country B that is taxed by that country at a rate of 10%. Country A's exemption of that interest income from tax clearly eliminates any double taxation since the income is subject only to the tax of Country B. The taxpayer benefits since he has earned income that would have been taxed at 40% if earned in his home country, but has paid a tax of only 10% to the host country.

However, Country A suffers disadvantages from this exemption. If its only goal is to avoid international double taxation, it has lost revenue unnecessarily since it could impose a tax of 30% on the income without subjecting the taxpayer to double taxation. In addition, Country A has created both horizontal and vertical inequity among its own taxpayers. The taxpayer who invests abroad will pay less tax on the same amount of income than other taxpayers who invest in Country A. He will also pay the same tax, on more income, as other taxpayers who invest in Country A. Finally, Country A's exemption of foreign source income gives foreign countries with low tax rates an advantage in competition for investment from the residents of Country A.<sup>18</sup>

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16. Hufbauer, *A Guide to Law and Policy*, in UNITED STATES TAXATION OF AMERICAN BUSINESS ABROAD 1-3 (1975).

17. In all the examples in this article, we have used a flat rate of tax, ignoring the possibility of a progressive tax system. Under a progressive system, a decision must be made as to what rate to use in calculating the limitations. Possibilities include using the lowest rate, the highest rate, or some average of the two. Additionally, if certain types of income are subject to special tax rates, the calculation of the limitation should consider such rates. The United States uses the taxpayer's average effective rate. See *infra* note 49.

18. Roin, *The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 VAND. L. REV. 919, 924-25 (1989).

### *B. Foreign Tax Credit*

The basic notion of the foreign tax credit is simple. Country A imposes a tax on its residents and citizens on their worldwide income and then allows a dollar for dollar credit against this tax for foreign income taxes paid.

The goal of the foreign tax credit is capital-export neutrality. Pure capital-export neutrality seeks to have tax considerations play no part in a taxpayer's decision whether to invest capital at home or abroad. This is achieved when a firm pays the same total tax on its foreign profits as it pays on its domestic profits.<sup>19</sup> For example, if a Country A firm has income from Country A that is taxed at 40% and foreign income that is taxed at 30%, Country A will allow a credit equal to the foreign taxes paid and collect tax only at the rate of 10% on the foreign income (the difference between the domestic tax rate of 40% and the foreign tax rate of 30%). Capital-export neutrality allows firms to invest in different countries on the basis of pre-tax returns. If pure capital-export neutrality were the goal, all foreign taxes paid would be allowed as a credit, regardless of whether the foreign tax rates were lower or higher than the domestic rate. For example, consider a Country A firm with Country A source income that is taxed at 30% and foreign source income taxed at 40%. If Country A's goal is pure capital-export neutrality, it will allow a credit of the entire foreign tax paid even though that tax exceeds the domestic tax paid on the foreign source income.

A variation of the pure capital-export neutrality is achieved when domestic firms pay at least the domestic tax rate on all profits, both domestic and foreign, but firms pay more than the domestic rate on foreign profits earned in countries with a higher tax rate than the domestic tax rate. This limited capital-export neutrality is achieved by limiting the allowable foreign tax credit to the lesser of the domestic tax paid on the foreign source income (the "domestic tax limitation") or the foreign tax paid (the "foreign tax limitation"). Thus, if a Country A firm has income from Country A that is taxed at 30% and foreign income taxed at 40%, Country A will allow a foreign tax credit equal only to the domestic tax. Subjecting the foreign tax credit to the domestic and foreign tax limitations insures that the credit is available only when the taxpayer is paying more tax because of double taxation and not when the extra tax is merely the result of different tax rates imposed by the countries involved.

The foreign tax limitation is needed when the foreign tax rate is lower than the domestic one. For example, if there is a domestic tax rate of 40% and a foreign rate of 25%, the double taxation is 25%. The 15% excess of the domestic tax over the foreign tax reflects the simple fact that the domestic tax burden is higher than the foreign one. It should not give rise, therefore, to any tax relief. Thus, the allowable credit cannot exceed the foreign tax paid (or accrued) on the income that is also subject to domestic tax.

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19. *Id.* at 921.

The domestic tax limitation is needed when the foreign tax rate is higher than the domestic rate. In that case, if the entire foreign tax is credited against the domestic one, the domestic country will actually subsidize the foreign country. For example, if there is a domestic tax rate of 40% and a foreign rate of 60%, only two-thirds of the foreign tax (40% out of 60%) represents double taxation. The remaining one-third (20%) results solely from the fact that the taxpayer has decided to operate in a country that has a higher tax rate. There is no need or justification for the domestic country to grant tax relief for that portion of the foreign tax. The double tax is eliminated when the creditable foreign tax is limited to the amount of tax paid to the domestic country on the income taxed by both the domestic country and the foreign country.

The two tax limitations can be determined in several ways, with dramatically different results. All the foreign income and foreign taxes may be considered together (a worldwide limitation) or some division can be made. This division can be made on a per country basis or according to the type of income involved.<sup>20</sup>

Applying the tax limitations on a worldwide basis creates economic distortion and may lead to a situation where the home country indirectly gives a unilateral tax sparing to a country with a higher tax rate.<sup>21</sup> An example will illustrate the problem. Country A taxes its citizens on their worldwide income at a flat rate of 30% and allows a tax credit for foreign taxes paid on foreign source income, subject to the domestic and foreign tax limitations discussed above. Consider a citizen of Country A that has a total income of 100,000, 30,000 of which is produced in Country B, which taxes that income at a 50% rate. His tentative tax in Country A is 30,000, but he is allowed a foreign tax credit of 9,000. Therefore, his final Country A tax is 21,000.<sup>22</sup> The taxpayer is left with 6,000 in foreign taxes that cannot be credited. As explained above, this is a proper result since this extra 6,000 results from the higher tax rate in Country B and not from double taxation. Country A has

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20. J. ISENBERGH, *supra* note 1, at 477-81.

21. Tax sparing generally refers to tax incentives provided by the foreign source country. In general, the application of a foreign tax credit results in the taxpayer not realizing the tax incentives provided by the foreign country when he has income sourced within that country. A low foreign tax rate (or an exemption from taxation) will not have any effect upon a taxpayer whose home country imposes a tax on all income and provides a credit for foreign taxes paid. For such a taxpayer, the tax incentives granted by the foreign country will simply translate into higher taxes paid to his home country.

Tax sparing provisions are enacted by the home country and allow the taxpayer to feel the effect of the tax incentives by permitting a foreign tax credit, as if the tax incentives were not present. The United States has consistently refused to agree to any tax sparing provisions in tax treaties. European countries, however, generally agree to such provisions in treaties with developing countries. Vogel, *The Search for Compatible Tax Systems*, in *TAX POLICY IN THE TWENTY-FIRST CENTURY* 79-80 (H. Stein ed. 1988).

22. The allowable foreign tax credit is limited to the amount of the domestic tax limitation since that is lower than the amount of foreign taxes paid. The domestic tax limitation is determined by calculating the amount of tax Country A imposes on the foreign source income, in this case 30% of 30,000.

assessed the correct amount of tax on the domestic source income since the final tax paid is 21,000, the domestic source income is 70,000, and the Country A tax rate is 30%. It has assessed no tax on the foreign source income, but this is also proper since Country B taxes at a higher rate and has the right to the first bite on income sourced within that country.

The drawback of the worldwide limitation can be shown by altering the above facts. Assume that the taxpayer still has worldwide income of 100,000 and income from Country B of 30,000, but that he has income of 20,000 from Country C that is not taxed by that country. His total foreign source income is now 50,000 and the domestic tax limitation is increased to 15,000.<sup>23</sup> If the foreign tax limitation is applied on a worldwide basis, the taxpayer is allowed to credit all his foreign tax payments, including the excess of the Country B tax over the domestic rate.

Since the home country's goal is to assess as much tax as possible while mitigating double taxation only as needed, Country A should tax the income produced within Country C at its tax rate of 30%. Therefore, it should assess a tax of 6,000 on the 20,000 of income produced within Country C.<sup>24</sup> Yet, with a worldwide limitation, Country A gives up the right to tax that 20,000.

Country A, the home country, therefore, subsidizes the government of Country B, which can then compete with the home country for investments without its high tax rate being a factor. Country C also benefits. The taxpayer has a strong incentive to invest in that country in order to use his otherwise uncreditable foreign tax; therefore, he may invest in Country C rather than in his home country even though the investment in Country C has a lower pre-tax return.

These economic distortions would generally be eliminated if Country A imposed a per country limitation. In that case, the allowable foreign tax credit would be calculated separately for each country. Let us once again consider a Country A taxpayer with 100,000 worldwide income taxed by Country A at 30%, 30,000 of which is sourced in Country B and taxed at 50%, and 20,000 of which is sourced in Country C and not taxed by that country. The foreign tax credit allowable for the Country B income is determined by comparing the foreign tax paid on that income (15,000) with the domestic tax paid (9,000). Since the foreign tax exceeds the domestic tax paid on that foreign income, the allowable foreign tax credit is 9,000 (the domestic tax limitation). Since no foreign tax was paid on the income sourced in Country C, the taxpayer is entitled to no foreign tax credit with regard to that income. Thus, the taxpayer is entitled to a total foreign tax credit of 9,000 and must pay 6,000 in tax to Country B for which he receives no credit. This

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23. This is determined by multiplying the foreign source income of 50,000 by the domestic tax rate of 30%.

24. There is no need for Country A to forgive any of that tax in order to prevent double taxation since the 20,000 of Country C source income has been subject only to taxation by Country A.

is the proper result since the tax of 6,000 is a result of Country B's higher tax rate, not the result of double taxation. Country A has collected the correct tax since it has collected nothing on the Country B income but has collected its entire 30% tax on the Country C income.

However, the per country limitation eliminates economic distortion only if the foreign country taxes all types of income at the same rate. Suppose again a citizen of Country A, which taxes worldwide income at 30% and allows a foreign tax credit, but now uses a per country rather than a worldwide limitation. If the taxpayer has 30,000 of income sourced within Country B that is taxed at a 50% rate, his foreign tax credit will be limited to 9,000 and he will have 6,000 of foreign tax that cannot be credited against his Country A taxes. Let us now assume that the taxpayer's 30,000 of income is business income and that Country B exempts interest income from taxation. If the taxpayer arranges to earn 20,000 interest income within Country B, we are faced with the same problem we had above. In both cases, the taxpayer has arranged to earn money in a foreign country that exempts that income from taxation. The taxpayer now has 50,000 of income from Country B that is taxed by Country A at 30%, thereby increasing the domestic tax limitation to 15,000. Since the domestic tax limitation is equal to the foreign income tax paid to Country B, the taxpayer will be entitled to a foreign tax credit of the entire 15,000 paid. This result is theoretically incorrect. Country A should be entitled to tax the interest income since that is not subject to tax in Country B, but when the per country limitation is applied, it collects no tax on that interest income.

In order to avoid this problem, the limitation can be applied on an even narrower basis; that is, on a specific item of income basis (a "per transaction" limitation). Each of the taxpayer's transactions would be separated, and the limitations would be applied separately on the income produced by each transaction. Thus, in the example above, the business income would be separated from the interest income and the allowable tax credit determined for each item. The tax credit would be limited to 9,000 for the business income and zero for the interest income, for a total allowable credit of 9,000.

On a theoretical level, the optimal solution is almost obvious: the foreign tax limitation should be on a per specific item basis, calculated separately for each transaction that is subject to tax.<sup>25</sup> This was recognized by President

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25. Obviously, as the limitation is applied more narrowly, from the worldwide basis to the per transaction basis, the foreign tax credit becomes ever more complicated and the country must deal with the disadvantages that accompany such complications. For example, on a worldwide basis, a loss in one basket can offset income in another. Thus, no credit will be granted. However, on a per transaction basis, each basket is considered separately, resulting in a credit for the basket with income, regardless of a loss in another basket. Therefore, the more narrowly-defined limitations may decrease the revenue of the country granting the credit when there is income in one basket (whether that be a country in the case of the per country limitation or a specific item of income in the case of the per transaction limitation) and a loss in another. For example, if in the above example, the citizen of Country A, which still taxes worldwide income at a flat 30% rate, has income of 20,000 in Country B, which taxes at a 30% rate, and a loss of 20,000 in

Reagan, who requested that Congress impose a per country, per transaction limitation, stating:

The purpose of the foreign tax credit is to relieve international double taxation of foreign income. Double taxation would be fully relieved if income derived from each separate transaction were treated separately for credit purposes and the U.S. tax were offset by a credit for the foreign tax paid with respect to that income. Any departure from a transactional approach to crediting foreign tax will permit some averaging of foreign taxes and will therefore involve some surrender of the residual tax imposed by the United States on foreign income that is taxed by foreign countries at rates below the U.S. rate.<sup>26</sup>

### C. Deduction

The final mechanism to be discussed is a deduction for foreign taxes paid. The goal of the deduction for foreign taxes paid is national neutrality. This is achieved when the domestic government receives the same taxes regardless of where the profits are earned.<sup>27</sup>

The deduction of foreign taxes merely reduces the burden of double taxation rather than entirely eliminating it. To illustrate, assume a citizen of Country A who has income of 30,000 sourced within Country B. Both countries tax at the rate of 30%; Country A taxes because of a personal connection while Country B taxes because of a territorial connection. Clearly, the 30,000 is subject to a pure double taxation. If Country A offers no relief, the taxpayer will pay a total tax of 18,000 to the two countries.<sup>28</sup> Thus, the taxpayer will pay a combined tax on the income at a rate of 60%. If Country A were to choose to mitigate double taxation by allowing a deduction of foreign taxes paid, the taxable income in that country would be reduced by the 9,000 paid to Country B, for a total taxable income of 21,000. The tax to Country A would be reduced to 6,300 (30% of 21,000) and the total tax paid to the two countries would be reduced to 15,300. Therefore, the combined rate at which the income is taxed has been reduced from 60% to 51%. This can be contrasted with the situation where the foreign tax credit is used, in which case the taxpayer would pay no tax to Country A (since the entire 9,000 of foreign tax paid would be credited against the 9,000 tentative tax due to Country A) and double taxation would be eliminated entirely.

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Country C, he would prefer that Country A's foreign tax credit be limited on a per country basis. In that case, he would be allowed a foreign tax credit of 6,000 for the taxes paid to Country B. The domestic and foreign tax limitation, on a per country basis, would both equal 6,000. However, if the foreign tax credit were calculated on a worldwide basis, his foreign source income would be zero, thereby reducing the domestic tax limitation to zero.

26. R. HELLAWELL & R. PUGH, *TAXATION OF TRANSNATIONAL TRANSACTIONS* 141 (1987) (quoting *The President's Tax Proposals to the Congress* (May 1985)).

27. *Kay*, *supra* note 14, at 210.

28. Each country will tax the 30,000 at the rate of 30%, for a total in each country of 9,000.

While the deduction of foreign taxes has been recognized as proper in order to arrive at the true income tax base,<sup>29</sup> it has generally not been recognized in the United States as a mechanism for relief from double taxation.<sup>30</sup> However, it should be recognized as such a mechanism and included in an analysis of the United States' system for relief from double taxation since it serves to reduce the burden of double taxation.

#### IV. U.S. RELIEF PROVISIONS

The United States asserts its jurisdiction to tax when there is either a personal or a territorial connection. The personal connection under the U.S. tax system is either residence or citizenship for individuals and domestic incorporation for corporations.<sup>31</sup> When a personal connection is present, the United States taxes on a worldwide basis.<sup>32</sup>

With certain exceptions, if no personal connection is present (the taxpayer is either a non-resident alien or a foreign corporation), the United States only taxes that portion of the taxpayer's income that has a territorial connection with the United States.<sup>33</sup> Under the U.S. tax system, the existence of such a territorial connection depends upon the location of the source of the income. If the income is sourced within the United States, the United States has jurisdiction to tax that income; if the income is sourced without, the United States generally does not tax that income.<sup>34</sup>

The U.S. tax system provides extensive relief from double taxation and does so by employing all three of the mechanisms discussed above. Each of these will be reviewed in order to determine how effectively each alleviates double taxation and how closely each adheres to the notion that the first bite should go to the host country.

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29. I.R.C. § 162(a)(3) (1988).

30. See Roin, *supra* note 18, at 923-24.

31. I.R.C. §§ 11(d), 881-882 (1988).

32. See *id.* § 61(a) (providing that "gross income means all income from whatever source derived"). No provision in the Internal Revenue Code allows resident individuals or domestic corporations to exclude or deduct all foreign source income when calculating taxable income. See B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES & GIFTS* ¶ 65.1 (1981); see also Cook v. Tait, 265 U.S. 47, 53-56 (1924).

33. I.R.C. §§ 871(a)-(b), 881-882 (1988).

34. If the foreign taxpayer is not engaged in a trade or business in the United States, only income sourced within the United States is taxed by the United States. *Id.* §§ 871(a), 881. However, if the taxpayer is engaged in a U.S. trade or business, there are limited circumstances in which the United States taxes foreign source income. *Id.* § 864(c)(4).

### A. Tax Exemption

Section 911 provides a limited tax exemption for certain income earned outside of the United States.<sup>35</sup> The exemption is available only to U.S. citizens or residents who live abroad and applies only to "foreign earned income," which includes only foreign source income.<sup>36</sup> In other words, the exemption applies only when the taxpayer is taxed by the United States because of a personal connection (i.e., either citizenship or residence) and by the foreign country because of a territorial connection (i.e., the source of the income). Therefore, in every case in which section 911 applies, the foreign country has the right to the first tax bite and the United States is the proper country to offer relief from double taxation.

Section 911 is an elective provision. If the U.S. citizen will benefit by having more income taxed by the United States, he need not make the election.<sup>37</sup> If the taxpayer claims the benefit of the tax exemption, he gives up the right to either a foreign tax credit or a deduction for any foreign taxes paid with regard to the exempted income.<sup>38</sup>

While it may initially appear that a taxpayer would always prefer to have income exempted from taxation, the taxpayer may prefer to have his foreign income included in his U.S. taxable income whenever the foreign country taxes at a rate higher than the United States. For example, consider a U.S. tax rate of 30% and a U.S. taxpayer with earned income of 100 in Country A, which taxes at a rate of 50%. He meets the requirements of section 911 and therefore can choose to exclude this income from U.S. taxation. He has additional income of 100 from Country B, which taxes at a rate of 10%. As to this income, the taxpayer does not meet the requirements of section 911; thus, this income will be included in his U.S. taxable income. If the taxpayer chooses to have section 911 apply, his U.S. taxable income will be 100, his U.S. tentative tax will be 30, and he will be allowed a foreign tax credit of 10

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35. *Id.* § 911. Section 911 provides that a qualified individual can choose to exclude from taxable income an amount equal to his "foreign earned income," as defined in section 911(b), and his "housing cost amount," as defined in section 911(c). The amount of foreign earned income that can be excluded is limited to \$70,000 per year. *Id.* § 911(b)(2). A qualified individual is defined as one whose tax home is in the foreign country and who is either a citizen of the United States who has been a resident of a foreign country for a period that includes a full taxable year, or a citizen or resident of the United States who has been present in a foreign country during 330 full days during a period of 12 consecutive months. *Id.* § 911(d). The term "tax home" refers to the location of the taxpayer's regular or principal place of business or, if he has no place of business, his regular place of abode. Treas. Reg. § 1.911-2(b) (1985).

36. "Foreign earned income" is income received from sources within a foreign country attributable to personal services provided by the taxpayer. *Id.* § 911(b)(1), (d)(2). Although the definition of "housing cost amount" makes no reference to the source of the income, that amount is limited to the excess of the taxpayer's total foreign source income over the amount of such income otherwise excluded under section 911. *Id.* § 911(c)(3)(B). Any housing cost amount not excluded because of this limitation can be carried over to the next taxable year, subject again to the limitation. *Id.* § 911(c)(3)(C).

37. The election is made separately for the foreign earned income and the housing cost amount. *Id.* § 911(a).

38. *Id.* § 911(d)(6).

(the amount of the tax paid to Country B), resulting in a final U.S. tax payment of 20.<sup>39</sup>

The taxpayer is in a better situation if he chooses not to have section 911 apply. In that case, his U.S. taxable income is increased to 200, with a corresponding increase in his tentative U.S. tax to 60. However, the domestic tax limitation is also increased to 60.<sup>40</sup> He will be allowed a foreign tax credit in that amount and will pay no taxes to the United States. Therefore, by not making the section 911 election, the taxpayer has reduced his U.S. tax by 20. The taxpayer may elect not to have section 911 apply even if his only foreign source income in the current year is the potentially exempted income, since by doing so, a foreign tax credit is created (at no cost to the taxpayer) that may be carried forward and back.<sup>41</sup> On the other hand, if the foreign country taxes at a rate lower than the U.S. rate, the taxpayer would generally want to make the section 911 election.<sup>42</sup>

The section 911 exemption is effective in eliminating double taxation. In addition, it adheres to the principle of the first bite to the host country since it is limited to those situations in which the United States is the home country. However, due to the nature of an exemption from tax that applies regardless of whether and to what extent the foreign country imposes a tax, the relief provided is ineffective because it is not limited to the minimum amount necessary to avoid double taxation.

### B. Foreign Tax Credit

The foreign tax credit is the primary mechanism used by the United States to mitigate or eliminate double taxation.<sup>43</sup> U.S. citizens, resident aliens, and domestic corporations ("domestic taxpayers") are generally entitled to credit foreign income taxes paid or accrued against their U.S. tentative

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39. Although he will pay a tax of 50 to Country A, no credit is allowed for this payment since that is foreign tax paid with regard to income that is exempt from U.S. taxation by section 911.

40. This is determined by multiplying his foreign source income (200) by his marginal tax rate (30%).

41. I.R.C. § 904(c) (1988).

42. In such situations, the United States loses more revenue than is necessary to eliminate double taxation since the United States can impose a tax equal to the difference between the U.S. tentative tax and the foreign taxes paid without subjecting the taxpayer to double taxation.

43. The foreign tax credit, which was first enacted in 1918, is set forth in I.R.C. sections 901 to 908. I.R.C. §§ 901-908 (1988). In addition to the direct credit available for taxes paid directly by the taxpayer, there is an indirect credit that allows corporate parents to credit the foreign income taxes paid by their subsidiaries as the subsidiaries pay dividends to the parent. The indirect credit is set forth in section 902. For a general discussion of the origins and mechanics of the foreign tax credit, see J. ISENBERGH, *supra* note 1, at 472-81. See generally E. OWENS, *THE FOREIGN TAX CREDIT* (1961).

income taxes.<sup>44</sup> In limited situations, nonresident aliens and foreign corporations ("foreign taxpayers") are also entitled to such a credit.<sup>45</sup>

In order to be creditable, the foreign taxes must be income taxes or taxes paid in lieu of income taxes.<sup>46</sup> In addition, the foreign tax credit is elective. If elected in a given year, no deduction of foreign creditable taxes is allowed for that year.<sup>47</sup>

The amount of the allowable credit is limited to the lesser of the amount of foreign income taxes paid or accrued (the "foreign tax limitation") or the U.S. tax on foreign source income (the "domestic tax limitation").<sup>48</sup> The domestic tax limitation is calculated using the taxpayer's average tax rate.<sup>49</sup> Any foreign taxes that cannot be credited because they exceed the domestic tax limitation can be carried back two years and carried forward five years.<sup>50</sup>

The United States applies the tax limitations on a worldwide basis, with income from all foreign countries considered together.<sup>51</sup> However, the domestic tax limitation is calculated separately for certain types of income. Section 904(d) divides income into nine different baskets (eight specific and one residual) and provides that the tax limitation shall be applied separately with respect to each type of income.<sup>52</sup> Active and passive income are separated into different baskets. Passive income, such as dividends, interest, and rent,

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44. I.R.C. § 901(b) (1988). No credit is available for taxes paid to certain foreign countries; included in this group are those countries whose governments are not recognized by the United States, those with which the United States does not maintain diplomatic relations, those designated as supporting international terrorism, and South Africa. *Id.* § 901(j). In addition, the President is authorized by section 901(c) to disallow the credit to resident aliens who are citizens of a foreign country that does not allow U.S. citizens who reside in that foreign country a similar credit. *Id.* § 901(c).

45. *Id.* § 906.

46. *Id.* §§ 901(b), 903.

47. *Id.* § 275(a)(4)(A).

48. *Id.* §§ 901(b), 904. The United States has adopted the goal of a limited capital-export neutrality. *See supra* text accompanying note 19.

49. Specifically, section 904 states that the allowable foreign tax credit may 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 . . . bears to his entire taxable income for the same taxable year." *Id.* § 904(a). In the United States, the domestic tax limitation is determined by multiplying the U.S. taxes (before any credit) by a fraction, the numerator of which is the foreign source income and the denominator of which is the total taxable income. *Tipton & Kalmbach, Inc. v. United States*, 480 F.2d 1118, 1120 (10th Cir. 1973). This results in a domestic tax limitation that is equal to the taxpayer's average effective tax rate multiplied by his foreign source income.

50. *Id.* § 904(c).

51. The domestic tax limitation may be calculated on a worldwide, per country, or per transaction basis, with the per transaction calculation resulting in the least opportunity for the taxpayer to average foreign tax rates and thus the least economic distortion. *See supra* text accompanying notes 20-26.

52. Section 904(d) divides income into the following categories: passive income, high withholding tax interest, financial services income, shipping income, dividends received by a corporation from each noncontrolled section 902 corporation, certain dividends from a DISC or former DISC, taxable income attributable to foreign trade income, certain distributions from a FSC, and all other income. *See also* I.R.C. § 902 (1988).

comprises a separate basket.<sup>53</sup> Most active income, such as income derived from marketing, manufacturing, and services, would fall within the residual basket.<sup>54</sup> This separation of active and passive income has made it more difficult for taxpayers to create foreign income in order to use their otherwise uncreditable foreign taxes.<sup>55</sup> For example, consider a U.S. citizen whose U.S. tax rate is 30% and who has foreign business income produced in Country A, which taxes at a 50% rate. Since the domestic tax limitation will be less than her total foreign taxes paid, she will have foreign taxes that she cannot credit against her U.S. taxes.<sup>56</sup> Without any separate basket limitation, she can arrange to use that excess foreign tax merely by arranging to earn interest income in a country that taxes at a lower rate than the United States. Thus, without the separate basket limitations, the taxpayer can accomplish the averaging of foreign tax rates by an act as simple as opening a bank account in a foreign country. With the separate basket limitations, the taxpayer can use the excess foreign tax only by arranging to earn additional active income in a foreign country with a lower tax rate. Thus, while the separation of income into separate baskets has made it more difficult for the U.S. taxpayer to manipulate the source of income in order to be able to average foreign tax rates, the absence of either a per country or per transaction limitation continues to allow some averaging of the foreign tax rates.

### 1. Domestic Taxpayers

The U.S. provisions allowing domestic taxpayers a foreign tax credit are generally in accord with the principle of the host country having the first bite. This is because the United States is taxing because of a personal connection, while in most instances any foreign country taxing that taxpayer will be doing so because of a territorial connection; that is, the foreign income taxes are on income sourced outside of the United States. However, there is no specific provision stating that foreign taxes paid on income sourced within the United

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53. "Passive income" is not defined in section 904. Rather, section 904(d) treats as passive any income (with certain minor adjustments) that constitutes "foreign personal holding company income" as defined in section 954(c). Under section 954(c), foreign personal holding company income consists of investment income, such as dividends, interest, and rent. See also *id.* § 904. For a complete discussion of the application of the separate limitations, see J. ISENBERGH, *supra* note 1, at 534-38.

54. Since the residual basket is comprised of many different categories of income and contains the basic types of business profit, many large businesses may be unaffected by the separate basket limitations and will continue to have the tax benefits of a single worldwide limitation. J. ISENBERGH, *supra* note 1, at 537-38.

55. One commentator has suggested that the separation of active and passive income into two separate baskets may actually be harmful to the U.S. economy if a substantial portion of taxpayers continue to average foreign tax rates. Taxpayers with an unusable foreign tax credit arising from active income now have to relocate additional active business to foreign countries in order to use that credit, instead of merely changing the source of passive income. This relocation of active business will result in a loss of U.S. jobs. Roin, *supra* note 18, at 935-36.

56. The domestic tax limitation will be 30% multiplied by her foreign source income, while the foreign tax limitation will be 50% multiplied by her foreign source income.

States cannot be credited against U.S. taxes. The domestic tax limitation usually serves to limit the tax credit to those situations in which the foreign country taxes income that is sourced within that country, but this is not always the case.

For example, assume a U.S. corporation that operates in the United States and in Country A, both of which tax at a rate of 30%. Let us further assume that this corporation is involved in two lines of business. One of these businesses (B1) produces income of 100 that, according to U.S. law, is sourced within Country A but is not taxed by Country A. The other business (B2) produces income of 100 that, according to U.S. law, is sourced within the United States, but that according to Country A, is sourced within that country and is subject to tax in that country. The corporation pays foreign tax of 30 and its tentative U.S. tax is 60. The domestic tax limitation is 30 since the corporation has foreign-source income of 100 (produced by B1) and the U.S. tax upon that amount is 30. Therefore, the United States will allow a foreign tax credit of 30. This result is overly generous since the corporation has not been subject to double taxation on any income sourced outside of the United States. The income produced by B1 is sourced within Country A; therefore, if that income had been taxed by both the United States and Country A, it would have been proper for the United States to grant tax relief. However, that income was taxed only once (by the United States). The income produced by B2 is sourced within the United States according to U.S. law and within Country A according to that country's law; therefore, neither country has a superior jurisdictional claim to tax the income. Despite this, the United States would grant full relief from double taxation.

A similar problem arises when a taxpayer maintains personal connections with the United States and one foreign country and has income sourced in a second foreign country.<sup>57</sup> An example will illustrate this difficulty. Suppose a U.S. citizen resides 200 days a year in Country A and has a business in Country B. Because of his personal connections with both the United States (citizenship) and Country A (residence), both of these countries have jurisdiction to tax. Under the current U.S. law, the taxpayer would be allowed a credit for the Country A taxes paid on the income sourced within Country B.<sup>58</sup> In this way, the United States gives up the right to tax such a taxpayer to Country A, even though that country does not maintain a closer relationship to the taxpayer or to her income than does the United States.

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57. There is no problem if the income is sourced within the United States. In that event, the domestic tax limitation is zero and no foreign tax credit is allowed. Nor is there any problem if the income is sourced within Country A. In that event, Country A is the host country and the foreign tax credit is properly allowed.

58. This credit would be allowable subject to the domestic tax limitation. If Country B imposes a tax equal to or greater than the U.S. tax rate, no credit would be allowed in the current year for the taxes paid to Country A; nevertheless, a usable tax credit would be created that could be carried forward or back.

## 2. *Foreign Taxpayers*

Generally, there is no need for the United States to grant a foreign tax credit to a foreign taxpayer since for the most part only that portion of his income which is sourced within the United States is subject to U.S. taxation.<sup>59</sup> As to that income, the United States has the first bite and no tax credit should be allowed. If double taxation results, it is appropriate for the other country to provide relief.

There are limited circumstances, however, in which foreign source income earned by a foreign taxpayer is subject to U.S. taxation. A foreign taxpayer engaged in a trade or business in the United States is taxed by the United States on all income that is "effectively connected" with that trade or business.<sup>60</sup> Although effectively-connected income is generally sourced within the United States,<sup>61</sup> this income includes certain foreign source income if the taxpayer maintains an office or fixed place of business within the United States to which the foreign source income is attributable.<sup>62</sup> Since the United States is not the host country as to this income, it is appropriate for the United States to grant a foreign tax credit for taxes paid to the country in which the income is sourced.<sup>63</sup>

However, section 906(b) contains a significant limitation. No credit is allowed if the effectively-connected income is sourced within the United States *and* the foreign country taxes the income because of a personal rather than a territorial connection.<sup>64</sup> Although the legislative intent suggests that

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59. See I.R.C. § 872(a) (1988).

60. *Id.* §§ 871(b), 882.

61. *Id.* § 864(c)(1)-(3).

62. Foreign source income treated as effectively-connected income includes: (1) rents or royalties from intangible property derived in the active conduct of the U.S. trade or business; (2) dividends or interest from stock or securities that is either derived from the active conduct of a banking, financing, or similar business, or is received by a corporation that is involved principally in the trading of stocks and securities on its own account; and (3) income from the sale or exchange of inventory if such sale is through the U.S. office, unless the inventory is sold for use outside the United States and a foreign office materially participated in the sale. *Id.* § 864(c)(4).

The inclusion of foreign source inventory as effectively-connected income appears to be without any effect, since such income would appear to be U.S. source income. Section 865(e)(2) provides that, notwithstanding any other provisions, if a nonresident maintains an office in the United States, income from the sale of property (including inventory) attributable to that office shall be U.S. source income unless the inventory is sold for use outside the United States and a foreign office materially participated in the sale. *Id.* § 865(e)(2).

63. See *id.* § 906(a).

64. Section 906(b)(1) states:

For purposes of subsection (a) . . . in determining the amount of any tax paid or accrued to any foreign country or possession there shall not be taken into account any amount of tax to the extent the tax so paid or accrued is imposed with respect to income from sources within the United States which would not be taxed by such foreign country or possession but for the fact that—

(A) in the case of a nonresident alien individual, such individual is a citizen or resident of such foreign country or possession, or

(B) in the case of a foreign corporation, such corporation was created or organized under the law of such foreign country or possession or is domiciled for tax purposes in such country or possession.

the credit is to be allowed only when income is sourced outside of the United States,<sup>65</sup> the language of section 906(b) does not achieve this goal. Section 906(b) disallows the credit only when the income is sourced within the United States and the foreign country taxes that income because of a personal connection.<sup>66</sup>

A foreign country may also tax income sourced in the United States because of a territorial connection, as illustrated by the following example. Assume that a foreign taxpayer has a business (B1) in Country A with a branch (B2) in the United States that produces taxable income of 200. Each country has essentially the same income tax system, but Country A uses the "force of attraction" concept to determine territorial connections with a taxpayer's income.<sup>67</sup> Country A therefore taxes B2 not because of a personal connection but because of a territorial connection. Section 906(b) would not prohibit a foreign tax credit under these circumstances; therefore, the general rule of section 906(a) allowing a credit for foreign taxes paid on effectively-connected income would apply. Assuming that both Country A and the United States tax at a rate of 30%, the total foreign tax and the U.S. tentative tax on B1's income will be 60. No U.S. tax payment will be made since the foreign tax will be credited against the U.S. tentative tax.<sup>68</sup> Thus, the United States has given up the priority to tax the income sourced within the United States to a foreign country that lacks a closer territorial connection to the income, a connection as defined by the U.S. system. This violates the accepted international principle that the host country is entitled to the first bite.

To summarize, the major features of the foreign tax credit generally adhere to the rule that the first bite should go to the host country. Generally, the United States allows the credit when the income is sourced outside of the United States and the United States taxes because of a personal connection. The foreign tax limitation is relied upon to limit the credit to foreign taxes actually accrued or paid. The domestic tax limitation is relied upon to allow the credit only when the United States is taxing foreign source income. However, a taxpayer may credit foreign taxes assessed upon U.S. income as long as he has some foreign source income subject to U.S. tax. There is no specific provision that requires the credited foreign taxes actually being assessed upon

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*Id.* § 906(b)(1).

65. The Senate Finance Committee Report explains that section 906 was added "to allow a foreign tax credit to nonresident aliens and foreign corporations with respect to *foreign source* income which is subject to tax in the United States because it is effectively connected with the conduct of a trade or business in the United States." S. REP. NO. 1707, 89th Cong., 2d Sess. 44, reprinted in 1966 U.S. CODE CONG. & ADMIN. NEWS 4446, 4490 (emphasis added).

66. See I.R.C. § 906(b)(1) (1988).

67. According to the "force of attraction" theory, if a taxpayer maintains a permanent establishment in a country, that country will assert jurisdiction to tax all income derived from the home office from sources and property within that country, rather than only taxing income derived by and property attached to the permanent establishment. INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, *supra* note 14, at 117.

68. I.R.C. § 906(a) (1988).

the income that forms the basis for the domestic tax limitation. The U.S. system is also overly generous in that it may allow a nonresident alien to credit foreign taxes assessed upon effectively-connected income even though that income is sourced within the United States, as long as the foreign country asserts jurisdiction through a territorial connection.

### C. Deduction

An additional mechanism available to the taxpayer under the U.S. system is the deduction of foreign tax payments. If a taxpayer waives the foreign tax credit, she may deduct the foreign tax payment against her taxable income.<sup>69</sup> However, when available, the tax credit is often preferable to the deduction, although this is not universally true.<sup>70</sup>

A taxpayer may choose to deduct foreign taxes rather than to claim the foreign tax credit where his foreign tax credit is reduced by the separate basket limitation of section 904. For example, suppose a taxpayer has in Year 1 foreign source business income of 100, which is subject to foreign income tax at a rate of 50%, and, in the same year, his business activity in the United States ends with a loss. He assumes that he will be able to recover the loss only in Year 5, that he will not have any foreign business income during the next five years, and that in the fifth year his U.S. tax liability will be more than 500. If in Year 1, the taxpayer also has investment income within the United States of 200 that is subject to tax at 30%, he has the option of either deducting the foreign tax in Year 1 against the investment income, thereby enjoying a tax saving of 15,<sup>71</sup> or carrying forward the credit amount of 50 and crediting it against his U.S. taxes in Year 5.<sup>72</sup> This decision should be made according to the discount rate. Thus, if the present value of a foreign tax credit in Year 5 is less than 15 (the value of the deduction), the taxpayer would prefer the deduction over the carried-forward tax credit.<sup>73</sup>

A taxpayer may also prefer the deduction over the credit where the computation of the taxable income in the foreign country is more restrictive than

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69. *Id.* § 164(a)(3).

70. A credit differs substantially from a deduction. A credit reduces one's tax by the amount of the credit. The benefit is not dependent upon the taxpayer's marginal tax rate; each dollar of credit reduces the tax by one dollar. In contrast, a deduction, which is subtracted from taxable income, reduces the tax due by the marginal tax rate. For instance, if the taxpayer's marginal tax rate is 30%, a dollar deduction reduces tax due by 30 cents. M. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 2-3 (1988).

71. This is determined by multiplying the deduction (500) by the taxpayer's marginal tax rate (30%).

72. He cannot claim a foreign tax credit in Year 1 because he has no business income in that year; therefore, his domestic tax limitation is zero.

73. The more restrictive carry-forward and carry-back rules applicable to the foreign tax credit may also lead a taxpayer to prefer the deduction. If the taxpayer in the illustration above did not expect to recover his business loss until Year 6, he would choose to deduct the foreign taxes since the foreign tax credit can be carried back only two years and forward only five while a net operating loss can be carried back three years and forward fifteen years. I.R.C. §§ 904(c), 172(b) (1988).

in the United States, causing a higher taxable income in the foreign country. To illustrate, consider a U.S. taxpayer who has a business income of 100 sourced within the United States that is subject to tax at a rate of 30%. In addition, she has gross income of 50 in Country A. Under the U.S. tax system, she is allowed deductions of 40 for business, travel, lodging, and miscellaneous expenses pertaining to the foreign income, which results in taxable foreign source income of 10. The amount of U.S. tax payable on the foreign source income (and thus, the domestic tax limitation) equals 3. Country A's tax system, however, allows only expenses of 10 as deductions; hence, the Country A taxable income is 40. Since the maximum amount of foreign tax credit is 30, the taxpayer will not be able to credit the entire foreign taxes paid if the tax rate in Country A exceeds 7.5%.<sup>74</sup> In such a case, the taxpayer will consider the option of waiving the foreign tax credit and deducting the entire foreign tax paid.<sup>75</sup> If the tax rate in Country A exceeds 25%, the taxpayer will realize more tax benefit in the current year by deducting the foreign tax payment.<sup>76</sup>

The option of deducting the foreign tax payment is available even when the tax credit is not an option (either because the income is sourced within the United States or because the taxpayer is not a U.S. citizen or resident).<sup>77</sup> In this situation, the taxpayer is denied the foreign tax credit to insure that the United States gets the first tax bite when it is so entitled. Allowing the deduction of the foreign income taxes undermines this objective. Moreover, allowing the deduction when the United States is the host country increases the chance that the taxpayer will be entitled to double tax relief; the foreign country will be likely to offer relief from double taxation because it is the home country. Thus, if the deduction is analyzed solely as a mechanism for relief from double taxation, the deduction should not be allowed when the United States is the host country.

## V. DOUBLE TAX RELIEF

Additional problems arise when the U.S. system of relief from double taxation is viewed in relation to relief granted by the foreign countries involved. The taxpayer may be granted double tax relief; that is, the taxpayer may be granted relief from double taxation by both the United States and the foreign country.

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74. The 7.5% tax rate yields a tax of 30 when applied to taxable income of 400.

75. A taxpayer cannot choose to deduct a portion of the foreign taxes paid and claim a credit for the remainder. Moreover, if a foreign credit is claimed in one year and part of the credit is carried forward, this carried-over credit can never be deducted. *Treas. Reg. § 1.901-1(c)* (as amended in 1987).

76. With a foreign tax rate of 25%, the value of the deduction for foreign taxes paid (determined by multiplying the foreign taxes paid by the 30% U.S. tax rate) will equal 30, the maximum foreign tax credit allowable.

77. *See I.R.C. § 162(a)(3)* (1988).

Double relief may occur in two circumstances. First, it may result when the United States grants relief when it is actually the host country. Second, it may result from a conflict between the different standards used to determine what constitutes a personal and territorial connection. Application of the different standards may result in each country concluding that, regarding the income involved, the other is the host country, thereby leading both countries to grant relief from double taxation.

Double tax relief can occur in four ways: (1) both countries may grant a foreign tax credit (Case 1);<sup>78</sup> (2) both countries may grant a deduction of the foreign taxes paid (Case 2);<sup>79</sup> (3) the United States may allow a deduction while the foreign country allows a credit (Case 3);<sup>80</sup> and (4) the United States may allow a credit while the foreign country allows a deduction (Case 4).<sup>81</sup>

Several problems are created by double tax relief, regardless of the form in which it occurs. First, the United States may be giving up more revenue than is necessary to alleviate double taxation. Double taxation is eliminated when one country grants relief. Thus, it is not necessary for the other country to also grant relief. For example, if both the United States and the foreign country are taxing because of a personal connection and the foreign country allows a foreign tax credit, the United States need not also allow a credit in order to prevent the taxpayer from being subjected to double taxation. Second, when the taxpayer is entitled to tax relief from two countries, the amount of tax paid may vary according to which country he pays first; this effectively gives the taxpayer the choice of which country has priority in taxing. Finally, double tax relief can result in tedious calculation problems and numerous amendments to both the U.S. and foreign tax returns.

Double tax relief could be eliminated if every country adhered strictly to the principle that the host country has the first bite and if every country consistently applied the same jurisdictional rules. This does not seem possible. Therefore, the mathematical formulas below are proposed as a means of alleviating some of the problems associated with double tax relief.

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78. Case 1 could occur when a taxpayer maintains a personal connection with both the United States and a foreign country, such as when a U.S. citizen becomes a resident of a foreign country and has income sourced within a third country. It could also occur when the United States and the foreign country employ different source rules, leading each country to conclude that the income is sourced within the other country and to further conclude that it should grant relief.

79. Case 2 could occur when the income is sourced within the United States and taxed by a foreign country because of its personal connection to the taxpayer. Adhering to the rule that the host country has taxing priority, the foreign country might grant relief in the form of a deduction. As we have seen above, the United States would also allow a deduction in that situation despite the fact that it is the host country.

80. Case 3 could occur when a foreign country taxes U.S. source income because of a personal connection with the taxpayer and allows a credit since it is not the host country. The taxpayer would not be entitled to a U.S. foreign tax credit since the income is U.S. source. Thus, his only option would be to deduct the foreign taxes.

81. Case 4 could occur in the same situations as Case 1, the difference being that the foreign country allows a deduction of foreign taxes rather than a credit.

While the relief granted by the United States should theoretically consider the territorial and personal connection rules of the foreign tax system, practical considerations make this impossible. Therefore, the following discussion will assume that the foreign country involved has rules identical to those of the United States and that the aim is to divide the tax between the countries involved according to the principles elaborated above. This assumption is made merely to enable the United States to unilaterally formulate logical solutions to the problems discussed below. No reciprocal treatment by the foreign country is needed.

#### *A. Case 1*

In Case 1, where both countries grant a foreign tax credit, the taxpayer is, in effect, given the right to choose which country has priority in taxing. This requires a tedious series of calculations in order to determine the tax owed to each country.

To illustrate how the taxpayer is given the right to choose which country has priority, consider the example of a taxpayer who has income in both the United States and a foreign country and is entitled to a foreign tax credit in both countries. She has foreign taxable income of 100, the U.S. tax rate is 30%, and the foreign tax rate is 40%. Her tentative tax liability (before allowance of the foreign tax credit) in the United States, therefore, is 30 and in the foreign country is 40. She must choose which country to pay first, with the amount of tax each country receives dependent upon which country is paid first. If the taxpayer first pays the foreign tax of 40, she will pay no income tax in the United States and may be entitled to use the unclaimed tax credit of 10 for other foreign taxes. On the other hand, if the taxpayer first pays the U.S. tax of 30, she will then pay only 10 to the foreign country.

A burdensome series of amendments to a taxpayer's tax returns also results from the allowance of a foreign tax credit by both countries. A taxpayer is required to amend her U.S. return if a foreign tax credit is claimed and the amount of foreign taxes ultimately paid differs from the amount initially credited.<sup>82</sup> If, on the other hand, the amount of foreign tax paid exceeds the amount claimed on the return, the taxpayer may desire to file an amended return in order to claim the additional foreign tax credit. If the taxpayer makes all required amendments to her U.S. returns and the corresponding amendments to her foreign returns, the tax received by each country will no longer be dependent upon which country she pays first.

However, as illustrated below, it is unreasonable to expect or require a taxpayer to undergo this formidable task. For example, if the taxpayer in the above example first pays the U.S. tax of 30, she will claim a credit of 30 on her foreign tax return, paying the foreign country a final tax of 10. Suppose that after paying the foreign country she amends her U.S. tax return and

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82. I.R.C. § 905(c) (1988).

claims a foreign tax credit of 10, thereby reducing her U.S. tax to 20. If the foreign country does not require any further amendments, she ends up paying a total foreign and domestic tax of 30, 10 less than what she would pay if the income was subject only to the foreign tax system. However, the foreign country may have a provision requiring a taxpayer to amend her return to reduce the foreign tax credit claimed when the amount of foreign tax paid is less than originally claimed. In that case, if the taxpayer chooses to amend her U.S. return to claim the maximum tax credit to which she is entitled, a series of amended returns will follow. The following table illustrates the difficulty in amending both tax returns:

Phase	<u>United States</u> (30% Tax Rate)				<u>Foreign Country</u> (40% Tax Rate)			
	Taxable Income	Tentative Tax	Tax Credit	Tax Paid	Taxable Income	Tentative Tax	Tax Credit	Tax Paid
1	100	30	0	30	100	40	30	10
2	100	30	10	20	100	40	20	20
3	100	30	20	10	100	40	10	30
4	100	30	30	0	100	40	0	40
5	100	30	*	0	100	40	0	40

\* She will have creditable foreign tax of 10, which cannot be used because of the domestic tax limitation, but which can be carried forward or backward.<sup>83</sup>

Where both countries grant the foreign tax credit, either one of the countries can disallow the credit, thereby asserting primary jurisdiction, or the two countries can divide primary jurisdiction. The formula presented below divides primary jurisdiction between the two countries by dividing the total tax between the two countries. This division is based on two assumptions. First, the total tax in both countries should equal the tax in the "highest tax rate country"; thus,  $TA + TB = TTA$  (where  $TTA$  is the tentative tax in the country with the higher tax rate,  $TA$  is the final tax in the higher rate country, and  $TB$  is the final tax in the lower rate country). Second, the allocation of the total tax between the two countries should be in the same ratio as the tax rates of these countries; thus,  $TA/TB = TTA/TTB$  (where  $TTB$  is the tentative tax in the lower tax rate country). Combining these two equations and solving for  $TA$  and  $TB$  results in  $TA = TTA^2/(TTB + TTA)$ ;  $TB = (TTA)(TTB)/(TTB + TTA)$ .<sup>84</sup>

83. *Id.* § 904(c).

84. The first equation,  $TA + TB = TTA$ , is solved for  $TA$  to become  $TA = TTA - TB$ , which replaces  $TA$  in the second equation.

The second equation,  $TA/TB = TTA/TTB$ , thus becomes  $(TTA - TB)/TB = TTA/TTB$ .

The second equation is then solved for  $TB$  as follows:

$$(TTA)(TTB) - (TB)(TB) = (TTA)(TB);$$

$$(TTA)(TTB) = (TB)(TB) + (TTA)(TB);$$

$$(TTA)(TTB) = (TB)(TTB + TTA);$$

$$TB = (TTA)(TTB)/(TTB + TTA).$$

$TA$  is then determined. The second equation,  $TA/TB = TTA/TTB$ , is solved for  $TA$  and thus becomes  $TA = (TB)(TTA)/TTB$ . Replacing  $TB$  by  $(TTA)(TTB)/(TTB + TTA)$  yields  $TA =$

To illustrate application of the formula, consider a taxpayer with income of 100, taxed by the United States at 30% and by a foreign country at 40%. Applying the above formula, the tax payment in the United States (the lower rate country) is determined as follows:  $(40)(30)/(40 + 30) = 17.14$ . The tax in the foreign country (the higher rate country) is determined as follows:  $(40)(40)/(40 + 30) = 22.86$ . The use of this formula avoids the difficulties above. The taxpayer will pay the same amount of tax, regardless of which country is paid first, and the tedious amendments of returns will not be required.

*B. Case 2*

The same problems result when both countries allow a deduction for foreign taxes paid rather than a foreign tax credit. For example, assume that a taxpayer with U.S. source income of 100 is taxed by the United States at 30% and also by a foreign country at 40%. If both countries allow a deduction for foreign taxes paid, the taxpayer can choose which country gets the first bite. If she decides to pay the foreign country first, she will pay 40 to the foreign country and deduct that amount from her gross income for U.S. purposes, reporting a U.S. taxable income of 60 and paying 18 in U.S. income tax.

In such a case, the first bite has been granted to the foreign country even though the source of the income is within the United States. The taxpayer is now faced with the circuitous amendment problem. Let us assume that she decides to amend her tax return in the foreign country and hence reports there a taxable income of 82 (100 - 18), paying tax of only 32.8. She then would be required to amend her U.S. tax return and would report taxable income of 67.2 instead of 60. As in the example above where both countries grant tax credits, the taxpayer is faced with a nearly unending cycle of amendments, as demonstrated by the following table:

Phase	<u>Foreign Country</u> (40% Tax Rate)			<u>United States</u> (30% Tax Rate)		
	Deduction for Foreign Taxes	Taxable Income	Tax	Deduction for Foreign Taxes	Taxable Income	Tax
1	0	100	40	40	60	18
2	18	82	32.8	32.8	67.2	20.16
3	20.16	79.84	31.93	31.93	68.06	20.42
4	20.42	79.58	31.83	31.83	68.16	20.45
5	20.45	79.58	31.81	31.81	68.18	20.45
6	20.45	79.58	31.81	31.81	68.18	20.45

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$TTA[(TTA)(TTB)/(TTB + TTA)]/TTB$ . Solving this equation results in  $TTA^2/(TTB + TTA)$ .

The amount of tax due to the United States in Case 2 can also be determined by algebraic formula. If TA represents the total U.S. tax, RA the U.S. tax rate, TF the total foreign tax payment, RF the foreign tax rate, and Ti the tentative taxable income (the income before any deduction for foreign taxes), the appropriate formulas are:

$$\begin{aligned} TA &= (RA)(Ti)(1 - RF)/[1 - (RA)(RF)],^{85} \\ TF &= (RF)(Ti)(1 - RA)/[1 - (RF)(RA)]. \end{aligned}$$

To illustrate the application of this formula, let us assume a taxpayer with income of 100, which is taxed by the United States at 30% and the foreign country at 40%. The tax payment in the United States should be:  $(.30)(100)(1 - .40)/[1 - (.30)(.40)] = 20.45$ . The accuracy of this formula is confirmed by noting that the above table yields the same result. Thus, the application of the algebraic formula in Case 2 does not result in any difference in the amount of tax due, but it does simplify the calculation required to determine the amount of the allowable deduction.

### C. Case 3

When the United States allows a deduction while the foreign country allows a credit, problems should arise only where the U.S. average tax rate is lower than the foreign tax rate. If the U.S. tax rate is higher and the foreign country allows a credit for foreign taxes, any reasonable taxpayer would pay the higher tax first (the U.S. tax) and credit it against the lower tax in the foreign country. The tax payment in the foreign country would be zero and no deduction would be allowed in the United States.<sup>86</sup> If the U.S. tax rate is lower than the foreign one and the taxpayer decides to pay the foreign country first, the following table illustrates the phases needed to arrive at the final tax payment in both countries:<sup>87</sup>

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85. These equations are derived as follows:

$$TA = (RA)(Ti - TF);$$

$$TF = (RF)(Ti - TA).$$

In the equation for TA, we replace TF with  $(RF)(Ti - TA)$ , hence:

$$TA = (RA)[Ti - (RF)(Ti - TA)];$$

$$TA = (RA)[Ti - (RF)(Ti) + (RF)(TA)];$$

$$TA = (RA)[(Ti)(1 - RF) + (RF)(TA)];$$

$$TA = (RA)(Ti)(1 - RF) + (RA)(RF)(TA).$$

Moving the expression,  $(RA)(RF)(TA)$ , to the left yields:

$$TA - (RA)(RF)(TA) = (RA)(Ti)(1 - RF);$$

$$(TA)[(1 - (RA)(RF))] = (RA)(Ti)(1 - RF).$$

Isolating TA leads to:

$$TA = (RA)(Ti)(1 - RF)/[1 - (RA)(RF)].$$

Similarly, isolating TF leads to:

$$TF = (RF)(Ti)(1 - RA)/[1 - (RF)(RA)].$$

86. I.R.C. § 905(c) (1988).

87. With the figures used, the changes starting with phase 10 are very small and are not seen in the table because of the rounding of the figures.

Phase	<u>Foreign Country</u> (40% Tax Rate)			<u>United States</u> (30% Tax Rate)			
	Taxable Income	Tentative Tax	Tax Credit	Tax	Foreign Tax Deduction	Taxable Income	Tax
1	100	40	0	40	40	60	18
2	100	40	18	22	22	78	23.4
3	100	40	23.4	16.6	16.6	83.4	25.02
4	100	40	25.02	14.98	14.98	85.02	25.5
5	100	40	25.5	14.49	14.49	85.5	25.65
6	100	40	25.65	14.34	14.34	85.65	25.69
7	100	40	25.69	14.30	14.30	85.69	25.70
8	100	40	25.70	14.29	14.29	85.70	25.71
9	100	40	25.71	14.28	14.28	85.71	25.71
10	100	40	25.71	14.28	14.28	85.71	25.71

The formula for Case 3 would be needed only when the U.S. tax rate is lower than that of the foreign country.<sup>88</sup> Let TA represent the U.S. tax payment, RA the U.S. average tax rate, Ti the tentative income, TB the foreign tax payment, and RB the foreign tax rate. It is given that the tax in the United States is equal to the tentative income minus the foreign tax payment, multiplied by the U.S. average tax rate. Additionally, the foreign tax payment is equal to the foreign average tax rate multiplied by the tentative income, minus the U.S. tax payment. Therefore,  $TA = (RA)(Ti - TB)$  and  $TB = (RB)(Ti - TA)$ . Since we are dealing with a situation in which the foreign tax is higher than that of the United States and the latter is credited against the former, the total tax payment in both countries is equal to the tentative tax in the foreign country; therefore,  $TA + TB = (Ti)(RB)$ . Combining these three equations and solving for TA and TB, we find that  $TB = (Ti)(RB - RA)/(1 - RA)$ <sup>89</sup> and that  $TA = (Ti)(RA)(1 - RB)/(1 - RA)$ .<sup>90</sup>

88. The Internal Revenue Service has recognized the difficulty involved in calculating the amount of tax due in this circumstance and has indicated that the amount of tax due may be determined by an algebraic formula. See Rev. Rul. 55-532, 1955-2 C.B. 592.

89. Isolating TA in the equation,  $TA + TB = (Ti)(RB)$ , yields  $TA = (Ti)(RB) - TB$ . In the equation,  $TA = (RA)(Ti - TB)$ ,  $(Ti)(RB) - TB$  is substituted for TA to yield  $(Ti)(RB) - TB = (RA)(Ti - TB)$ , which is solved for TB as follows:

$$\begin{aligned} (Ti)(RB) - TB &= (RA)(Ti) - (RA)(TB); \\ (Ti)(RB) &= (RA)(Ti) - (RA)(TB) + TB; \\ (Ti)(RB) &= (RA)(Ti) - (TB)(RA - 1); \\ (TB)(RA - 1) &= (RA)(Ti) - (Ti)(RB); \\ TB &= [(RA)(Ti) - (Ti)(RB)]/(RA - 1); \\ TB &= (Ti)(RA - RB)/(RA - 1); \\ TB &= (Ti)(RB - RA)/(1 - RA). \end{aligned}$$

90. Isolating TA in the equation,  $TA + TB = (Ti)(RB)$ , yields  $TA = (Ti)(RB) - TB$ . Since  $TB = (Ti)(RB - RA)/(1 - RA)$ ,  $(Ti)(RB - RA)/(1 - RA)$  is substituted for TB in the first equation, which yields  $TA = (Ti)(RB) - (Ti)(RB - RA)/(1 - RA)$ . That equation is solved for TA as follows:

$$\begin{aligned} TA &= (Ti)[RB - (RB - RA)/(1 - RA)]; \\ TA &= (Ti)[(RB)(1 - RA) - (RB - RA)]/(1 - RA); \\ TA &= (Ti)[(RB - (RB)(RA) - RB + RA)/(1 - RA)]; \end{aligned}$$

To apply these formulas to calculate the U.S. tax payment, assume again a taxpayer with income of 100 subject to a foreign tax rate of 40% and a U.S. tax rate of 30%. The use of the formula results in a U.S. tax payment of:  $(100)(.30)(1 - .40)/(1 - .30) = 25.71$ . This is the same amount that was the ultimate result from the numerous amendments, as illustrated in the above table.

#### D. Case 4

The final situation, where the United States grants a foreign tax credit and the foreign country grants a deduction, is basically the same as the third situation except that the countries are reversed. Therefore, no problems occur when the U.S. tax rate is lower than the foreign one. Here again the reasonable taxpayer will pay the higher tax first and credit it against the lower tax, resulting in zero tax in the United States. However, if the U.S. tax rate is higher, the difficult calculation problem results. These problems are illustrated by the above table in Case 3, except that now the United States and the foreign countries are reversed.

Since Case 4 is the reverse of Case 3 and the same assumptions apply, we can calculate the U.S. tax payment by using the formula that in Case 3 represented the foreign tax payment. If TA represents the U.S. tax payment, RA the U.S. tax rate, RB the foreign tax rate, and Ti the tentative income, the appropriate formula is  $TA = (Ti)(RA - RB)/(1 - RB)$ .

If a taxpayer with income of 100, subject to a U.S. tax rate of 40% and a foreign tax rate of 30%, is entitled to a U.S. tax credit and a deduction in the foreign country, the total U.S. tax payment will be:  $(100)(.40 - .30)/(1 - .30) = 14.28$ .

Application of the above formulas removes the taxpayer's right to choose which country will get the first tax bite and thus makes certain the amount of revenue to be received by the United States. The use of these formulas also eliminates the need for amendments of the U.S. return and does away with the calculation difficulties. Finally, these formulas present a unilateral solution: the same solutions can be implemented regardless of the tax system actually used by the foreign country involved.

## VI.

### CONCLUSION

The U.S. tax system offers extensive relief from double taxation and, in some instances, the different forms of relief may conflict. All three mechanisms of relief are employed even though each of them seeks to obtain a different form of tax neutrality. One method of analyzing the effectiveness of

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$$\begin{aligned} TA &= (Ti)[(RA - (RB)(RA))/(1 - RA)]; \\ TA &= (Ti)[(RA)(1 - RB)/(1 - RA)]; \\ TA &= (Ti)(RA)(1 - RB)/(1 - RA). \end{aligned}$$

these mechanisms is to determine whether they adhere to the principle that the host country is entitled to the first tax bite. To the extent they do not adhere to this principle and to the extent that the mechanisms overlap, they are not necessary to eliminate or alleviate double taxation.

The exemption under section 911 is not needed to eliminate double taxation since the foreign tax credit achieves that goal. Although the exemption only applies when the United States is not entitled to the first bite, as a mechanism for relief from double taxation, it goes further than is necessary to achieve the goal of eliminating double taxation; it applies even though the foreign country may tax the income either at a rate lower than the U.S. rate or not at all.

The primary mechanism used by the United States to mitigate double taxation, the foreign tax credit, is overly generous in several situations. Despite the enactment of the separate basket limitations of section 904(d), it is still possible for taxpayers to average foreign tax rates since there is no per country or per transaction limitation. In order to strictly adhere to the principle that the host country is entitled to the first bite, a foreign tax credit should be allowed only where the United States taxes income because of a personal connection and a foreign country taxes that same income because of a territorial connection. The U.S. system relies primarily upon the domestic tax limitation to limit application of the foreign tax credit to those situations. While this mechanism is largely effective, there are certain situations in which the domestic tax limitation does not succeed and the foreign tax credit is granted where it should not be.

Since there is no specific provision requiring foreign taxes be paid on foreign source income in order to be creditable, a domestic taxpayer can claim a foreign tax credit for foreign taxes paid on U.S. source income as long as he has some foreign source income (in the same basket) that is subject to U.S. tax. This violates the accepted principle of the host country having the first bite. Although the foreign country is taxing U.S. source income and the United States is the host country, the United States is granting relief from double taxation.

Since there is no provision requiring foreign taxes be imposed because of a territorial connection in order to be creditable, a domestic taxpayer can also claim a foreign tax credit for foreign taxes paid when the foreign country has jurisdiction to tax because of a personal connection with the taxpayer. This is overly generous even if the income being taxed is sourced outside of the United States since the foreign country has no closer territorial connection to the income than does the United States.

The foreign tax credit is also overly generous in that it may allow foreign taxpayers to claim a credit for taxes paid to foreign countries on effectively-connected income even though that income is sourced within the United States. This is obviously contrary to the norm that the host country is entitled to the first bite.

In analyzing the deduction of foreign income taxes as a provision providing relief from double taxation, it is clear that the deduction conflicts with the objectives of the foreign tax credit. Even in those situations where the United States adheres to the principle of the host country getting the first tax bite by disallowing any foreign tax credit when income is sourced within the United States, section 164 grants partial relief by allowing a deduction of the foreign tax payments. This increases the possibility that the taxpayer will be entitled to relief from double taxation in both countries.

The overly generous aspects of the U.S. system become more pronounced when one considers that the foreign country involved may also grant relief from double taxation. Double tax relief would occur less often if the United States adhered strictly to the principle that the host country should have the first bite by not allowing tax relief in any form when the United States is the host country. However, double tax relief could still occur in situations where the United States and the foreign country apply different source rules.

The major problems created by double tax relief are that the taxpayer may have the right to determine which country gets the first bite and that numerous amendments to both the U.S. and the foreign tax returns are needed. The mathematical solutions offered alleviate these difficulties in a fairly simple manner that can be unilaterally applied by the United States.