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## Taxation-Federal Income Tax-Liquidation Distributions Entitled to Both Capital Gains Treatment and Foreign Tax Credit

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TAXATION—FEDERAL INCOME TAX—LIQUIDATION DISTRIBUTIONS ENTITLED TO BOTH CAPITAL GAINS TREATMENT AND FOREIGN TAX CREDIT—Plaintiff, Associated, is an American corporation whose wholly-owned subsidiary, Automatic, owned all the stock of Filcrest, a Canadian corporation. In 1954 all the assets of Filcrest were distributed to Automatic pursuant

to a plan of complete liquidation, accomplished in accordance with Canadian law. In its 1954 consolidated return, plaintiff treated the gain realized<sup>1</sup> on the Filcrest liquidation as a capital gain, and also claimed a foreign tax credit for any Canadian income, war or excess profits taxes which Filcrest had paid over the years to Canada on that part of the liquidation distribution which represented Filcrest's accumulated earnings and profits. The Commissioner of Internal Revenue assessed a deficiency, maintaining that the foreign tax credit was applicable only to dividends, and that a liquidation distribution was not a "dividend" within the purview of the statute. In a suit for refund of taxes paid, *held*, for the purposes of the foreign tax credit provisions of section 902(a),<sup>2</sup> the liquidation distribution was a "dividend," and therefore plaintiff is entitled to the claimed credit, though it is required to pay only at capital gains rates on the amount realized in the distribution.<sup>3</sup> *Associated Tel. & Tel. Co. v. United States*, 199 F. Supp. 452 (S.D.N.Y. 1961).

The income of a foreign subsidiary of an American corporation is presently not subject to a United States tax until received in some form by the American corporation. When received, such income is taxed as if it were domestic income of the parent corporation, but a tax credit is allowed for any foreign income, war or excess profits taxes paid to the

<sup>1</sup> In general, a corporation complying with the requirements of INT. REV. CODE OF 1954, § 332, does not recognize a gain on the receipt of property distributed in a complete liquidation of a subsidiary. However, in the case of a foreign subsidiary, INT. REV. CODE OF 1954, § 367 requires, before a distribution is entitled to the benefits of § 332, that it be established that one of the principal purposes of the distribution is not federal income tax evasion. Apparently this was not done in the principal case.

<sup>2</sup> INT. REV. CODE OF 1954, § 902(a): "[A] domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits." INT. REV. CODE OF 1954, § 901(a) allows credit for such taxes against the United States income tax, subject to the limits of INT. REV. CODE OF 1954, § 904(a)(1): "the amount of the credit in respect of the tax paid or accrued to any foreign country or possession of the United States shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer's taxable income from sources within such country or possession (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year." Section 904(a)(2) provides an alternative, whereby the numerator of the limiting fraction consists of all income from foreign sources.

<sup>3</sup> A contrary result was reached in *Freeport Sulphur Co. v. United States*, 143 Ct. Cl. 111, 163 F. Supp. 648 (1958), *amended*, 172 Supp. 462 (1959). Involved was a liquidation distribution of a Cuban subsidiary of the plaintiff. Plaintiff claimed both capital gains treatment and a foreign tax credit. The court disallowed the credit, observing that if plaintiff had received the sum distributed as dividends over the years, its tax, even with a credit, would have been more than the capital gains tax without the credit. The court felt that Congress had not intended such a double benefit as would result if plaintiff's claim were sustained.

foreign country with respect to any "dividends" transmitted to the American corporation. The central question presented in the principal case was whether a liquidation distribution is a "dividend" for foreign tax credit purposes.

The term "dividend" is not defined in the foreign tax credit provision. The Internal Revenue Code of 1954, section 316(a),<sup>4</sup> however, defines a dividend generally as any distribution of property made by a corporation to its shareholders, further providing that to the extent that any distribution of property governed by sections 301-395<sup>5</sup> is treated as a distribution to which section 301<sup>6</sup> (relating to the tax consequences of corporate distributions to the recipients) applies, such distribution will be treated as a distribution of property for the purposes of section 316(a). Except where specifically excluded, section 301 is applicable throughout sections 1-1377<sup>7</sup> and provides that for the purposes of its application, "dividend" is defined by section 316. However, section 331(b)<sup>8</sup> specifically excludes the application of section 301 to any distribution of property in partial or complete liquidation. In the principal case the Government contended that these sections taken together should be construed to mean that the definition of a dividend contained in section 316 applies only in those instances where section 301 is applicable, and that since section 331(b) precludes the application of section 301 to liquidation distributions, such distributions are not "dividends" and, therefore, are not entitled to the section 902 foreign tax credit. The contention of plaintiff, as accepted and sustained by the court, was that section 316(a) includes, but is not limited to, section 301 transactions; therefore, the unqualified use of the term "dividends" in section 902(a) includes liquidation distributions.

Although an examination confined to sections 301, 316, and 331 might support the court's conclusion,<sup>9</sup> other sections of the Code indicate that liquidation distributions are not automatically to be subsumed within the term "dividend." For example, section 346<sup>10</sup> applies to a corporate distribution of assets, but only if such distribution is "not essentially equivalent to a dividend." Section 562(b)<sup>11</sup> provides that liquidation distribu-

<sup>4</sup> INT. REV. CODE OF 1954, § 316(a).

<sup>5</sup> INT. REV. CODE OF 1954, §§ 301-95, relating to corporate distributions and adjustments.

<sup>6</sup> INT. REV. CODE OF 1954, § 301, entitled "Distributions of Property."

<sup>7</sup> INT. REV. CODE OF 1954, §§ 1-1377. (Chapter One of the Code, entitled "Normal Taxes and Surtaxes.")

<sup>8</sup> INT. REV. CODE OF 1954, § 331(b), entitled "Nonapplication of § 301." Section 331 is entitled "Gain or Loss to Shareholders in Corporate Liquidations."

<sup>9</sup> See Beauregard, *Distributions in Liquidation as Dividends in the Foreign Affiliate Tax Credit of the 1954 Code*, 41 VA. L. REV. 731 (1955); S. REP. NO. 1662, 83d Cong., 2d Sess. 255 (1954).

<sup>10</sup> INT. REV. CODE OF 1954, § 346.

<sup>11</sup> INT. REV. CODE OF 1954, § 562(b).

tions "shall be treated as a dividend for purposes of computing the dividends paid deduction," while section 583<sup>12</sup> speaks of allowing a deduction for "any dividend (not including any distribution in liquidation)." Thus, the term "dividend" is at times specifically qualified, when used in the Code, to insure inclusion of liquidation distributions, and at other times to insure the contrary result. It would appear, then, that the use in section 902(a) of "dividends" does not indicate, in and of itself, what treatment is to be accorded liquidation distributions.<sup>13</sup>

Not only is the decision in the principal case not required by the relevant statutory provisions, but it also appears to be contrary to the basic philosophy behind the allowance of a foreign tax credit. The foreign tax credit provisions were not passed to exempt the foreign income of a domestic taxpayer from United States taxes entirely, but rather to provide, as far as could be done without wiping out any United States tax attributable to purely domestic income, that the total tax, both foreign and domestic, which a United States corporation pays on income from abroad, should not be more than the tax would be if the income had arisen entirely within the United States.<sup>14</sup> In the principal case the capital gains tax which plaintiff paid to the federal government on the liquidation distribution amounted to about one and one-half million dollars; the tax credit allowed was about two and three-tenths million dollars. Granting of the credit thus resulted in an effective reduction of the rate of taxation of plaintiff's domestic income. Previous to the holding in the principal case, such a situation could not have arisen, since, according to prior case authority, dividends from foreign corporations would be taxed at the same rate as domestic income, and foreign liquidation distributions, while entitled to capital gains rates which taxed them less heavily than ordinary domestic income, were not entitled to the foreign tax credit.<sup>15</sup> In the context of this previous scheme of taxation, the limitations on the foreign tax credit provided by section 904 had prevented the foreign tax credit

<sup>12</sup> INT. REV. CODE OF 1954, § 583.

<sup>13</sup> If § 902 had provided that income received from a foreign source "shall be treated as a taxable dividend," there would seem to be little doubt but that it would then be entitled to a tax credit. *Cf. Helvering v. Credit Alliance Corp.*, 316 U.S. 107, 110-11 (1942).

<sup>14</sup> Int. Rev. Code of 1918, ch. 18, § 222(a), 40 Stat. 1058 (1919), gave credit for all foreign income, war or excess profits taxes paid. This was done because it was felt that paying all the foreign and all the United States taxes was a severe burden. H.R. No. 767, 65th Cong., 2d Sess. 11 (1918). However, Int. Rev. Code of 1921, ch. 136 § 238(e), 42 Stat. 227 (1921) limited this credit essentially as provided for in INT. REV. CODE OF 1954, § 904, since it was realized that otherwise a foreign tax rate higher than the United States tax rate might cancel some United States tax based on purely domestic income. H.R. REP. NO. 350, 67th Cong., 1st Sess. 13 (1921); 61 CONG. REC. 7184 (1921) (remarks of Senator Smoot). See S. REP. NO. 1393, 86th Cong., 2d Sess. 3 (1960); *Dexter v. Commissioner*, 47 B.T.A. 285, 291 (1942).

<sup>15</sup> See note 3 *supra*.

from cancelling any United States taxes on domestic income.<sup>16</sup> As to Western Hemisphere trade corporations, Congress had realized that the special tax privileges granted them might result in a credit being allowed to such corporations offsetting United States taxes due on other foreign income,<sup>17</sup> and had acted to prevent it.<sup>18</sup> By analogy it would appear unlikely that Congress intended to condone the granting of both capital gains treatment and a tax credit to foreign income, as presented by the circumstances and result in the principal case, since such a procedure entails an endangering of United States taxes on domestic income.

The decision of the court in the principal case is subject to still another criticism. The credit allowed for the foreign taxes paid by a foreign subsidiary is similar in function to the dividends-received deduction allowed a parent corporation upon receipt of dividends from its subsidiary,<sup>19</sup> in that both provide some relief for taxes previously paid on the income

<sup>16</sup> The amount of credit allowed is determined by multiplying the United States tax on the total income, foreign and domestic, by a fraction, the numerator of which is the foreign income received in the United States and the denominator of which is the total income, foreign and domestic. Let the tax credit allowable be C, foreign source income be F, domestic source income be D, United States tax rate on foreign source income be  $R_f$ , United States tax rate on domestic source income be  $R_d$ . Then C may be expressed as:

$$C = F \cdot R_f \left( \frac{\frac{R_d}{R_f} D + F}{D + F} \right)$$

Thus, if the United States tax rate on all of the income is at the same level, no United States taxes will be wiped out, regardless of the rate of foreign taxation or the amount of foreign income. A fortiori, if the United States rate on the domestic portion of the total income is less than that on the foreign portion, again the tax on the domestic portion will be unaffected by the credit. It is only when the United States tax rate on the foreign portion is less than the United States tax rate on the domestic portion that the latter tax is endangered by the credit.

<sup>17</sup> By INT. REV. CODE OF 1954, § 922, Western Hemisphere Trade Corporations (WHTC) are allowed a deduction such that their taxable income for United States tax purposes becomes

$$I - I \left( I - \frac{14}{52} \right)$$

where I is the total foreign income of the WHTC. This difference is the taxable foreign income, on which WHTC's are taxed at the full 52% rate. However, this means that the effective United States tax rate on the total foreign income of the WHTC is 38%. Since the total foreign income of corporations not qualifying under § 922 is taxed at the 52% rate, the problem discussed in the text arose. It is to be noted that this lower rate on the total foreign income of a WHTC does not result in endangering the tax on domestic income, since, it will be recalled, the "F" of the equation in note 16 *supra* consists only of the taxable foreign income.

<sup>18</sup> See INT. REV. CODE OF 1954, § 1503(d), which was added in 1960. The reasons for the addition are discussed in S. REP. NO. 1393, 86th Cong., 2d Sess. 9 (1960).

<sup>19</sup> INT. REV. CODE OF 1954, § 243. It should be noted that this deduction is not limited to the parent-subsidiary situation.

received by the parent corporation.<sup>20</sup> If a domestic subsidiary of a corporation were to liquidate in such a manner as to result in capital gains to the parent, the parent would not also be entitled to the dividends-received deduction.<sup>21</sup> To give a corporation with a foreign subsidiary the benefit of the foreign tax credit in a situation where a corporation with a domestic subsidiary would not enjoy the dividends-received deduction would appear to grant the former a preference for which no basis appears in the Code, or in policy or logic.

Aside from statutory questions, arguments have been made that, if any doubts exist, the foreign tax credit should be construed liberally in favor of the taxpayer, since it serves to implement our foreign policy, especially in promoting the economic advancement of under-developed areas.<sup>22</sup> However, it is doubtful that a foreign tax credit for liquidation distributions would result in a significant increase in investment in under-developed countries, since the rate of taxation is seemingly not a controlling consideration in American investment abroad. Rather, such factors as a history of political stability, the degree of industrial sophistication of the populace, and geographical location with respect to markets and raw materials appear to be determinative.<sup>23</sup>

Thus, the provisions of the Code themselves do not compel a conclusion that the unqualified use of "dividends" includes liquidation distributions. No compelling policy reasons require giving foreign source income both a credit and capital gains treatment. In such circumstances, permitting the payment of foreign taxes to lower the effective tax rate on domestic income, as accomplished by the holding in the principal case, appears to be unjustified, especially in view of evidences of apparent congressional disapproval of such a result. Absent a definite congressional indication that liquidation distributions are to receive both a foreign tax credit and capital gains treatment, they should be restricted to the latter benefit.

*Lloyd C. Fell*

<sup>20</sup> See OWENS, *THE FOREIGN TAX CREDIT* 99 (1961).

<sup>21</sup> *Auto Fin. Co. v. Commissioner*, 24 T.C. 416 (1955), *aff'd per curiam*, 229 F.2d 318 (4th Cir. 1956); *Robert Gage Coal Co. v. Commissioner*, 2 T.C. 488, 501-02 (1943).

<sup>22</sup> *Beauregard*, *supra* note 9.

<sup>23</sup> See generally Lidstone, *Double Taxation of Foreign Investment? Or an Adventure in International Double Tax?*, 44 VA. L. REV. 921, 925-26 (1958); Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815, 843 (1956); S. REP. NO. 1393, 86th Cong., 2d Sess. 23 (1960) (Minority Report).