Comment on this Special Report

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Creditability of Italian IRAP Tax Under Sections 901 and 903 of U.S. Internal Revenue Code

[P. 2015]In 1997, under its most radical tax reform since 1970, Italy introduced the regional tax on productive activities (IRAP). Since its enactment, IRAP has raised serious questions as to its creditability for U.S. foreign tax credit purposes. [2] This state of uncertainty opened the doors for a renegotiation of the U.S.-Italy income tax treaty, which was initialed in Washington on November 25, 1998, and signed on August 25, 1999. One of the main features of the new treaty is the insertion of IRAP among the taxes for which a tax credit will be granted. However, by making IRAP creditable by treaty, the new U.S.-Italy tax convention bypasses the fundamental question of whether IRAP should be credited under the foreign tax credit provisions of the Internal Revenue Code (IRC).

This article first traces the development of the treaty-based foreign tax credit and its difficult coexistence with the statutory credit. Second, it analyzes the scope of application of sections 901 and 903 of the code as applied to IRAP and concludes that case law and legislative history allow a more flexible approach to the notion of statutory foreign tax credit than that provided by the Treasury regulations. The result of this narrow approach is the proliferation of treaty-based tax credits seeking to reach foreign taxes that are creditable under U.S. statutory law. This indiscriminate use of treaties increases the friction between statutory and treaty-based tax credits, which raises a number of tax policy and legal concerns. [3]

I. Statutory Foreign Tax Credit

The statutory foreign tax credit has been the main device employed by the United States for alleviating the problem of double taxation of the same income by two or more countries. [4] The effect of the credit is to reduce the U.S. tax on foreign income of U.S. citizens and residents by the amount of income tax paid to foreign governments. The main goals that the statutory tax credit seeks to achieve are fostering the export of capital abroad and ensuring that foreign and U.S.-source income is subject to the same tax burden. [5]

Since its inception, a central issue regarding the foreign tax credit has been the determination of which foreign taxes should be creditable. The statutory

approach to the foreign tax credit is to allow the credit for two classes of taxes paid to foreign countries. First, income, war profits, or excess profit taxes are eligible for credit under section 901. [6] Alternatively, a foreign tax is creditable under section 903 if it is imposed in lieu of an income tax. [7] To be creditable, the Treasury regulations promulgated under section 901 require not only that a foreign levy be a tax, but also that its predominant characteristic be that of an income tax in the U.S. sense. [8]

To qualify as a tax under the regulations, a foreign levy must be compulsory and levied under the authority of a foreign country. [9] The regulations provide that penalties, fines, and custom duties, are not taxes, regardless of how they are denominated by the [P. 2016]foreign countries imposing them. In addition, if a specific economic benefit is received in exchange for a payment to a foreign country, that payment is not a tax since it is not levied under the authority of a foreign country. Whether a foreign levy is in fact compulsory is determined according to the principles of U.S. law, as opposed to those of a foreign country.

Once it is established that a foreign levy qualifies as a tax, it must be determined if the foreign levy is an income tax under U.S. principles. To satisfy this second test, the foreign levy must be likely to reach net gain. As detailed in the regulations, a foreign tax is likely to reach net gain if it passes the realization, gross receipts, and net income requirements. [10]

A foreign tax satisfies the realization test if, by looking at its predominant character, it is imposed on the occurrence of what would constitute a realization event under U.S. tax laws. [11]

A foreign tax satisfies the gross receipt requirement if it is based either on actual gross receipts or on gross receipts computed under a method that is likely not to exceed fair market value. [12]

Finally, a foreign tax satisfies the net income test if it allows deduction of significant expenses incurred in the production of income. [13] These expenses do not have to be recovered at the same time as required under the IRC, unless the timing discrepancy is such that it effectively denies recovery. [14]

Alternatively, if a foreign tax is not an income tax it may still be creditable under section 903 if it is levied "in lieu of" an income tax generally imposed by a foreign country. [15] A tax in lieu of an income tax qualifies under section 903 only if it operates as a tax in substitution of an income tax otherwise generally imposed. [16] Thus, a foreign tax, such as IRAP, that totally replaces another foreign tax otherwise generally imposed will not qualify under section 903 regulations. [17]

II. Treaty-Based Foreign Tax Credit

Traditionally, the foreign tax credit provisions contained in tax treaties negotiated by the United States were used to simply confirm the tax credit rules of the Internal Revenue Code. [18] Starting in the late 1970s, however, a growing number of tax treaties have provided for the creditability of foreign taxes that were not creditable under the code. [19] This trend was formalized in 1977 and 1981 by the Treasury Department's issuance of two model treaties that provide for the creditability of foreign taxes irrespective of whether they would be creditable under sections 901 or 903 of the code. [20]

A treaty-based tax credit expands the scope of applicability of the U.S. statutory foreign tax credit by covering the entire income tax of a country, which contains taxes that are not creditable under section 901 of the code. Alternatively, a treaty provides a list of foreign taxes for which a tax credit will be granted.

An example of the first category is the U.S.-Canada tax treaty, which covers all taxes imposed by Canada under parts I, XIII, and XIV of its Income Tax Act. [21] Although most of these taxes are creditable under the code, serious doubts have been raised with respect to the Canadian corporate tax on exploitation of natural resources. The U.S.-Canada treaty, in fact, seems to make this tax [P. 2017] creditable irrespective of whether it is deductible in computing taxable income. [22]

An early example of the second category of treaty-based creditable taxes is offered by the tax treaty between the United States and Sweden. [23] This treaty treats the Swedish "fees tax," which is based on gross income, as a creditable tax in the United States to the extent that it affects musicians, athletes, and actors. Other examples of this second category are offered by the United Kingdom and Norwegian treaties, which make certain taxes on oil extraction having the nature of production or severance taxes creditable for U.S. tax purposes. [24]

Yet another case of otherwise not creditable foreign levies that are made creditable by treaty is the Moroccan and Israeli compulsory loans. [25] Under Moroccan and Israeli law, businesses were required to make certain loans to these governments. These loans were not income taxes and, as such, were not creditable under sections 901 and 903 of the code. However, under the United States treaties with Israel and Morocco, U.S. citizens or residents who make such compulsory payments can elect to treat these amounts as a creditable foreign tax. [26]

One of the most recent examples of crediting foreign taxes by treaty is offered by the new U.S.-Italy tax treaty. [27] Under article 23(2) of the current Italian treaty, the U.S. grants its citizens and residents a tax credit for income taxes paid to the Italian government. Article 2 lists the Italian taxes that are to be considered income taxes under the treaty. Both the Italian corporate income tax (IRPEG) and the local income tax on profits (ILOR) are listed as income taxes for which a credit can be claimed. In addition, article 2(3) of the treaty provides that any tax

that is identical, or substantially similar to a tax covered by the treaty, will be considered creditable. Effective January 1, 1998, Italy repealed ILOR and replaced it with IRAP, which allows no deductions for labor and interest expenses. Although the Italian authorities stated that for foreign tax credit purposes, IRAP had to be considered equivalent to ILOR, the U.S. Treasury refused to consider IRAP substantially similar to ILOR because it could not be regarded as an income tax under sections 901 and 903 of the code. After a temporary administrative agreement that made IRAP partially creditable in the United States, the U.S. and Italian authorities renegotiated the 1984 treaty which, once ratified, will include IRAP among the taxes for which a credit can be claimed. The result of this new treaty is to make IRAP creditable for U.S. tax purposes irrespective of whether it could be creditable under sections 901 and 903 of the code.

III. The Tension Between Statutory and Treaty-Based Foreign Tax Credits

The tension between the statutory tax credit and the growing number of treaty-based tax credits derives from the uneasiness in reconciling conventional legal analysis with modern policies. The Constitution does not settle conflicts between treaties and acts of Congress. The only reference to the legal status of treaties and statutory legislation is found in the Supremacy Clause, which declares that both treaties and statutory law are considered the law of the land. [28] In a series of cases, the Supreme Court interpreted the Supremacy Clause by ruling that because treaties and statutory legislation are of equal dignity, whenever a treaty and an act of Congress conflict the later in time prevails. [29] This doctrine has been codified in section 7852(d) of the code, which [P. 2018]provides that neither a treaty nor a statutory law must have preferential status.

The first issue raised by a treaty modification of the statutory foreign tax credit stems from the fact that the ratification of treaties is subject to a lower level of scrutiny than statutory legislation. While Congress plays a central role in the passage of statutory laws, the House of Representative has no official role in the treaty ratification process.

Tax treaties are generally negotiated and drafted by the Treasury Department. Once a treaty is concluded, it is transmitted to the Executive to obtain the president's signature. The president then submits the treaty to the Senate for ratification. The Senate can either approve or reject the treaty in its entirety, with very limited opportunity to make changes. [30] In addition, neither the House nor the Senate tax-writing committees are involved in the ratification of treaties, which is conducted by the Senate Foreign Relations Committee. This lack of formal involvement by either the House or the Senate tax-writing committees could be viewed as a threat to the committees' powers. [31]

Another argument against treaty modifications of the statutory foreign tax credit is a possible violation of the constitutional separation of powers between Congress

and the Executive branch. While Congress is invested with the power to make tax policy, the Executive has the power to negotiate treaties with other countries. Given the limited involvement of Congress in the ratification of tax treaties, the Executive could enter into a treaty reflecting a foreign tax policy inconsistent with that pursued by Congress. [32]

Treaty-based foreign tax credits create a disparity of tax treatment between investments in treaty countries and nontreaty countries. The main policy goal of the foreign tax credit is to subject U.S. citizens and residents to the same tax treatment regardless of the geographical source of their income. By making the availability of the foreign tax credit subordinate to the existence of treaties, the treaty-based foreign tax credit grants U.S. taxpayers that invest in a particular country an unacceptable tax advantage over those who invest in nontreaty countries. U.S. taxpayers that invest in treaty countries, in fact, will receive a credit not only for their foreign-source income taxes, but also for the foreign nonincome taxes made creditable by treaty.

In addition, the treaty-based foreign tax credit does not promote the efficient allocation of U.S businesses' resources. The treaty-based tax credit, in fact, creates an incentive for U.S. businesses to shift their foreign investments to less cost-efficient countries that become artificially more attractive by reason of the treaty foreign tax credit.

Notwithstanding the aforementioned objections, a treaty-based foreign tax credit appears to be an effective tool to eliminate double taxation arising from the meshing of different legal systems. [33] In addition, under the pretenses of negotiating the creditability of a foreign tax, the U.S. Treasury can bring reluctant countries back to the negotiation table and get concessions that it would not otherwise necessarily obtain. For example, in exchange for making IRAP creditable in the United States, the Treasury has obtained a series of major tax concessions from Italy. These concessions include, among others, the expansion of antitreaty shopping provisions and a reduction of withholding on interest, dividends, and royalties. [34] From this perspective, the treaty- based tax credit appears to be a formidable foreign tax instrument, and its conflict with the statutory credit the inevitable price to be paid for the achievement of foreign tax goals.

Although it is not clear whether such conflict can be completely eliminated, it is possible to reduce the friction between the statutory and the treaty-based tax credit by providing a more flexible interpretation of section 901 of the code. [35] As will be seen for IRAP, case law [P. 2019] seems to allow a more flexible interpretation of section 901 of the code than that contained in the regulations. This flexible interpretation would prevent the indiscriminate use of treaty-based foreign tax credits to reach foreign taxes that present minor deviations from the notion of a U.S. income tax and that could be covered by section 901 of the code.

IV. Regional Tax on Productive Activities

IRAP was introduced in Italy by Legislative Decree N. 446 on December 15, 1997. The enactment of IRAP was a step for Italy toward aligning its tax regime to those of the other major European countries. One of the primary policy goals of the Italian legislature in enacting IRAP was the devolution of taxing powers from the central government to its regions, which are lower levels of government. [36] Under this policy, IRAP, which is taxed at the regional level, replaced the old local income tax on profits (ILOR), which was levied as a central tax.

Another policy goal IRAP seeks to achieve is the rationalization and simplification of the tax collection process. This policy goal was accomplished by replacing a number of preexisting taxes, such as the ILOR, the employers' compulsory medical contributions, the municipal tax on office premises (ICIAP), and the initial value added tax (VAT) with IRAP.

In creating IRAP, the Italian legislature also sought to encourage the capitalization of enterprises and reduce the discrepancy between the tax treatment of debt and equity. Before the enactment of IRAP, Italian companies were often thinly capitalized by virtue of the general deductibility of interest expenses from ILOR's taxable income, and by the application of a tax on net equity of companies (imposta sul patrimonio netto). Effective January 1, 1998, however, both the tax on net equity of companies and ILOR have been replaced by IRAP, which does not tax net assets and which disallows interest expense deductions. From this perspective, the Italian tax system appears to be neutral, since it provides equal treatment for both capital and debt. [37]

Yet another concern that inspired the enactment of IRAP was to relieve employers from the cost of social security contributions and reduce the tax component of labor costs. Before 1998, employers had to pay a portion of the employees' health contributions (tassa salute), which was equal to 9 percent of the employees' gross salary. By replacing the mandatory health contributions, IRAP is expected to reduce direct labor costs and stimulate the creation of new jobs.

From this perspective, the disallowance of interest and labor expenses in computing IRAP's taxable base derives from the pursuance of specific tax policy goals, rather than from a lack of intent to reach net income.

As devised by the Italian legislature, IRAP should be viewed as a regional tax intended to reach the net value of production derived from activities conducted in a region. [38]

Entities subject to IRAP are partnerships and stock companies, commercial entities, nonresident companies with permanent establishments in Italy,

entrepreneurs, artists and professionals, agricultural producers, and noncommercial entities.

As explained by the Italian minister of finance, IRAP is a tax with a large base intended to approximate the difference between the production value generated in each region and the typical costs thereof. [39] More specifically, the taxable base on which IRAP is imposed depends on the nature of the taxpayer. For example, the IRAP tax base for a manufacturing company generally equals gross revenue from sales in Italy minus cost of goods sold, rent, and depreciation. However, no deduction is allowed for interest and labor expenses. The IRAP's taxable base for a bank or other financial entity generally equals interest and other income received minus interest expenses, rent, and depreciation. Labor costs, however, remain nondeductible. Foreign-source income is excluded from IRAP's taxable base. [40]

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The initial IRAP tax rate is equal to 4.25 percent for manufacturing entities and 5.4 percent for banks. However, two years after IRAP's enactment, the regions will be able to increase the rate of the tax by an amount not exceeding 1 percent.

The text of the IRAP law provides that it should be treated the same as ILOR, which was an income tax creditable for U.S. tax purposes. [41] This unilateral statement by the Italian authorities was not binding on the Internal Revenue Service, which refused to credit IRAP either under section 901 of the code or the U.S.-Italy tax treaty. This was due to the fact that IRAP was not viewed as an income tax in the U.S. sense, because it disallowed recovery of interest and labor costs. [42] In March 1998, the IRS reached a temporary agreement with the Italian authorities for the partial creditability of IRAP against U.S. taxes. [43] This temporary agreement was followed, on November 25, 1998, by the initialing of the new U.S.-Italy income tax treaty, which was signed on August 25, 1999. This will ensure the continued creditability of IRAP until the new treaty and protocol takes effect. [44]

V. Creditability of IRAP Under Section 901

The payment of IRAP is compulsory and based on gross receipts. [45] Thus, IRAP appears to meet the tax, realization, and gross receipts requirements set forth in the regulations. [46] However, since it includes labor and interest costs in computing its taxable base, IRAP does not seem to satisfy the net income requirement of the Treasury regulations. This rigid approach, however, begs the question of whether the regulations provide a test that is too narrow and that does not reconcile either with case law or the congressional design for the credit. [47] A consequence of this narrow construction is the failure to allow the crediting of foreign taxes having the predominant character of an income tax, but that do not fully conform to every requirement of the Treasury regulations. [48] The real

question is what taxes were meant to be creditable under section 901 of the code. Hence, it is first necessary to trace the legislative history and the theoretical justifications for restricting the credit under section 901 to income taxes. Then, an analysis of how the courts constructed the notion of income tax under section 901 will be provided. [49]

When Congress enacted the foreign tax credit in 1918, it did not explain the reasons for restricting the credit to foreign income taxes. [50] The main reason for granting the relief was that American corporations operating abroad were subject to a competitive disadvantage when compared to American corporations with no foreign activities. While U.S. entities operating within the U.S. territory were subject only to U.S. law, U.S. entities with foreign operations were subject both to U.S. and foreign taxation. [51]

Congress considered extending the scope of the foreign tax credit on two separate occasions. The first attempt, in 1942, led to the extension of the foreign tax credit rules to foreign taxes imposed "in lieu of" foreign income taxes. A comment in the 1942 hearings explains that the U.S. notion of an income tax had become more refined than that of many other countries. This situation, accompanied by the insistence on crediting only foreign taxes that [P. 2021] mirrored the U.S. notion of an income tax, was resulting in double taxation, since it excluded the creditability of these less refined foreign taxes. [52] While the concept of a credit for foreign taxes paid "in lieu of" an income tax was now born, Congress did not enunciate a rationale for distinguishing between creditable and noncreditable taxes.

The second occasion occurred in 1954, in conjunction with the recodification of the income tax law. In the House version of the 1954 code, the Treasury proposed that the credit be extended to the "principal" taxes that a taxpayer had to pay to a foreign country. A principal tax was defined as a non-income tax that was the principal burden of the taxpayer in a foreign country. [53] That proposal failed due to the fear that the unintended consequence of the legislation would have been to narrow the types of taxes creditable as income taxes.

While the legislative history does not define the contours of creditable income taxes, the record shows a trend toward expanding, rather than narrowing, the scope of the foreign tax credit.

The next question is why only foreign income taxes should be creditable under section 901 of the code. The main analytical justification for restricting the foreign tax credit to foreign income taxes is based on the notion of tax shifting. Simply stated, this theory is based on the premise that double taxation really occurs only when foreign taxes cannot be passed on by the taxpayer to other persons. This situation usually occurs when the tax is levied on profits that, unlike custom duties or other exercise taxes, cannot be shifted forward in terms of higher prices. Since income taxes normally fall on profits, the foreign tax credit should

be limited to foreign income taxes. [54] While the principle that income taxes cannot be shifted may be true for individuals, economic studies indicate that corporate income tax is in fact shifted. [55] This suggests that there is no definite theoretical justification for restricting the availability of the foreign tax credit to foreign income taxes.

Thus, both the legislative history and the lack of a definite theoretical justification for restricting the foreign tax credit to income taxes seem to warrant a flexible approach to the creditability of foreign taxes that, like IRAP, only partially diverge from the concept of U.S. income tax. This does not mean that any foreign tax should be credited under section 901 irrespective of whether it reaches net income. However, when a foreign tax is substantially similar to an income tax in the U.S. sense, it should be credited under section 901 of the code, rather than through treaty negotiation. In analyzing the judicial construction of income tax under section 901, an important issue is whether a foreign tax should be characterized under the laws of the United States or of the foreign country. In Keen v. Commissioner, [56] the taxpayer was an American citizen temporarily residing in France. Under French law, resident aliens were subject to a tax based on estimated income equal to seven times the rental value of the residence that the resident alien occupied. The taxpayer claimed a credit for the income tax paid to France against income taxes due to the United States. The commissioner took the position that this tax was not an income tax, but rather a property tax and that the taxpayer's payments pursuant to the tax were not creditable. The Board of Tax Appeals rejected the commissioner's claim and held that the French tax was an income tax. The court's reasoning was based on the fact that French law deemed the tax at issue an income tax, and the fact that it was computed differently from U.S. principles did not alter the nature thereof. [57]

The holding of Keen was followed in Havana Elec. Ry., Light & Power Co. v. Commissioner58 and New York & [P. 2022]Honduras Rosario Mining Co. v. Commissioner. [59] In Havana, the taxpayer was a New Jersey corporation that paid a net profit tax to the Municipality and Province of Havana, Cuba. The issue the Board of Tax Appeals faced was whether a Cuban tax based on a percentage net income was an income tax for U.S. tax credit purposes. The government contended that the Cuban tax was not an income tax, but rather a privilege or concession tax. In support of this position, the government relied on expert witnesses on Cuban law and on an opinion of the Havana's Court of Appeals. [60] The taxpayer, on the other hand, argued that the Cuban tax was an income tax and presented evidence of several decisions of the Supreme Court of Cuba contradicting the government's contention. The court held that the weight of the evidence presented by the parties indicated that the tax at issue was an income tax under Cuban law and that it was creditable against U.S. taxes. [61] The court also held that the fact the tax was paid to the Municipality and Province of Havana, rather than to the Cuban central government was irrelevant.

In Honduras Rosario, the taxpayer was a New York corporation engaged in mining operations in the Republic of Honduras. Under the Honduras mining laws, all mining enterprises were required to pay a tax equal to at least 5 percent of their liquid profits. This tax was characterized under Honduras law as an income tax and allowed cost recovery in a manner consistent with U.S. tax principles. [62] Under said provisions, the taxpayer made a contract with Honduras fixing the tax rate at 7 percent and made a nonrefundable advance payment to the Honduras government against which future tax assessments would be charged. The government argued that because the tax was payable in advance and not refundable if the taxpayer stopped operations, it was not an income tax. The court conceded that both the determination of the 7 percent tax rate made by contract and the nonrefundable advance payment were outside the notion of U.S. income tax. The court, however, noted that although the Honduras tax did not fully conform to U.S. tax principles, it was in essence a creditable income tax. [63]

Thus, following the holdings of Keen, Havana, and Honduras Rosario, the fact that IRAP is regarded as an income tax under Italian law would seem a positive factor in establishing its creditability under section 901 of the code. [64]

The line of authority set forth in Keen, Havana, and Honduras Rosario was not followed in Biddle v. Commissioner65 and Keasbey & Mattison Co. v. Rothensies. [66] In Biddle, the issue faced by the Supreme Court was whether a U.S. shareholder of a British corporation was entitled to credit taxes on corporate earnings that were distributed to the shareholder. According to U.K. law, stockholders in British corporations were required to report as income not only the amounts of dividends actually received, but also the portion of taxes paid by the corporation on such distribution. [67] Pursuant to the aforementioned provision, the taxpayer reported to the British authorities as taxable income not only the amount of money actually received as a dividend, but also the tax paid by the corporation on such dividend distribution. The taxpayer claimed these amounts as a credit against her U.S. income tax liability. As a corollary of the taxpayer's claim, it had to be shown that the taxpayer, as opposed to the corporation, had to be regarded as the payer of the [P. 2023]tax. [68] In discussing this issue, the Court noted that the United States law should make the determination of whether a foreign tax was an income tax for foreign tax credit purposes. Thus, the Court denied the credit on the basis that the United States tax laws "afford no scope for saying that the stockholder of a British corporation pays the tax which is laid upon and collected from the corporation." [69]

The principle set forth in Biddle was followed in Keasbey, where a tax under the Quebec Mining Act was held not to be creditable. More specifically, the court decided whether a Quebec tax based on consumption of ore was creditable in the United States. The court noted that although the foreign tax was designated by the Quebec Mining Act as a tax based on profits, it was in reality based on privilege, as opposed to income. This was because the tax at issue was based

on the output of the Quebec mines, and it disallowed deductions incident to certain general costs related to the conduct of the mining business. [70]

Although Biddle and Keasbey provide that labels and classifications created by foreign governments are not controlling in determining whether a foreign tax is an income tax under U.S. tax principles, they are not in conflict with Keen, Havana, and Honduras Rosario. In Biddle, the Court did not disregard British law, but rather it was willing to look at U.K. law to determine whether the payments made to the British authorities could be the substantial equivalent of creditable payments under U.S. law. [71] In addition, as in Keen, Havana, and Honduras Rosario, Biddle and Keasbey recognize the basic principle that a creditable foreign tax need not conform to U.S. law in all details. [72] Thus, it can be argued that under Biddle, Keasbey, Keen, Havana, and Honduras Rosario a foreign tax can be credited under section 901 of the code even if it diverges from the notion of an income tax under U.S. law.

To be creditable under section 901, IRAP must have the predominant character of a U.S. income tax. As mentioned above, the regulations promulgated under section 901 require that the "predominant character" of a foreign tax be that of an income tax in the U.S. sense. [73] The "predominant character test," however, is somehow vague and obscure since the regulations do not provide for a definition thereof. [74]

The issue of when a foreign tax has the predominant character of a U.S. income tax was addressed in Schering Corporation v. Commissioner.75 In Schering, the question faced by the court was whether a Swiss withholding paid pursuant to a settlement between the taxpayer and the commissioner was creditable. The taxpayer was a New Jersey corporation doing business in Switzerland through a wholly owned corporation, Scherico Ltd. (Sherico). Scherico was organized as a Swiss corporation for the purpose of collecting royalties arising from the patents that the taxpayer had transferred to Scherico. The commissioner sought reallocation of the royalties received by Scherico to the taxpayer, which was carried out through the payment of a dividend to the taxpayer. [76] The taxpayer claimed a tax credit for the Swiss tax, which Swiss law characterized as an income tax. The commissioner, conversely, contended that the Swiss tax was not an income tax since it was not levied on income, but rather on repayment of indebtedness.

In rejecting the commissioner's argument, the court noted that "it is the predominant character of a foreign tax which controls its classification for section 901 purposes." [77] The court also noted that in determining the predominant character of a foreign tax, it is not necessary to establish exact congruence between the foreign tax and American law. Thus, the court held that the Swiss withholding tax was creditable. Following Scherico, it seems that IRAP could be viewed as a foreign tax with the predominant character of an income tax

because, but for the recovery of interest and [P. 2024] labor expenses, it meets otherwise all the other tests set forth in the regulations.

To credit IRAP under the section 901 regulations, it is also necessary to overcome the holding of Bank of America v. United States.78 This is because the regulations promulgated under section 901 of the code generally restate the standards of creditability set forth in Bank of America. [79] In Bank of America, the issue faced by the court was whether foreign taxes based on gross income that allowed no cost or expense recovery were income taxes under U.S. tax principles. In this case, the taxpayers claimed a tax credit for taxes paid to the governments of the Philippines, Argentina, and Thailand. These taxes were based on a percentage of the taxpayers' gross income and did not allow any recovery for the expenses incurred in the production of such income. The taxpayers relied on New Colonial Ice Co. v. Helvering80 for the proposition that a tax on gross income falls within the notion of income tax under U.S. principles. The court in Bank of America rejected the taxpayer's claim and noted that, notwithstanding the Supreme Court's statement in New Colonial Ice, Congress had always directed the income tax to reach net gain. Thus, the Bank of America's court concluded that a gross tax is generally not an income tax unless it is very likely or "reasonably intended to reach some net gain in the normal circumstances in which it applies." [81]

The holding of Bank of America, however, can be distinguished on two grounds. First, while the foreign gross taxes in Bank of America did not allow any cost or expense recovery, IRAP, with the exception of labor, interest, and other minor costs, allows recovery of production expenses from its taxable base. [82] Second, Bank of America did not hold that any foreign tax that does not fully conform with U.S. tax principles cannot be credited, but rather that for a foreign tax to be creditable, it must be intended to reach net gain in the normal circumstances in which it operates.

As explained above, the fact that IRAP does not allow interest expenses recovery does not negate its character of tax intended to reach net income. The tax is in fact expected to operate by inducing Italian taxpayers to replace debt financing with equity capital, which allows cost recovery. As for the labor costs recovery disallowance, the Italian Ministry of Finances explains that IRAP's labor costs disallowance has been counterbalanced by a decrease of its tax rate. [83] This means that where the Italian legislator had made IRAP's labor costs deductible, it would have raised IRAP's tax rate accordingly. [84] From this perspective, it appears that IRAP's labor recovery disallowance does not affect its capability of reaching net income since Italian taxpayers would have been subject to the same amount of tax under either of the two aforementioned alternatives. Thus, IRAP seems to reach net gain in the normal circumstances in which it applies and can find shelter in the doctrine of Bank of America.

It seems, therefore, that under the standards of creditability of Schering and Bank of America, IRAP is covered by section 901 of the code.

VI. Creditability of IRAP Under Section 903

The main obstacle to crediting IRAP under the section 903 regulations is that IRAP does not substitute (is not "in lieu of"), but rather entirely replaces ILOR. [85] Thus, to determine whether IRAP [P. 2025]could be credited under section 903, it is necessary to analyze the scope of application of the "in lieu of" requirement contained in the regulations. More specifically, it must be determined whether the "in lieu of" requirement can be interpreted so as to include foreign taxes that entirely replace, as opposed to substitute, a generally applied foreign income tax. [86] Although there are strong policy reasons for applying section 903 in cases in which the foreign tax fully replaces an income tax, [87] neither the scant legislative history of section 903 nor case law seem to support the creditability of a foreign tax in complete replacement of an income tax. [88] In Ingolf Motland v. United States, [89] the court addressed the issue of whether a Cuban export tax was creditable as a tax "in lieu" of an income tax. In that case the plaintiff shareholder received a large dividend on the liquidation of a Cuban corporation. Shortly thereafter, the plaintiff sought to remove the dividend proceeds from Cuba to the United States and paid a 2 percent export tax. In filing its U.S. tax return, the plaintiff claimed a tax credit based on the theory that the Cuban tax was paid "in lieu of" an income tax. In rejecting the plaintiff's claim, the court held that the Cuban export tax was not creditable because it was a not a substitute for an income tax. [90]

In Abbot Laboratories International Company v. United States, [91] the issue was whether a Colombian patrimony tax was creditable as being "in lieu of" an income tax. In Abbot, the plaintiff was a Delaware corporation that, among others, paid a patrimony tax to the Colombian government. The plaintiff claimed a tax credit for the Colombian tax on the basis that the patrimony tax was a foreign tax paid "in lieu of" an income tax. The court rejected the taxpayer's claim and held the Colombian tax was not creditable as a tax "in lieu of" an income tax. The court based its holding on the fact that the tax ran parallel to an income tax otherwise applied in Colombia and, as such, was not "in lieu" thereof. In addition, the court relied on a report of the Senate Committee on section 131(h), [92] which stated that a tax levied on capital without reference to production or sales would not be regarded as a tax "in lieu of" an income tax. [93]

In IBM Corp. v. United States, [94] the Court of Federal Claims analyzed, among other things, whether the Italian tax ILOR, the predecessor of IRAP, was a tax "in lieu of" an income tax under section 903 of the code. In this case, the plaintiff sought a tax credit for an Italian corporate tax (ILOR) paid on certain royalties received by its affiliated corporation, IBM Italy. Under Italian law, IBM Corp. was a nonresident corporation without a permanent establishment in Italy. The plaintiff's claim was based on the fact that ILOR's base, as applied to a

nonresident corporation without a permanent establishment was different from the base of ILOR as applied to statutory corporations.95 More specifically, the plaintiff argued that as applied to a nonresident corporation without a [P. 2026] permanent establishment, ILOR was imposed in substitution for the general ILOR that applied to resident corporations. The court noted that the plaintiff ignored the existence of IRPEG, which is an Italian national income tax applicable to both resident and nonresident corporations. Thus, the court concluded that ILOR failed to qualify as a tax "in lieu of" an income tax because it was not imposed in substitution of IRPEG. [96]

In view of the aforementioned authority, it appears that IRAP would probably fail to qualify as a tax "in lieu of" an income tax under section 903.

VII. Conclusions

The treaty-based tax credit is an important U.S. foreign tax instrument whose coexistence with the statutory foreign tax credit cannot be fully reconciled under U.S. principles. As demonstrated by IRAP, legislative history and case law allow a more flexible interpretation of the statutory tax credit than that provided by the regulations promulgated under section 901 of the code. This flexible interpretation could be accomplished by broadening the scope of the "predominant character test" contained in the regulations. This interpretation would also alleviate the friction between statutory and treaty tax credits by preventing the indiscriminate proliferation of treaty-based tax credits covering foreign taxes that could be credited under statutory law.

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- Italy-U.S. income tax treaty and protocol, signed August 25, 1999. AccServ & Microfiche: Doc 1999-33613 (65 pages, in English); Electronic: 1999 WTD 202-31 (in English)

FOOTNOTES

[1] The author wishes to thank Professor Laurie Malman, NYU School of Law, for editorial suggestions and comments.

[2] The IRS refused to credit IRAP against U.S. income taxes on the basis that it excluded from its taxable base deductions for certain labor and interest expenses.

[3] As will be seen, the main concern arising from the use of treaties to credit foreign taxes is that the ratification of treaties is subject to a lower level of scrutiny by Congress than statutory legislation and that there is no guarantee that the foreign tax policy pursued by the Executive Branch conforms to that of Congress. See Richard L. Doernberg, "Overriding Tax Treaties: The U.S. Perspective," 9 Emory Int'l Law Review, 71, 75 (1995). See also Income Tax Treaties: Hearings Before the Sub Com. on Oversight of The House Comm. on Ways and Means, 96th Cong., 2 Sess. 33-34 (1980) (Statement of David H. Brockway), and Pamela B. Gann, "The Concept of an Independent Treaty Foreign Tax Credit," 38 Tax Law Review, note 72 (1982).

[4] Karen Nelson Moore, "The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal," 7 Am. J. Tax Pol'y 207.

[5] Stanley L. Ruby, "Characterization of an Income Tax for the Purpose of the Foreign Tax Credit," 14 Vand. L. Rev. 1469, 1472.

[6] I.R.C. section 901(b).

[7] I.R.C. section 903.

[8] Since the United States policy is aimed at mitigating double taxation of income earned domestically and abroad, it follows that a credit should be extended to levies in the nature of income taxes. See Stanley L. Ruby, supra note 5, 1473.

[9] Treas. reg. section 1.901-2(a) (2) (i).

[10] Treas. reg. section 1.901-2(b)

[11] Treas. reg. section 1.901-2(b) (2). See also F.W. Woolworth Co. v. U.S., 91 F.2d 974 (2d Cir. 1937), in which a U.K. tax on imputed rental value was not credited because it did not meet the realization requirement under U.S. tax principles.

[12] Treas. reg. section 1.901-2(b) (3).

[13] Treas. reg. section 1.901-2(b) (4).

[14] Treas. reg. section 1.901-2(b) (2) (b) (4) (B).

[15] Treas. reg. section 1.903-1(a).

[16] Treas. reg. section 1.903-1(b). The regulations also specify that the foreign country's purpose for imposing the foreign tax is irrelevant in meeting the substitution for requirement.

[17] As will be seen, IRAP cannot be credited under section 903 as a tax "in lieu of" an income tax because it totally replaces the old local income tax on profits (ILOR).

[18] Pamela Gann, supra note 3 at 1. According to this author, the following early tax treaties clearly do not provide for an independent foreign tax credit: Tax Convention, March 30, 1955, United States-Italy, art. XV(1)(a), 7 U.S.T. 2977, 3011, T.I.A.S. No. 3678; Tax Convention, October 25, 1956, United States-Austria, art. XV(1), 8 U.S.T. 1699, 1708, T.I.A.S. No. 3923; Tax Convention, December 13, 1946, United States-Union of South Africa, art. IV(1), 3 U.S.T. 3821, 3825, T.I.A.S. No. 2510.

[19] Tax Convention, May 7, 1975, United States-Iceland, art. 5(1), 26 U.S.T. 2004, T.I.A.S. No. 8151; Tax Convention, February 12, 1979, United States-Hungary, art. 20(1), 30 U.S.T. 6357, 6380, T.I.A.S. No. 9560, etc. See Pamela Gann, supra note 3 at 7.

[20] Model Income Tax Treaty of May 17, 1977, article 23(1), 1982-1 Tax Treaties (CCH), 153; and Model Income Tax Treaty of June 16, 1981, article 23(1), 1982-1 Tax Treaties (CCH), 158.

[21] Tax Convention, September 26, 1980, United States-Canada, article XXIV(1), 1982-1 Tax Treaties (CCH) P1317G.

[22] See Pamela Gann, supra note 3 at 13.

[23] Tax Convention, March 23, 1939, United States-Sweden, 54 Stat. 1759, T.S. 958, amended by Protocol of March 23, 1939, P6, 54 Stat. 1759, 1774, T.S. 958.

[24] These taxes are not creditable under sections 901 and 903 of the code because they are not income taxes. See Rev. Rul. 78-424, 1978-2 C.B. 197, which denies the possibility of crediting the U.K. tax on oil extraction under sections 901 and 903 of the code.

[25] Tax Convention, November 20, 1975, United States-Israel, art. 26(1), 1982-1 Tax Treaties (CCH) P4229; Tax Convention, August 1, 1977, United States-Morocco, art. 21(1), T.I.A.S. No. 10194.

[26] This election, however, was subject to the condition that any repayment of these loans by the Moroccan or Israeli governments would be treated as a refund of the Moroccan or Israeli tax.

[27] The new U.S.-Italy tax convention, signed on August 25, 1999, has not yet been ratified.

[28] U.S. Constitution, article VI, section 2.

[29] The Cherokee Tobacco, 78 U.S. (11 Wall.) 616 (1870). The Cherokee Tobacco was the first Supreme Court case to hold that a federal statute overrode a prior treaty. See also Whitney v. Robertson, 124 U.S. 190, 195 (1888), and The Head Money Cases, 112 U.S. 580, 599 (1884). It should be noted, however, that under Cook v. United States an act of Congress overrides an inconsistent prior tax treaty only if Congress clearly expressed such an intent. See Cook v. United States, 288, U.S. 102 (1933).

[30] In some instances, the Senate may ratify a treaty subject while making a reservation, which provides that a particular modification or omission be made. In these cases, a treaty will come into force only if it is revised in accord with the reservation. See Richard L. Doernberg, supra note 3 at 75.

[31] Richard L . Doernberg, supra note 3 at 78.

[32] See Income Tax Treaties, supra note 3.

[33] See Pamela B. Gann, supra note 3 at 3.

[34] These new treaty provisions hardly benefit the Italian tax authorities since the amount of U.S. investment in Italy is much higher than the investments of Italians in the United States.

[35] Perhaps the United States could follow the example of Germany, France, Italy, and the Netherlands, and eliminate this conflict by making treaty provisions superior to statutory law. Another solution would be to require the concurrence of the House of Representatives in the treaty ratification process.

[36] See OECD Economic Surveys-Italy, December, 1998, available on Lexis-Nexus.

[37] Id. at 35-36.

[38] Lorenzo Piccardi and Stefania Trezzini, "Major Reform Around the Corner for Reorganizations and Taxation of Italian Entities and Nonresidents on Profits Realized in Italy," 8 J. Int'l Tax N. 7, 19-20.

[39] See Piergiorgio Valente and Paul Smith, "1997 Italian Tax Reform: Dual Income Tax System and Regional Tax on Productive Activities from a U.S. Perspective," 8 J. Int'l Tax N. 514, 8.

[40] Guglielmo Maisto, "Italy Introduces Regional Tax on Productive Activities," Tax Notes Int'l, Mar. 31, 1997, p. 1029, or 97 TNI 61-28, or Doc 97-9005 (7 pages).

[41] See IBM v. United States, 38 Fed. Cl. 661, 678 (1997), in which the Court of Claims held that ILOR is an income tax under section 901 of the Internal Revenue Code. Under articles 2 and 23(2) of the current U.S.-Italy treaty, ILOR is a creditable income tax. See Constance M. McCarthy, "Court of Claims Ruling on Creditability of Italian Corporate Tax," International Bureau of Fiscal Documentation, Vol. 38 - 1998 No. 3.

[42] Albertina M. Fernandez, Tax Notes Int'l, Dec. 7, 1998, p. 1757, or 98 TNI 234-8, or Doc 98-35628 (2 pages).

[43] The taxable base for IRAP purposes disallows most labor and interest expenses. Under the mutual agreement, the creditable portion of IRAP is calculated as follows:

Amount Creditable = Applicable Ratio X Total Amount of IRAP

The Applicable Ratio is given by:

IRAP Base Minus Labor and Interest

Expenses Not Already Deducted

Total IRAP Base

See IR-INT-98-6, March 31, 1998, and Jennifer Gann and Robert Tharaeparmbil, Tax Notes Int'l, May 3, 1999, p. 1743, or 1999 WTD 82- 3, or Doc 1999-15518 (4 original pages).

[44] U.S. Department of Treasury, "U.S., Italy Initial New Income Tax Treaty," Tax Notes Int'l, Dec. 7, 1998, p. 1780, or 98 TNI 232-18, or Doc 98-34928 (1 page).

[45] See Lorenzo Piccardi, supra note 38.

[46] Paul A. Smith and Piergiorgio Valente, "Italian Tax Reform: Eligibility of New Taxes for U.S. Foreign Tax Credit," Tax Notes Int'l, Dec. 1, 1997, p. 1793, or 97 TNI 230-36, or Doc 97-32344 (17 pages).

[47] See Glenn E. Coven, "International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes," 4 Fla. Tax Rev. 83, 85 (1999). According to this author U.S. administrative rules and procedures have over the years resulted in the adoption of an overly narrow scope of the foreign tax credit that is not supported by statutory authority and perhaps in conflict with the congressional intent for the credit. For a more radical approach, see Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes," 39 Tax L. Rev.

227 (1984). According to this commentator, there is no reason for granting foreign tax credit only to foreign levies that qualify as income taxes and the credit should be allowed for all foreign taxes.

[48] See Glenn E. Coven, supra note 47. Failure to credit foreign taxes that do not fully conform to the notion of income tax in the U.S. sense is considered by this author as the most serious deficiency in the U.S. tax credit mechanism.

[49] The judicial construction of income tax is of fundamental importance for understanding which foreign taxes constitute an income tax for tax credit purposes, given that neither the code nor the legislative history of the tax credit provide a definition of income tax. See Stanley L. Ruby, supra note 5, 1473.

[50] See Karen Nelson Moore, supra note 4, 211.

[51] Stanley Surrey, "The United States Taxation of Foreign Income," 1 J. Law & Economics, 72-74 (1958).

[52] Revenue Revision of 1942: Hearings on H.R. 7378 before the House Comm. on Ways and Means, 77th Cong., 2d Sess. 577 (1942) (statement of Mitchell Carroll, National Foreign Trade Council, Inc.).

[53] See Stanley L. Ruby, supra note 5, at 1484.

[54] For a more detailed explanation of the economic implications of the tax-shifting theory, see R & P Musgrave, Public Finance in Theory and Practice 249-52 (1984).

[55] M. Krzyzaniak & R. Musgrave, The Shifting of the Corporation Income Tax, 46-49 (1963). According to these authors, the corporate income tax is completely passed on to consumers in the short term.

[56] 15 T.B.A. 1243 (1929)

[57] 15 T.B.A., supra 1245.

[58] 168 F. 2d 745 (2d Cir. 1948). See also Helvering v. Campbell, 139 F. 2d 865 (4th Cir. 1944). In Helvering, in computing the taxpayer's net income, while certain items were excluded under U.S. law, they were allowed under Philippine law. The court noted that there was no statutory authority for denying the credit and held that the Philippine tax was fully creditable.

[59] 34 B.T.A. 782 (1936).

[60] 34 B.T.A. supra at 787.

[61] 34 B.T.A. supra at 789-790. Although it declared that the characterization of the tax under Cuban law was not controlling, most of the court's attention was devoted to the classification of the tax under Cuban law.

[62] Honduras Rosario, supra note 57 at 748.

[63] Honduras Rosario, supra note 57 at 748, 749. The court was particularly concerned with the tax policy issues underlying the tax credit mechanism and stated that denying the creditability of the Honduras tax would have meant defying the purpose of the tax credit "which was to encourage statutory corporations to do business abroad without having to operate through a foreign corporation..."

[64] As explained before, the Italian authorities expressly declared that IRAP should be regarded as an income tax.

[65] 302 U.S. 573 (1938).

[66] 133 F.2d 894 (3d Cir. 1942).

[67] While the U.S. system adopted a "classical system" of taxation, which subjects income to tax both at the corporate and shareholder levels, the United Kingdom uses an "integrated" system, which taxes corporate income only once, even if distributed to the shareholders. See Philip R. West, "Foreign Law in U.S. International Taxation: The Search for Standards," 3 Fla. Tax Rev. 147, note 20 (1996).

[68] See Biddle, supra note 65 at 581. This controversial outcome lasted for eight years, when it was overruled by the U.S.- U.K. treaty. See Glenn E. Coven, supra note 32, at 98 (note 39).

[69] Biddle, supra note 65 at 579. The holding of the Supreme Court in Biddle was compatible with Keen because the concept of income tax was not narrow and provincial, but rather broad and generalized. See Glenn E. Coven, supra note 32 at 99.

[70] Keasbey, supra note 66 at 898. In disallowing the credit, the court also noted that a foreign tax, to be creditable, had to be based on realized net income.

[71] Philip R. West, supra note 67 at 154.

[72] Glenn E. Coven, supra note 47 at 99.

[73] Treas. reg. section 1.901-2(b) (1).

[74] See D.K. Doland and C.M. DuPuy, supra note 14 at 901.

[75] Schering Corp. v. Commissioner, 69 T.C. 579 (1978).

[76] The reallocation of Schering's royalties was made under a settlement agreement between the commissioner and the taxpayer. See Schering, supra note 75 at 581-582.

[77] Schering, supra note 75 at 592.

[78] 459 F. 2d 513 (Ct. Cl. 1972).

[79] D.K. Dolan and C.M. DuPuy, supra note 14 at A-20.

[80] 292 U.S. 435, 54 S.Ct. 788 (1934). In New Colonial Ice, the question presented to the Supreme Court was whether a new corporation that takes over the assets of an older corporation is entitled to deduct from its net income the net losses sustained by the older corporation. In denying the deductibility of these net losses, the Court stated that the power to tax income extends to gross income and that deductions can be made only when allowed by the legislator.

[81] Bank of America, supra note 78 at 519-520. This view was supported 10 years later in Inland Steel Co. v. United States, 677 F.2d 72 (Ct. Cl. 1982). In Inland Steel, the Claims Court found that an Ontario Tax was not creditable, because it disallowed deductions of significant costs, such as interests, depletion of natural resources, royalty payments, and certain capital expenditures.

[82] While manufacturing companies cannot deduct interest and labor costs from IRAP's taxable base, banks and other financial institutions are allowed to deduct interest expenses.

[83] Available on the worldwide web at http://www.finanze.it/internet/prodedit/notfisca/speciale/irap_tst.htm

[84] It is not clear how the Italian authorities would have accomplished this objective. A solution could have been to make IRAP's marginal rate subordinate to the amount of labor deductions.

[85] Under section 903 regulations, a foreign tax is "in lieu of" an income tax if it substitutes, rather than replaces an income tax otherwise generally imposed by a foreign country.

[86] See Glenn E. Coven, supra note 47 at 118-119. According to this author a foreign tax should be creditable if it generates revenues that could have been generated by an income tax.

[87] The "in lieu" requirement as currently interpreted by the IRS largely disadvantages special industries, such as mining and finance, that are subject to special tax regimes and are outside the scope of the general income tax. Similarly, in cases in which a country completely repeals an income tax and adopts some substitute form of taxation, section 903 would not guarantee relief from double taxation. See Glenn E. Coven, supra note 47 at 119.

[88] The only legislative attempt to expand the notion of "in lieu of" was made at the 1942 hearings related to the enactment of section 903. During those hearings, one commentator suggested that Congress allow credit for foreign taxes that not only substitute, but also add to a net income tax. However, Congress did not follow this suggestion. See Karen Nelson Moore, supra note 4, at 229. A number of cases decided under section 903 address the issue of whether a foreign tax not based on net income should be "in lieu of" an income tax. See Northwestern Mutual Fire Assurance v. Commissioner, 181 F.2d 133 (9th Cir. 1950), in which the court held that a Canadian tax based on gross sales was a tax in lieu of an income tax; Compania Embotelladora Coca-Cola, S.A. v. United States, 139 F. Supp. 953 (Ct. Cl. 1956), in which a Cuban production tax imposed in lieu of a tax on profits qualified for credit since it replaced an income tax; Equitable Life Assurance Soc'y of The United States v. United States, 366 F. 2d 967 (Ct. Cl. 1966), in which the court held that the Canadian insurance premium tax was in lieu of a general corporate income tax, even if this latter was enacted after the insurance premium tax.

[89] 192 F. Supp. 358 (N.D. Iowa 1961).

[90] Ingolf Motland, supra note 87, at 363.

[91] 160 F. Supp. 321 (N.D. Ill. 1958).

[92] Section 131(h) of the Internal Revenue Code of 1939 was the precursor of section 903 of the current Internal Revenue Code.

[93] Abbot Laboratories, supra note 91, at 23.

[94] 80 AFTR2d Par. 97-5205; No.95-828T (August 8, 1997).

[95] While nonresident corporations without permanent establishment computed ILOR on gross income, statutory corporations computed ILOR on net income.

[96] IBM Corp., supra note 94, at 681.

END OF FOOTNOTES