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Taxes Covered by §960(a)(3)

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The Internal Revenue Code is liberally sprinkled with provisions which, like medieval fiefdoms, operate according to laws peculiar to them. On occasion, it is necessary -- sometimes crucial -- to look closely at one of these provisions in an effort to understand its details and perhaps even the principles it reflects. This article focuses on one such provision, §960(a)(3).[3]

The section is labeled "Taxes Paid by Foreign Corporation and Not Previously Deemed Paid by Domestic Corporation" and it applies, in general, to allow deemed-paid credits for certain foreign taxes paid with respect to earnings and profits previously taxed -- that is, previous to their distribution -- and therefore excluded from gross income upon their distribution pursuant to §959(a). The section reads, in its entirety, as follows:

Any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income under section 959(a) shall be treated by the domestic corporation as a dividend, solely for purposes of taking into account under section 902 any income, war profits, or excess profits taxes paid 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 distribution is made, which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year.

There are some mysterious aspects of §960(a)(3): it fails to mention distributions from lower-tier foreign corporations;[4] it is operational not when foreign taxes are paid or might first be viewed as deemed paid but only when a domestic corporation has actually received a distribution of previously taxed income;[5] and it appears to operate independently of the pools of post-1986 earnings and taxes established in §902. But what is most mysterious, and the focus of this article, is the absence of any indication in either the statute or the oblique regulations that interpret it of precisely which are the taxes to which the Code is referring. Although the language of the section seems clear, there are at least four different candidates for the types of taxes to which §960(a)(3) applies. This article identifies those candidates and the support, sometimes tenuous, that each finds in existing authorities.

Pursuant to §951(a), some or all of the earnings and profits of a controlled foreign corporation ("CFC") (as defined in §957(a)) may be included in the gross income of the CFC's U.S. shareholders (as defined in §951(b)) that own stock in the CFC within the meaning of §958(a). Pursuant to §960(a)(1), a U.S. shareholder that is a domestic corporation may, for purposes of §902, treat any such inclusion as though it were a dividend to the U.S. shareholder, thus possibly making deemed-paid credits available with respect to the inclusion.[6] Pursuant to §960(a)(2), when there is an actual distribution to that shareholder (or a successor) of value attributable to the amount included in income under §951(a) (the "previously taxed income"), any taxes that were deemed paid under §960(a)(1) at the time of the inclusion cannot again be deemed paid under §902 at the time of the actual distribution. Section 960(a)(3) provides, however, that when value treated as previously taxed income is distributed to a domestic corporate shareholder, deemed-paid credits are allowed for certain taxes imposed with respect to that value, provided those taxes were not previously deemed paid under §960(a)(1).

POSSIBLE INTERPRETATIONS

The narrowest view of §960(a)(3) is that it applies only to taxes imposed on an upper-tier foreign corporation with respect to previously taxed income received from a lower-tier foreign corporation ("upper-tier taxes").[7] Under this view, §960(a)(3) does not apply to any taxes imposed on a foreign corporation with respect to previously taxed income to which it gave rise (rather than received from a lower-tier foreign corporation). For example, if a CFC distributes its own previously taxed income and incurs a tax with respect to that distribution, such as a tax similar to the former U.K. Advance Corporation Tax ("ACT"), §960(a)(3) would not apply to that tax under this view of the statute. Similarly, if a CFC is treated by a foreign country as a branch of another foreign corporation and the foreign country imposes a branch profits tax when the CFC distributes its own previously taxed income, this view would find §960(a)(3) inapplicable to the branch profits tax because, from the U.S. point of view, the tax is imposed on the CFC that gave rise to the previously taxed income.[8]

A slightly broader view of §960(a)(3) is that it applies to upper-tier taxes and, in the case of the foreign corporation that gave rise to the previously taxed income, to taxes imposed with respect to the *distribution* of that previously taxed income *after* the year of inclusion of that income under §951(a). (Such taxes (including upper-tier taxes) are hereinafter referred to as "distribution taxes.") Under this view, §960(a)(3) would apply to the taxes in the examples in the preceding paragraph, assuming the distribution in each example occurred *after* the year of inclusion under §951(a). However, §960(a)(3) would apply only to taxes imposed with respect to a distribution. Thus, if a CFC has a branch office that gave rise to previously taxed income and the CFC incurs a branch profits tax when that previously taxed income is remitted to the head office of the CFC, §960(a)(3) would not (under this view) apply to that branch profits tax because the previously taxed income has simply been transferred from one branch to another and has not been distributed by the CFC. Similarly, if a CFC has a branch office that is treated as a separate taxable entity by the foreign country in which the branch is located, and that foreign country imposes a withholding tax when, from the U.S. point of view, there is a remittance of previously taxed income from the branch office to the head office of the CFC, §960(a)(3) would not apply to that tax because, for U.S. tax purposes, the previously taxed income has not been distributed by the CFC. The same is true if the foreign country in which the head office is located treats the head office as a separate taxable entity and imposes a direct tax on the remittance from the branch office (which, in that country's view, is viewed as a distribution from a separate taxable entity).

An even broader view of §960(a)(3) is that it applies to upper-tier taxes and, in the case of the foreign corporation that gave rise to the previously taxed income, to *any* taxes imposed with respect to that previously taxed income *after* the year of inclusion of that income under §951(a). (Such taxes (including upper-tier taxes) are hereinafter referred to as "post-year-of-inclusion taxes." [9]) Under this view, §960(a)(3) would apply to the taxes in the examples in the preceding paragraph, assuming the taxes in each example are imposed *after* the year of inclusion under §951(a). However, §960(a)(3) would *not* apply to any taxes that are imposed *before or during* the year of inclusion under §951(a).

For example, under this view, §960(a)(3) would not apply in the following situation: A domestic corporate shareholder owns directly less than 10% of a first-tier CFC's voting stock at the time of an inclusion under §951(a), and thus is not entitled to deemed-paid credits under §960(a)(1).[10] In a later year, an actual distribution of the previously taxed income occurs. At that time, the shareholder owns directly at least 10% of the CFC's stock and, thus, if the distribution were not a distribution of previously taxed income, the shareholder would be entitled to deemed-paid credits under §902. However, because the distribution is a distribution of previously taxed income, the shareholder is entitled to deemed-paid credits only if §960(a)(3) applies. Under this third view, §960(a)(3) would not apply because the taxes in question were incurred *in the year of* the inclusion.

Similarly, §960(a)(3) would not apply under this third view in a situation in which a first-tier CFC did not possess the requisite ownership percentage in a second-tier CFC for purposes of §960(a)(1) but did for purposes of §902. Such a situation could have arisen during the 1971-1976 period, in which the requirements for deemed-paid credits under §960(a)(1) were tighter than those for deemed-paid credits under §902.[11] If an inclusion under §951(a) is required with respect to the second-tier CFC and then, in the same or a later year, a distribution of that previously taxed income to the first-tier CFC and then to the domestic corporate shareholder occurs, under this view, the domestic corporate shareholder would not be deemed to have paid the taxes actually paid by the second-tier CFC at the time the previously taxed income was earned because the taxes were incurred in the year of the inclusion.

Similarly, §960(a)(3) would not apply under this third view to taxes paid by a CFC with respect to exempt export trade income at the time the income was earned. Pursuant to §805(b) and (c) of the Deficit Reduction Act of 1984,[12] a CFC that was an export trade corporation (within the meaning of §971) may treat its export trade income earned prior to January 1, 1985, as exempt income. Regs. §1.921-1T(c)(1) implies such income is treated as previously taxed income for purposes of §959, and therefore is deemed to have been included in income under §951(a) in the year in which it was earned. Thus, if a CFC has exempt export trade income for a particular year and then distributes that income to a domestic corporate shareholder, under this view, the domestic corporate shareholder would not be deemed to have paid the taxes actually paid by the CFC at the time the exempt export trade income was earned because the taxes were incurred in the year of the deemed inclusion.

The broadest view of §960(a)(3) is that it applies to *any* taxes imposed on a foreign corporation with respect to previously taxed income (whether before, during, or after the year of inclusion under §951(a)), as long as the taxes were not previously deemed paid under §960(a)(1).[13] Under this view, §960(a)(3) would apply to the taxes in all of the examples in the preceding paragraphs: the section would allow deemed-paid credits for all taxes not previously deemed paid under §960(a)(1) and for which deemed-paid credits would have been allowed under §902 had Subpart F never been enacted.

Various authorities and the light they shed on the validity of these four views are discussed below.

PRINCIPAL GUIDANCE

The Language of the Statute

Section 960(a)(3) applies to "any ... taxes paid ... with respect to the accumulated profits ... from which such distribution is made, which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year." With respect to a distribution of previously taxed income from the foreign corporation that gave rise to the income, the phrase "taxes paid ... with respect to the accumulated profits ... from which such distribution is made" would seem to include taxes paid by the foreign corporation with respect to the amount included in income under §951(a), whether paid before, during, or after the year of inclusion under §951(a). With respect to a distribution by an upper-tier foreign corporation of previously taxed income received from a lower-tier foreign corporation, the phrase includes taxes paid by the upper-tier foreign corporation with respect to the previously taxed income because a distribution of that previously taxed income by the upper-tier corporation is necessarily out of its own accumulated profits and those profits have borne the taxes paid by the upper-tier corporation with respect to the previously taxed income. Thus, on its plain language, §960(a)(3) applies to *any* taxes paid with respect to an amount included in income under §951(a) and not previously deemed paid under §960(a)(1). The plain language of the statute supports the fourth and broadest view.

This view also receives support from the fact that §960(a)(3) complements §960(a)(2). Section 960(a)(2) provides that a domestic corporation that receives a distribution of previously taxed income is *not* deemed to have paid the taxes that were paid by a foreign corporation with respect to that previously taxed income "to the extent such taxes were deemed paid by a domestic corporation under paragraph (1) for any prior taxable year." [14] Section 960(a)(3), on the other hand, provides that a domestic corporation that receives a distribution of previously taxed income *is* deemed to have paid taxes that were paid by a foreign corporation with respect to that income and "which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year." The implication is that §960(a)(3) applies to *any* taxes that were not previously deemed paid under §960(a)(1).

The Legislative History

The legislative history of §960(a)(3) contains *no* support for the narrowest view, that §960(a)(3) applies only to upper-tier taxes. However, there is some support for the slightly broader view that the section applies to distribution taxes. Support also exists in the legislative history for the broader view that the section applies to post-year-of-inclusion taxes. Finally, some support is provided, although not as strong as for the post-year-of-inclusion view, for the broadest view that §960(a)(3) applies to *any* taxes imposed on a foreign corporation with respect to an amount included in income under §951(a) and not previously deemed paid under §960(a)(1).

Section 960(a)(3) was enacted by §12(a) of the Revenue Act of 1962.[15] That Act was based on a proposal that had been presented in 1961 by President Kennedy and the Department of the Treasury. In a document entitled, "Detailed Explanation of the President's Recommendations Contained in His Message on Taxation, Submitted by Secretary of the Treasury Dillon in connection with the Hearings before the Committee on Ways and Means, House of Representatives, May 3, 1961," hereinafter referred to as "Recommendations," the following explanation is given of a provision in that proposal that was the precursor of §960:

Provision would be made to assure as closely as possible that foreign tax credits would be allowed to the same extent as if the controlled foreign corporation had actually distributed its earnings and profits. Thus, where an American shareholder includes in income a deemed dividend from a controlled foreign corporation a credit would be allowed against the U.S. tax for the foreign taxes imposed on the profits out of which the distribution is deemed to have been made. This credit would be allowed only to corporations which are entitled to the indirect credit under present law. When the controlled foreign corporation makes an actual distribution from profits which have been taxed to the shareholder in a prior year, the dividend is included in gross income and credits are allowed for the U.S. tax previously paid and the amount of foreign taxes previously credited. *Any additional taxes imposed by a foreign country on the dividend in the year of actual distribution, for example, through income tax withholding on the shareholder, would be taken into account for tax credit purposes.* In general this would mean that a refund would be made of U.S. tax previously collected, to the extent that the withholding tax would have been creditable had it been imposed at the time of the deemed distribution.[16]

This language does not explicitly state that *only* distribution taxes would be taken into account, but such taxes seem to have been what the Department of the Treasury had in mind.

Later in 1961 the Committee on Ways and Means prepared a draft bill that contained much of what President Kennedy had proposed, but did not contain the President's proposed tax haven legislation. In connection with this draft bill, the Joint Committee on Taxation prepared for the Committee on Ways and Means a document entitled "General Explanation of Committee Discussion Draft of Revenue Bill of 1961," dated August 24, 1961 (printed September 29, 1961). Appendix A of that document, entitled "Tentative Treasury Draft of Its Proposed Tax Haven Legislation," hereinafter referred to as "Appendix A," set forth an explanation by the staff of the Joint Committee on Taxation of the Treasury's draft tax haven legislation. The following comment is made with respect to the provision in the draft legislation that was the precursor of §960:

Provision is made for the allowance of the foreign tax credit with respect to taxes which were paid by the controlled foreign corporation at the time the undistributed tax haven profits were taxed to the U.S. shareholder. Any foreign taxes subsequently paid with respect to these profits are allowed as a credit under the Treasury draft against U.S. taxes in the year of the actual distribution.[17]

This explanation suggests that §960(a)(3) should apply more broadly, to post-year-of-inclusion taxes and not simply to distribution taxes.

On March 16, 1962, the Committee on Ways and Means reported out its version of the Revenue Act of 1962. On the same date, it also issued its report on the bill,[18] which included a Technical Explanation as an Appendix. Language in the report and Appendix bears on the meaning of §960(a)(3).[19] This language is in large part identical to the relevant language in the Senate report,[20] issued on August 16, 1962, when the Committee on Finance reported out its version of the Revenue Act of 1962. The report of the Finance Committee also included a Technical Explanation at the end.

The language in the main body of the Finance Committee report bearing on §960(a)(3) is as follows:

a. *Foreign tax credit*.--U.S. shareholders who are taxed on subpart F income, on a decrease in investments in less developed countries, or on the increase of earnings invested in U.S. property, can obtain a foreign tax credit for foreign income, etc., taxes paid by the foreign corporation, if the shareholder is a person to whom such a foreign credit would be allowed in the case of an actual distribution.... Taxes so allowed as credits will not again be allowed as credits when actual distributions are made.

Where the foreign country imposes a tax directly on dividend distributions, such a tax would not, of course, initially be taken into account when the shareholder at an earlier date was taxed on undistributed earnings of a controlled foreign corporation. These taxes on actual dividend payments, however, will be allowed as credits in the year in which the actual dividends are paid, even though these dividends are not taxable to the domestic corporation receiving them because of an earlier inclusion by it of these amounts in its income.[21]

Although this language does not explicitly state that *only* distribution taxes would be taken into account, such taxes were clearly the focus of the Committee on Finance (and the Committee on Ways and Means).

The Technical Explanation at the end of S. Rep. No. 1881, however, provides a broader view of the scope of §960(a)(3):

(a) *Taxes paid by a foreign corporation*.--Subsection (a) [of new section 960] applies to a domestic corporation which includes in gross income under section 951(a) an amount attributable to earnings and profits of a foreign corporation at least 10 percent of the voting stock of which is directly owned by such domestic corporation, or of a foreign corporation at least 50 percent of the voting stock of which is owned by a foreign corporation at least 10 percent of the voting stock of which in turn is directly owned by the domestic corporation.

If a domestic corporation receives a distribution any part of which is excluded from gross income under section 959, the foreign taxes which are deemed to have been paid under section 960(a) are not again deemed paid under section 902. *Other foreign taxes which are not deemed paid under section 960* because paid, for instance, by a first-tier corporation, through which profits of a second-tier corporation are distributed (after having been taxed for a prior year under section 951 to a United States shareholder which is a corporation), will still be deemed paid under section 902 when an actual distribution is made. A distribution of such profits, although excluded under section 959(a), is treated by the domestic corporation as a dividend solely for taking into account under section 902 *such foreign taxes as were not deemed paid under section 960*.

(b) *Special rules for foreign tax credit on receipt of previously taxed earnings and profits*.--Where a taxpayer receives a distribution which is excluded from income under section 959 because it was once taxed as income included in gross income of a United States shareholder under section 951(a), the section 904 limitation is increased in the year of actual distribution so that a credit will be allowed *for foreign taxes imposed on the income distributed after it was included in gross income under section 951*.[22]

The first two italicized phrases, taken literally, indicate that §960(a)(3) applies to any taxes not previously deemed paid under §960(a)(1); thus, the Technical Explanation clearly supports the broadest view. However, in the example given after the first italicized phrase, it is suggested (through the phrase "for a prior year" in the parenthetical) that the taxes subject to §960(a)(3) are those imposed *after* the year of inclusion of the income under §951.[23] This thought is reflected again in the last italicized phrase, in which it is explicitly stated that a credit will be allowed under §960(a)(3) for taxes imposed *after* the income was included in income under §951. This last italicized phrase is not limited to taxes imposed with respect to distributions and thus supports the view that §960(a)(3) applies to post-year-of-inclusion taxes.

In conclusion, the legislative history is murky, and one finds support for three views of the scope of §960(a)(3), *i.e.*, that it applies to: (1) distribution taxes; (2) post-year-of-inclusion taxes; and (3) *any* taxes not previously deemed paid under §960(a)(1). One does *not* find support for the narrowest view, *i.e.*, that §960(a)(3) applies only to upper-tier taxes. Overall, the legislative history might fairly be considered to support the view that §960(a)(3) applies to post-year-of-inclusion taxes. Of course, the broadest view still has the advantage of the plain language of the statute.

The Regulations

All of the examples in the §960 regulations that illustrate the operation of §960(a)(3) involve upper-tier taxes. *See* Regs. §1.960-1(c)(4), *Ex. (4)*; Regs. §1.960-2(f), *Exs. (2), (4), (5), (7), (8), (9),* and *(10)*; Regs. §1.960-3(c), *Exs. (1)* and *(2)*; and Regs. §1.960-4(f), *Ex. (3)*. However, no explicit rule is provided in the regulations that limits the scope of §960(a)(3) to upper-tier taxes. In fact, the regulations do not even mention §960(a)(3) and provide no guidance as to its scope.

It might be argued that the rules of Regs. §1.960-2 do in fact limit the scope of §960(a)(3) to upper-tier taxes. Regs. §1.960-2, entitled "Interrelation of section 902 and section 960 when dividends are paid by third-, second-, or first-tier corporation," focuses in part on the computation of deemed-paid credits when earnings and profits, whether previously taxed or not, are distributed from one foreign corporation to another foreign corporation or to a domestic corporation. The formulas for such computation found in §1.960-2(g)(1) do allow deemed-paid credits for taxes paid by an upper-tier foreign corporation with respect to previously taxed income received from a lower-tier foreign corporation. However, those formulas do not allow deemed-paid credits for taxes paid by a foreign corporation with respect to *its own* previously taxed income.

For example, in the case of a distribution from a first-tier foreign corporation to a domestic corporation, Regs. §1.960-2(g)(1)(iii)(A)(*1*) provides in part as follows:

...If the domestic corporation receives a dividend from a first-tier corporation attributable in whole or in part to amounts included in a domestic corporation's gross income under section 951 with respect to the first- or lower-tier corporations, the domestic corporation's credit for taxes paid and deemed paid by the first-tier corporation under section 902(a) is determined as follows:

((Dividend to domestic corporation less portion of dividend from earnings included in domestic corporation's gross income under section 951 with respect to first-tier corporation)/(Earnings and profits of first-tier corporation)) × (Taxes paid by first-tier corporation).

Thus, if a distribution is made from a first-tier foreign corporation to a domestic corporation out of the foreign corporation's own previously taxed income, the distribution is "from earnings included in domestic corporation's gross income under section 951 with respect to first-tier corporation," and therefore the numerator of the fraction is zero. Therefore, the amount of the fraction is zero and, under the formula, no deemed-paid credits are allowed with respect to the distribution, *even if* the first-tier foreign corporation has paid taxes with respect to the previously taxed income that were not previously deemed paid under §960(a)(1). Thus, it might be concluded that Regs. §1.960-2 views §960(a)(3) as applying only to upper-tier taxes.

However, a strong rebuttal can be made that the formula in Regs. §1.960-2(g)(1)(iii)(A)(*1*) produces this result because the formula assumes that all taxes paid with respect to the first-tier foreign corporation's previously taxed income have already been deemed paid by the domestic corporation under §960(a)(1). In fact, it appears that the formula was not even intended to apply to a distribution by a first-tier corporation of its own previously taxed income to a domestic corporation. Regs. §1.960-2(c) states that §902(a), *i.e., the rules of §1.960-2 implementing §902(a)*, shall apply to all dividends received by a domestic corporation from a first-tier foreign corporation "other than dividends attributable to earnings and profits of such first-tier corporation in respect of which an amount is, or has been, included in the gross income of a domestic corporation under section 951 with respect to such first-tier corporation." A similar statement is made in Regs. §1.960-2(b) with respect to distributions from lower-tier foreign corporations. Thus, in the case of a distribution described in the quoted language, the formula in Regs. §1.960-2(g)(1)(iii)(A)(*1*) does not apply.

The regulations under §960 do not specifically address the situation in which a first-tier foreign corporation has paid taxes with respect to its own previously taxed income that have not been deemed paid by the domestic corporation under §960(a)(1). However, nothing appears in the regulations under §960 that would preclude the application of §960(a)(3) to permit such taxes to be deemed paid when the previously taxed income is distributed to the domestic corporation. In fact, the last sentence of Regs. §1.960-2(a) provides,

In making determinations under this section, any portion of a distribution received from a first-tier corporation by the domestic corporation which is excluded from the domestic corporation's gross income under section 959(a) and §1.959-1 ... shall be treated as a dividend for purposes of taking into account under section 902 any foreign income taxes ... which are not deemed paid by the domestic corporation under section 960(a)(1) and §1.960-1.[24]

Although this sentence appears to be somewhat in conflict with Regs. §1.960-2(c), cited earlier,[25] the apparent intent is that, in the situation in which a first-tier foreign corporation has paid taxes with respect to its own previously taxed income that have not been previously deemed paid by the domestic corporation under §960(a)(1), the domestic corporation is deemed to have paid those taxes when it receives a distribution of that previously taxed income. The same is true with respect to a distribution by a lower-tier foreign corporation of its own previously taxed income. Thus, it must be concluded that Regs. §1.960-2 does not limit the scope of §960(a)(3) to upper-tier taxes.[26] This interpretation is not only permitted by the text of the regulation, but also, as discussed earlier, it is required by the plain language of §960(a)(3), which clearly permits deemed-paid credits for taxes paid by a foreign corporation with respect to its own previously taxed income when those taxes were not previously deemed paid under §960(a)(1).

The regulations under §959 explicitly mention §960(a)(3) in Regs. §1.959-4, but provide no guidance as to the scope of that section. The regulations under §959 provide one example illustrating the operation of §960(a)(3)[27] but, like the examples in the §960 regulations, it involves upper-tier taxes. Regs. §1.904-6(c), *Ex. (8)* refers to §960(a)(3) three times in line 15 and two times in the summary, but that example also involves upper-tier taxes.

Regs. §1.907(c)-3(b)(1)(iii), which addresses FOGEI taxes deemed paid with respect to dividends, contains a cross-reference to §960(a)(3) relating to "distributions that are treated as dividends for purposes of §902." Without explicitly mentioning §960(a)(3), Regs. §1.907(c)-3(e), *Ex. (2)* illustrates the operation of that provision, but again, only upper-tier taxes are involved. Regs. §1.961-2(d), *Ex. (1)* also involves upper-tier taxes but focuses on basis adjustments under §961 rather than the operation of §960(a)(3).

Although all of these examples illustrate the application of §960(a)(3) in a case involving upper-tier taxes, nothing in the regulations specifically limits the operation of §960(a)(3) to such taxes. In short, nothing in the regulations is inconsistent with the language of §960(a)(3).

The Case Law

No cases consider the scope of §960(a)(3).

OTHER GUIDANCE

Other Guidance Issued by the Internal Revenue Service

The Internal Revenue Service has republished the Revenue Act of 1962 and its legislative history at 1962-3 C.B. 111 and 402, respectively. It also set forth its own "digest" of the Act at 1962-3 C.B. 15. With respect to §960(a)(3) and §960(b) the IRS stated, "Rules are also provided ... to increase the section 904 limitation in the year of actual distributions so that a credit will be allowed for foreign taxes imposed on the income distributed after it was included in gross income under section 951." [28] Thus, the IRS adopts here the view that §960(a)(3) applies to post-year-of-inclusion taxes. However, the quoted language simply tracks language in the Senate Finance Committee report, discussed above. Consequently, no further authority is added by this language.

In a 1994 FSA,[29] the IRS Chief Counsel's Office considered the application of §960(a)(3) when a domestic corporate shareholder had an inclusion under §951(a) with respect to a first-tier CFC and also, in the same year, received a distribution of earnings and profits from that CFC that was in excess of the inclusion under §951(a). The Chief Counsel's Office held that, in the computation of deemed-paid credits under §902 with respect to the distribution, the amount of the previously taxed income was not taken into account because no taxes were imposed with respect to that income that were not previously taken into account in computing deemed-paid credits under §960(a)(1). In discussing the issue, the Chief Counsel's Office made two statements relevant to the scope of §960(a)(3). First, it stated that §960(a)(3) allows additional foreign tax credits "only for taxes paid or accrued after the deemed distribution, for example, taxes paid by a first-tier corporation on a distribution of previously-taxed income of a lower-tier CFC." Thus, the Chief Counsel's Office appears here to adopt the view that §960(a)(3) applies to post-year-of-inclusion taxes. Later on, however, the Chief Counsel's Office makes a broad statement, supportive of the broadest view, that §960(a)(3) "was intended to insure that all taxes paid on or with regard to accumulated profits were eligible to be considered for the foreign tax credit."

It is especially noteworthy that nowhere in the FSA does the Chief Counsel's Office discuss the regulations under §960. The strong implication is that those regulations, particularly Regs. §1.960-2, are not the definitive word with respect to the scope of §960(a)(3). Thus, the FSA indicates that deemed-paid credits may be available under §960(a)(3) for taxes other than upper-tier taxes even though Regs. §1.960-2 does not expressly so provide.

The Chief Counsel's Office has issued two other non-regulatory items of guidance that refer to §960(a)(3), but neither addresses the scope of §960(a)(3). GCM 38467,[30] which recommended against amending Rev. Proc. 65-17, 1965-1 C.B. 833, in response to *Schering Corp. v. Comr.*, 69 T.C. 579 (1978), referred to §960(a)(3) in passing in the second footnote, and said nothing about its scope. In TAM 9817001,[31] the Chief Counsel's Office considered the nature of unrefunded U.K. ACT paid by a first-tier U.K. CFC with respect to a distribution to a domestic parent of previously taxed income received from a second-tier U.K. CFC, which unrefunded ACT was surrendered by the first-tier CFC to the second-tier CFC in the year in which it was incurred. The domestic parent argued that the unrefunded ACT should be treated as additional foreign tax paid with respect to the distribution of the previously taxed income, and therefore an additional foreign tax credit should be available under §960(a)(3). The Chief Counsel's Office, however, concluded that because the unrefunded ACT had been surrendered to the second-tier CFC, it should be treated as paid by the second-tier CFC and taken into account in determining its post-1986 pools of undistributed earnings and profits and foreign income taxes as of the end of the year of the surrender. Thus, according to the Chief Counsel's Office, the unrefunded ACT was not subject to §960(a)(3). In any event, the TAM focuses only on the application of §960(a)(3) to upper-tier taxes, and says nothing about the scope of §960(a)(3).

Post-1962 Congressional Documents

A number of post-1962 Congressional documents describe the function of §960(a)(3), including a Joint Committee document [32] that provides as follows:

If in a year after the year of a subpart F income inclusion, a U.S. shareholder in the controlled foreign corporation receives a distribution from the corporation, the distribution may be deemed to come first out of the corporation's previously taxed income and, therefore, may be excluded from the U.S. shareholder's income. However, a distribution by a foreign corporation to a domestic corporation of earnings and profits previously taxed under subpart F is treated as an actual dividend, solely for purposes of determining the indirect foreign tax credit available to the domestic corporation (sec. 960(a)(3)). *Thus, a portion of the foreign taxes paid or accrued by the foreign corporation and not previously deemed paid by the domestic corporation are treated as paid by the domestic corporation under the principles of section 902 even though the domestic corporation recognizes no income in the current taxable year with respect to the distribution.*[33]

Obviously, the last sentence supports the broadest view of the scope of §960(a)(3). On the other hand, explanations of §960(a)(3) found in later Congressional documents from 1992, 1993, and 1995 contain substantially the same paragraph *but without the last sentence*.[34] It is not clear why the sentence was omitted from the later documents.

Articles and Treatises

Commentators have differed as to the scope of §960(a)(3), but the majority support the broadest view, *i.e.*, §960(a)(3) applies to any taxes not previously deemed paid under §960(a)(1).

Of three articles found which address this issue, two support the broadest view and one supports the narrowest, *i.e.*, §960(a)(3) applies only to upper-tier taxes. In support of the broadest view are Saul D. Kronovet[35] and Richard M. Hammer.[36] In support of the narrowest view is John F. Creed & Jesse M. Miles.[37]

Kronovet states that "if the full deemed paid taxes were not available to the parent upon the constructive distribution, the excess will be allowed upon an actual distribution." [38] He then discusses two situations in which §960(a)(3) would apply.[39] (The text is somewhat ambiguous as to whether these are considered to be the only situations in which §960(a)(3) would apply.) One situation, not surprisingly, involves upper-tier taxes. The other situation involves a change in a domestic corporation's percentage of direct ownership in a CFC. In that situation, as discussed earlier, the domestic corporation owns directly less than 10% of the CFC's stock at the time of an inclusion under §951(a), and thus is not entitled to deemed-paid credits under §960(a)(1). Later, at the time of an actual distribution of the previously taxed income, the domestic corporation owns directly at least 10% of the CFC's stock and thus, according to Kronovet, is entitled at that time to deemed-paid credits pursuant to §960(a)(3). Clearly, this second situation involves taxes imposed on the foreign corporation that gave rise to the previously taxed income *in the year of* the inclusion under §951(a), and thus Kronovet is taking the broadest view of §960(a)(3), *i.e.*, it applies to any foreign taxes that were not previously deemed paid under §960(a)(1).

Hammer notes that taxes previously deemed paid under §960(a)(1) cannot again be deemed paid when there is an actual distribution of previously taxed income,[40] but then states that "other foreign income taxes which were levied on these very same earnings, but not allowable as a deemed paid credit to the U.S. shareholder when computing his Subpart F liability in the earlier year, may be claimed as a deemed paid credit in the year in which the earnings are distributed to the U.S." Thus, he also adopts the broadest view of §960(a)(3). (He provides an example involving upper-tier taxes, however.)

Creed and Miles state that §960(a)(3) "provides for a credit under section 902 for additional foreign income taxes paid by a foreign corporation in respect of actual distributions made from earnings and profits already subjected to United States tax under section 951(a), to the extent that such taxes were not deemed paid previously under section 960(a)(1)." [41] Based on their reading of pages 260-61 of the Senate Finance Committee report for the Revenue Act of 1962, discussed above, Creed and Miles adopt the view that §960(a)(3) applies only to upper-tier taxes, stating that §960(a)(3) "was apparently meant to allow a U.S. corporation, upon receipt of amounts excludable from income under section 959(a), to obtain credit for foreign income taxes imposed on a first-tier corporation in respect of distributions by a second-tier corporation from earnings and profits that were previously subject to U.S. income tax under section 951(a)." [42] (As indicated earlier, the language at pages 260-61 actually suggests that §960(a)(3) applies to post-year-of-inclusion taxes and not simply upper-tier taxes.)

Three treatises on international taxation were examined with respect to the scope of §960(a)(3). In support of the broadest view are Joel D. Kuntz and Robert J. Peroni [43] and Joseph Isenbergh.[44] In support of the narrowest view, albeit not in a definitive fashion, is Elisabeth A. Owens and Gerald T. Ball.[45]

Kuntz and Peroni describe the scope of §960(a)(3) as follows:

Section 960(a)(3) contains a rule to ensure that the domestic corporation will get the appropriate amount of tax credit. Solely for purposes of taking into account under Section 902 any foreign or possession income, war profits, and excess profits taxes that were not deemed paid before under Section 960(a)(1), Section 960(a)(3) treats as a "dividend" a distribution received from a foreign corporation and excluded from gross income under Section 959. Dividend treatment is significant because dividends are the trigger for the deemed-paid credit under Section 902. Section 960(a)(3) applies by its terms for taxes paid with respect to accumulated profits from which the distribution is made. Thus, this provision requires that the distribution be traced to the accumulated profits and to the taxes.[46]

Thus, Kuntz and Peroni simply follow the plain language of the statute and, on that basis, adopt the broadest view of its scope.

Isenbergh also adopts the broadest view of the scope of §960(a)(3). He states, "A distribution of previously taxed income can, however, pull out foreign taxes from a foreign corporation under section 902, and can also be treated as a dividend for that purpose, if the taxes were not deemed paid at the time of the original inclusion of the income under Subpart F." [47] Isenbergh discusses the same situation discussed by Kronovet, above, involving a change in a domestic corporation's percentage of direct ownership in a CFC. He indicates that §960(a)(3) would apply in that situation, so that taxes paid by the CFC at the time of the Subpart F inclusion (when the domestic corporation held a less-than-10% direct ownership interest) could be deemed paid by the domestic corporation when the previously taxed income was distributed (and the domestic corporation held a 10%-or-greater direct ownership interest). Isenbergh also discusses the application of §960(a)(3) to withholding taxes imposed on the distribution of previously taxed income.[48]

At certain points, Owens and Ball clearly endorse the narrowest view. They describe the scope of §960(a)(3) as follows:

Section 960(a)(3) treats excludable income distributed to a domestic corporation as a dividend "solely for purposes of" taking into account under section 902 the taxes paid on the profits of the corporation from which the distribution is made. Although this language is vague, the Senate indicated in its report accompanying the Revenue Act of 1962 that the dividend treatment provided for in section 960(a)(3) is intended to apply for only one purpose, namely, to allow a credit for the additional taxes paid on income that is distributed through intermediary foreign corporations in a chain of ownership after being taxed under the hop-scotching principle of Subpart F. [49]

Thus, like Creed and Miles, Owens and Ball base their view on their reading of pages 260-61 of the Senate Finance Committee report. Owens and Ball reiterate their view of §960(a)(3):

In sum, section 960(a)(3) carves out an exception to the general rule that a distribution of previously taxed income does not constitute a dividend. But dividend treatment for excludable distributions is limited to the calculation of the domestic shareholder's credit for taxes paid by a foreign corporation that receives a distribution of earnings taxed currently at another tier. It applies for no other purpose.[50]

In addition, they state that "distributions of previously taxed income are treated as dividends under section 960(a)(3) in order to allow the domestic corporation to credit taxes paid by intermediary foreign corporations through which such distributions pass."[51]

However, Owens and Ball back away from this view of §960(a)(3) when they consider the time period of 1971-1976, when the requirements for deemed-paid credits under §960(a)(1) were tighter than those for deemed-paid credits under §902. (As mentioned earlier, effective for taxable years ending after January 12, 1971, §902 was changed to permit deemed-paid credits with respect to third-tier foreign corporations and the threshold ownership requirement for second- and third-tier foreign corporations was set at 10%, provided the total indirect ownership by the domestic corporation was at least 5%; effective for taxable years beginning after December 31, 1976, similar changes were made to §960.) Owens and Ball address the situation in which a first-tier corporation did not possess the requisite ownership percentage in a second-tier corporation for purposes of §960(a)(1) but did have sufficient ownership for purposes of §902. If there is an inclusion under §951(a) with respect to the second-tier corporation and then, in a later year, a distribution of that previously taxed income to the first-tier corporation and then to the domestic corporation, Owens and Ball argue that the domestic corporation should be deemed to have paid the taxes actually paid by the second-tier corporation at the time the previously taxed income was earned. They state:

...The language of section 960(a)(3) appears to be broad enough to allow the credit. The taxes were not credited under section 960(a)(1) and they were paid on the accumulated profits of foreign corporation *SS* [the second-tier corporation], which is regarded under the tracing rules of section 959 as the distributing corporation. The difficulty is that the taxes paid by *SS* were not additional taxes paid on a distribution of section 951 income, which are the taxes intended to be covered by section 960(a)(3), but, rather, taxes paid when the income was earned. In principle, this fact should not preclude a credit for taxes that would be creditable under section 902 upon receipt of a taxable dividend, but neither the Code nor the Regulations contain a specific statement to this effect.[52]

Thus, notwithstanding their earlier strong support for the narrowest view, even Owens and Ball admit that the plain language of §960(a)(3) is broad and should cover any taxes not previously deemed paid under §960(a)(1), even if incurred in the year of the inclusion under §951(a).

SUMMARY

In summary, the various sources of authority support various views of the types of taxes to which §960(a)(3) applies. The plain language of §960(a)(3) clearly supports the broadest of these views, *i.e.*, that §960(a)(3) applies to *any* taxes not previously deemed paid under §960(a)(1). The legislative history of §960(a)(3) primarily supports the view that §960(a)(3) applies to post-year-of-inclusion taxes. The regulations do not support any particular view, although superficially they might appear to support the narrowest view, *i.e.*, §960(a)(3) applies only to upper-tier taxes. Non-regulatory guidance issued by the IRS (in the form of its "digest" of the Revenue Act of 1962 and the 1994 FSA discussed above) supports either the view primarily supported by the legislative history (*i.e.*, §960(a)(3) applies to post-year-of-inclusion taxes) or the broadest view of §960(a)(3). Commentators support either the narrowest view or the broadest view.

As discussed earlier, the broadest view is consistent with the plain language of the statute. Moreover, the broadest view is best from a perspective of tax policy because it allows deemed-paid credits in all situations in which they would have been allowed under §902 had Subpart F not been enacted. In addition, the broadest view is not inconsistent with any regulation or any court decision. Although the legislative history might be read to support a different view, that history is not unambiguous and should certainly not overrule the very clear language of the statute. The best interpretation of the scope of §960(a)(3) would appear to be that it applies to all taxes not previously deemed paid under §960(a)(1).

Footnotes

[1] Law Firm of H.B. Bouma, Washington, D.C.

[2] Member, Caplin & Drysdale, Chartered, Washington, D.C.

[3] Unless the context clearly indicates otherwise, all section references are to sections of the Internal Revenue Code of 1986, as amended, or to sections of the Income Tax Regulations in 26 CFR Part 1.

[4] Regs. §1.960-2 indicates that the phrase "a distribution from a foreign corporation received by a domestic corporation" includes a distribution received from a second- or third-tier foreign corporation. (The regulation was promulgated prior to the amendment of §§902 and 960(a)(1) by the Taxpayer Relief Act of 1997, P.L. 105-34, and thus does not also refer to a distribution received from a fourth-, fifth-, or sixth-tier foreign corporation.)

[5] One might expect §960(a)(3) to be triggered whenever foreign taxes are paid or might first be viewed as deemed paid with respect to previously taxed income, regardless of whether an actual distribution to the domestic corporate shareholder has occurred. The previously taxed income has been included in income and there seems to be no good reason for deferring recognition of the foreign taxes just because the previously taxed income has not actually reached the domestic corporate shareholder. Thus, if in year 1 a domestic corporate shareholder has an inclusion under §951(a) with respect to a second-tier controlled foreign corporation ("CFC"), and that previously taxed income is then distributed in year 2 to a first-tier CFC subject to a withholding tax, the withholding tax could be taken into account immediately by the shareholder, even if the previously taxed income had not yet been distributed from the first-tier CFC to the shareholder. Although this makes sense conceptually, the language of the statute refers specifically to a distribution "received by a domestic corporation" and thus implies that no deemed-paid credits are allowed under §960(a)(3) until a distribution of previously taxed income is actually received by the domestic corporate shareholder. This is the approach taken by the regulations. *See* Regs. §1.960-2(f), *Ex. (4)*.

[6] An individual who has elected under §962 to be taxed on an inclusion as if he were a domestic corporation may also apply §960(a)(1).

[7] Upper-tier taxes are not subject to §960(a)(1) even if incurred in the same year as the inclusion under §951(a). *See* Regs. §1.960-2(f), *Ex. (4)*. Thus, deemed-paid credits are not allowed with respect to those taxes until the previously taxed income is actually distributed to the domestic shareholder, even though the shareholder was aware of them at the time of the inclusion under §951(a).

[8] The foreign country would probably also impose liability for the tax on the other foreign corporation, however, in which case it could be argued that the branch profits tax is an upper-tier tax.

[9] Upper-tier taxes are included in the term "post-year-of-inclusion taxes" even though, as noted earlier, they may be imposed in the year of inclusion of the income under §951(a).

[10] Assume the shareholder has an inclusion under §951(a) because it owns stock in the CFC within the meaning of §958(a) and is a U.S. shareholder within the meaning of §951(b) by reason of stock attribution under §958(b). For example, a shareholder who only owns 5% of the voting stock of a first-tier CFC directly but who owns 15% of the voting stock of the CFC after applying the constructive ownership tests of §958(b) will be required to include its pro rata share of the CFC's Subpart F income even though such a shareholder owns less than 10% of the voting stock directly and, thus, is not entitled to deemed-paid credits under §960(a)(1).

[11]Effective for taxable years ending after January 12, 1971, §902 was amended to permit deemed-paid credits with respect to third-tier foreign corporations. The threshold ownership requirement for second- and third-tier foreign corporations was set at 10%, provided the total indirect ownership by the domestic corporation was at least 5%. Effective for taxable years beginning after December 31, 1976, similar changes were made to §960.

[12]P.L. 98-369.

[13]This view is subject to the following two exceptions: (1) if in the year of inclusion of the income under §951(a) certain taxes could have been claimed as deemed-paid credits under §960(a)(1) but were not as a result of taxpayer *oversight*, the taxpayer would be required to file an amended return for the year of inclusion and could not claim the deemed-paid credits under §960(a)(3); and (2) if foreign tax redeterminations are made with respect to taxes for which deemed-paid credits were claimed under §960(a)(1), those redeterminations would be subject to the rules of §905(c) rather than §960(a)(3).

[14]Section 960(a)(2) apparently was drafted based upon the assumption that a distribution of previously taxed income always occurs *after* the year of inclusion of that income under §951(a). Thus, it refers to taxes deemed paid under §960(a)(1) "for any prior taxable year." However, a §959(a) distribution may also occur in the year of inclusion. Clearly, if a domestic corporation has an inclusion under §951(a) for year 1 and that income is also distributed in year 1, taxes deemed paid under §960(a)(1) when the income is included under §951(a) cannot also be deemed paid under §902 when the income is distributed. Thus, the phrase "for any prior taxable year" should not be given effect when the distribution to the domestic corporation occurs in the same year as the year of inclusion under §951(a). This is the approach taken in Regs. §1.960-2. A Technical Memorandum prepared by the IRS in connection with what became T.D. 7120 (5/25/71), promulgating the initial version of Regs. §1.960-2, provides as follows:

[15]P.L. 87-834.

[16]Recommendations at 53 (p. 193 (Part 1) of the compilation of the legislative history of the Revenue Act of 1962 produced in 1967 by the staff of the Committee on Ways and Means (hereinafter "the 1967 compilation")). (Emphasis supplied.)

[17]Appendix A at 54 (p. 620 (Part 1) of the 1967 compilation).

[18]H.R. Rep. No. 1447, 87th Cong., 2d Sess. (1962).

[19]Pp. 66 and A104-5 (pp. 1200 and 1334-5 (Part I) of the 1967 compilation).

[20]S. Rep. No. 1881, 87th Cong., 2d Sess. (1962).

[21]*Id.* at 94 (p. 2452 (Part 2) of the 1967 compilation).

[22]*Id.* at 259-61 (pp. 2617-19 (Part 2) of the 1967 compilation). (Emphasis supplied (other than titles).)

[23]As noted earlier, Regs. §1.960-2(f), *Ex. (4)* makes clear that taxes imposed on an upper-tier corporation are subject to §960(a)(3) even if imposed in the year of inclusion of the income under §951. However, insertion of the phrase "for a prior year" in the Senate Finance Committee report may indicate that the Committee was focusing on taxes imposed *after* the year of inclusion of the income under §951.

In H.R. Rep. No. 1447 the phrase "for a prior year" does not appear. In all other respects the language of the House report is similar to that of the Senate. The reason for the difference in language is not provided.

[24]The language omitted from the quotation deals with a distribution received by a foreign corporation from a lower-tier foreign corporation. The same sentence, but without the language that has been omitted here (and thus identical to the quotation except for the ellipses), is found in the initial version of Regs. §1.960-2(a), promulgated by T.D. 7120, 1971-2 C.B. 276, 36 Fed. Reg. 10851 (6/4/71).

[25]The Technical Memorandum written by the IRS in connection with what became T.D. 7120 (referred to in the prior footnote) provided the following cryptic explanation of how paragraphs (a) and (c) of Regs. §1.960-2 might be reconciled:

[26]The Technical Memorandum referred to in the prior footnote set forth the purpose of §960(a)(3) in very broad terms: "Section 960(a)(3) provides that distributions received by a domestic corporation which are excluded from its income under section 959(a) (by reason of being attributable to amounts included in income under section 951) shall be deemed to be a dividend for the purposes of crediting under section 902 foreign income taxes which were not deemed paid by the domestic corporation under section 960(a)(1) for any prior taxable year." 1971 *WL* 32903 (2/25/71). There is no indication in the Technical Memorandum that §960(a)(3) applies only to upper-tier taxes.

Similarly, a later Technical Memorandum, prepared by the IRS in connection with a notice of proposed rulemaking involving an amendment to Regs. §1.960-2, also set forth the purpose of §960(a)(3) in very broad terms: "The function of section 960(a)(3) was essentially to treat a distribution, although excluded from income under section 959(a), as a dividend solely for applying the rules of section 902 so as to take into account such foreign taxes as are not deemed paid under section 960." 1971 *WL* 32854 (7/15/71). Again, there is no indication in the Technical Memorandum that §960(a)(3) applies only to upper-tier taxes.

[27]Regs. §1.959-3(d).

[28]1962-3 C.B. at 30.

[29]Lexis 182.

[30]Aug. 11, 1980.

[31]Sept. 30, 1997.

[32]Staff of the Joint Comm. on Taxation, *Technical Explanation of the Tax Simplification Act of 1991 (H.R. 2777 and S. 1394)*, 102d Cong., 1st Sess., JCS-10-91 (6/28/91).

[33]*Id.* at 49. (Emphasis supplied.)

[34]*See, e.g.,* Staff of the Joint Comm. on Taxation, *Explanation of H.R. 5270 (Foreign Income Tax Rationalization and Simplification Act of 1992)*, 102d Cong., 2d Sess., JCS-11-92 (5/29/92) at 83; Staff of the Joint Comm. on Taxation, *Technical Explanation of the Tax Simplification Act of 1993 (H.R. 13)*, 103d Cong., 1st Sess., JCS-1-93 (1/8/93) at 124; Staff of the Joint Comm. on Taxation, *Comparison of Tax Simplification Provisions of H.R. 2491 as Passed by the House and the Senate*, 104th Cong., 1st Sess., JCS-23-95 (10/31/95) at IV-7 - IV-8.

[35]Kronovet, "Liquidations of and Distributions by Foreign Subsidiaries," 21 *NYU Inst. Fed. Tax'n* 827 (1963) ("Kronovet").

[36]Hammer, "How Sections 959 and 960 Operate to Avoid Double Taxation under Subpart F," 31 *J. Tax'n* 272 (1969) ("Hammer").

[37]Creed and Miles, "Foreign Tax Credits of Domestic Corporations: Sections 902, 960

and 963," 24 *NYU Inst. Fed. Tax'n* 1353 (1966) ("Creed and Miles").

[38] Kronovet at 846.

[39] *Id.* at 846-47.

[40] Hammer at 276.

[41] Creed and Miles at 1371.

[42] *Id.* at 1379.

[43] Kuntz and Peroni, *U.S. International Taxation* (2001) ("Kuntz and Peroni").

[44] Isenbergh, *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income* (2d ed. 2000) ("Isenbergh").

[45] Owens and Ball, *The Indirect Credit: A Study of Various Foreign Tax Credits Granted to Domestic Shareholders Under U.S. Income Tax Law*, Vol. II (1979) ("Owens and Ball").

[46] Kuntz and Peroni at B4-164. (Footnotes omitted.)

[47] Isenbergh at 39:31. (Footnote omitted.)

[48] *Id.* at 39:32.

[49] Owens and Ball at 105. (Footnotes omitted.)

[50] *Id.* at 109.

[51] *Id.* at 125.

[52] *Id.* at 142.