1 T.C. 1153 (1943)

For purposes of calculating the foreign tax credit limitation under Section 131 of the Revenue Acts of 1936 and 1938, foreign income must be reduced by expenses, losses, and other deductions, including a ratable proportion of unallocable expenses, as provided in Section 119, even if the foreign tax was withheld at the source without any deduction for such expenses.

Summary

International Standard Electric Corporation sought a foreign tax credit. The Tax Court addressed whether 'net income' from foreign sources should be calculated before or after deducting expenses. The court held that foreign income must be reduced by identifiable expenses and a ratable portion of unallocable expenses, regardless of whether the foreign tax was withheld at the source without deducting any expenses. Royalties paid to domestic corporations for patent use by foreign subsidiaries are ratably allocable against foreign source income. The declared value excess profits tax is allocable only to U.S. source income. British income taxes withheld from royalties are not creditable.

Facts

International Standard Electric Corporation (ISE), a Delaware corporation, served as a holding and management company for a worldwide system of telephone, telegraph, and radio communication businesses. ISE provided management services, technical assistance, and patent information to its foreign subsidiaries, charging fees and royalties. ISE earned income from various sources, including royalties, contract revenue, dividends from foreign corporations, and interest. Foreign taxes were typically withheld at the source before ISE received the income. ISE paid royalties to domestic corporations like Western Electric and Arcturus Co. for patent rights and technical information that ISE made available to its subsidiaries.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in ISE's income tax for 1937 and 1938, and in excess profits tax for 1938. The central issue was the calculation of the foreign tax credit under Section 131 of the Revenue Acts of 1936 and 1938. The Commissioner allocated deductions, including royalties paid to domestic corporations, and determined the amount of creditable foreign taxes. ISE petitioned the Tax Court, contesting the Commissioner's determinations. The Tax Court sustained in part and reversed in part the Commissioner's determinations.

Issue(s)

1. Whether the term "net income" in Section 131(b) of the Revenue Acts of 1936 and 1938 requires foreign income to be reduced by identifiable expenses and a ratable proportion of unallocable expenses when calculating the foreign tax

credit limitation, even if the foreign tax was withheld at the source.
2. Whether royalties paid by ISE to domestic corporations for the use of patents made available to its foreign subsidiaries are fully deductible from U.S. source income or ratably allocable against income from foreign sources.
3. Whether the declared value excess profits tax is deductible entirely from income from U.S. sources or should reduce income from sources without the United States for purposes of computing the foreign tax credit.
4. Whether British income taxes withheld from patent royalties accrued to ISE from its British subsidiary are allowable as a credit under Section 131 of the Revenue Act of 1936.

Holding

1. Yes, because the statute defines the foreign tax credit limitation based on a ratio of net income from foreign sources to entire net income, and Section 119 requires the reduction of foreign income by applicable expenses, losses, and deductions.
2. Royalties paid by petitioner to domestic corporations for use of patents made available to its foreign subsidiaries are ratably allocable against income from foreign sources, since such royalties are an inherent incident of the income received by petitioner from its foreign subsidiaries.
3. Yes, because the excess profits tax is a tax upon doing business within the United States and not upon income from foreign sources.
4. No, because prior Tax Court precedent held that such taxes were not directly creditable under Section 131.

Court's Reasoning

The Tax Court reasoned that the statutory language of Section 131(b) is clear in defining the foreign tax credit limitation based on a ratio of foreign net income to entire net income. The court emphasized that both factors in the ratio are described as "net" income, implying that deductions must be considered. Quoting the statute, the court noted that Section 119, incorporated by Section 131(e), mandates that unidentifiable deductions applicable to foreign income should be a ratable part of all unidentifiable deductions. The court rejected ISE's argument that "withholding-tax income" should be treated differently, stating, "There is no room for it in the statute." Regarding royalties paid to domestic corporations, the court found these payments to be "an inherent incident of the income received by petitioner from the foreign affiliates," and therefore allocable to foreign sources. As to the excess profits tax, the court cited *Superheater Co. v. Commissioner*, 125 F.2d 514, stating that it is "a tax upon doing business and not upon income." Finally, the court followed its prior decisions in *Trico Products Corporation* and *Irving Air Chute Co.*, which held that British income taxes withheld from royalty payments were not creditable under Section 131.

Practical Implications

This case provides guidance on how to calculate the foreign tax credit limitation under U.S. tax law. It clarifies that companies must reduce their foreign income by applicable expenses, including a ratable portion of unallocable expenses, regardless of whether foreign taxes are withheld at the source. This ruling impacts multinational corporations with foreign subsidiaries, particularly those receiving income subject to foreign withholding taxes. The decision underscores the importance of properly allocating deductions between U.S. and foreign source income. Later cases have cited this ruling for its interpretation of Section 131 and its emphasis on the statutory language when determining the foreign tax credit. It emphasizes that U.S. tax law requires an allocation of expenses even if the foreign jurisdiction does not permit such deductions when assessing its own tax.