T.C. Memo. 1944-294

For a foreign tax to qualify for the U.S. foreign tax credit, it must be an 'income tax' as defined under U.S. tax law, regardless of the foreign country's classification.

Summary

Petitioner, a Canadian citizen residing in the U.S., sought a foreign tax credit for Canadian income taxes paid on trust income. The Tax Court disallowed the credit for taxes paid on $20,000 of trust income, which the U.S. considered a non-taxable legacy, even though Canada taxed it as income. The court held that the foreign tax must be an income tax under U.S. standards to qualify for the credit, citing *Biddle v. Commissioner*. The court emphasized that the purpose of the foreign tax credit is to prevent double taxation of the same income, which was not the case here as the legacy was not taxable in the U.S.

Facts

Petitioner was a Canadian citizen residing in the U.S. She received income from a Canadian trust established by her deceased husband's will. The trust directed trustees to pay her $20,000 annually, drawing from capital if necessary. She also received Canadian dividends. Canada taxed both the $20,000 and the dividends as income. The U.S. treated the $20,000 as a non-taxable legacy but taxed the surplus trust income and dividends. Petitioner claimed a foreign tax credit for Canadian taxes paid on the entire amount, including the $20,000.

Procedural History

The Tax Court reviewed the Commissioner's disallowance of a portion of the foreign tax credit claimed by the petitioner.

Issue(s)

1. Whether the Canadian income tax paid on the $20,000 trust distribution, which is considered a non-taxable legacy under U.S. law, qualifies for the U.S. foreign tax credit under Section 131(a)(3) of the Internal Revenue Code?

Holding

1. No, because the Canadian tax on the $20,000 legacy is not considered an "income tax" under U.S. tax law, as it is not a tax on income as defined by U.S. statutes.

Court's Reasoning

The court relied on *Biddle v. Commissioner*, 302 U.S. 573 (1938), to establish that the definition of "income tax" for foreign tax credit purposes is determined by U.S. tax law, not foreign law. The court quoted *Biddle*: "Section 131 does not say that the

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meaning of its words is to be determined by foreign taxing statutes and decisions, and there is nothing in its language to suggest that, in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterizations and classifications of tax legislation. The phrase 'income taxes paid,' as used in our own revenue laws, has for most practical purposes a well-understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes. It is that meaning which must be attributed to it as used in section 131." The court also cited *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894 (3d Cir. 1943), stating that a foreign tax must conform "in its substantive elements to the criteria established under our revenue laws" to be considered an income tax. The court reasoned that the purpose of the foreign tax credit is to prevent double taxation of the *same income*. Since the $20,000 legacy was not taxable income in the U.S., allowing the credit would be contrary to the purpose of the statute.

Practical Implications

This case underscores that the U.S. definition of "income tax" is controlling when determining eligibility for the foreign tax credit. Taxpayers cannot claim a credit for foreign taxes on items not considered income under U.S. tax law, even if the foreign country classifies the tax as an income tax. Legal professionals should analyze the nature of the foreign tax and the item being taxed under U.S. tax principles when advising clients on foreign tax credit claims. This case highlights the critical need for alignment between foreign and U.S. tax concepts for the foreign tax credit to be properly applied and serves as a reminder that the label applied by a foreign jurisdiction is not determinative.

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