Schering Corporation and Subsidiaries v. Commissioner of Internal Revenue, 69 T. C. 579 (1978); 1978 U. S. Tax Ct. LEXIS 191

A U. S. corporation can claim a foreign tax credit for withholding taxes paid on income repatriated from a foreign subsidiary pursuant to a section 482 reallocation, even if the repatriation is treated as tax-free under a closing agreement.

Summary

Schering Corp. , a U. S. company, had income reallocated from its Swiss subsidiaries under section 482. It repatriated this income tax-free under Revenue Procedure 65-17 and closing agreements. Switzerland withheld taxes on this repatriation, which Schering claimed as a foreign tax credit. The Tax Court held that Schering was entitled to this credit, ruling that the Swiss withholding tax was a creditable income tax under U. S. law, and that neither the closing agreements nor section 482 barred the credit.

Facts

Schering Corp. , a U. S. corporation, transferred patents and licensing agreements to its Swiss subsidiary, Scherico Ltd. , in the mid-1950s. The IRS reallocated income from these transactions to Schering under section 482 for the years 1961-1963. Schering and the IRS entered into closing agreements in 1969, allowing Schering to set up accounts receivable from Scherico and another Swiss subsidiary, Essex Chemie A. G. , for the reallocated income. Schering repatriated these amounts within 90 days, treated as tax-free under Revenue Procedure 65-17. Switzerland withheld 5% of the repatriated amount as a dividend under its tax laws, and Schering claimed a foreign tax credit for this withholding.

Procedural History

The IRS audited Schering’s 1969 tax return and disallowed a portion of the foreign tax credit claimed for the Swiss withholding tax. Schering petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court ruled in favor of Schering, allowing the full amount of the foreign tax credit.

Issue(s)

1. Whether the Swiss withholding tax withheld on the repatriated income from Scherico and Essex is a creditable income tax under section 901 of the U. S. Internal Revenue Code.
2. Whether the closing agreements between Schering and the IRS, which allowed for tax-free repatriation of the reallocated income, bar Schering from claiming a foreign tax credit for the Swiss withholding tax.
3. Whether section 482 of the U. S. Internal Revenue Code allows the IRS to disallow the foreign tax credit claimed by Schering.

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Holding

1. Yes, because the Swiss withholding tax is the substantial equivalent of an income tax as understood in the U. S. , and it was paid by Schering on income it repatriated.
2. No, because the closing agreements only specified that the repatriation would not constitute taxable income to Schering, not that it would bar foreign tax credits.
3. No, because section 482 does not authorize the IRS to disallow a foreign tax credit where no related entity exists to which the credit could be reallocated.

Court’s Reasoning

The Tax Court analyzed the Swiss withholding tax under U. S. tax principles, determining it to be a creditable income tax under section 901. The court rejected the IRS’s arguments that the closing agreements and section 482 barred the credit. The court noted that the closing agreements only addressed the tax treatment of the repatriation itself, not the foreign tax credit. Regarding section 482, the court held that it does not allow the IRS to disallow a credit where no related entity exists to which the credit could be reallocated. The court also considered but rejected the IRS’s arguments about Schering’s failure to pursue competent authority proceedings under the U. S. -Swiss tax treaty, stating that such proceedings were not required for Schering to claim the credit.

Practical Implications

This decision clarifies that U. S. corporations can claim foreign tax credits for withholding taxes paid on repatriated income reallocated under section 482, even if the repatriation is treated as tax-free under a closing agreement. It emphasizes that the foreign tax credit is available regardless of how the repatriation is treated under U. S. tax law, as long as the foreign tax is creditable under U. S. principles. This ruling impacts how U. S. multinational corporations should approach tax planning and treaty negotiations, particularly in cases involving section 482 reallocations and foreign tax credits. It may also influence future IRS guidance on the interaction between closing agreements, section 482, and foreign tax credits.

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