Theo. H. Davies & Co. , Ltd. & Subsidiaries v. Commissioner of Internal Revenue, 75 T. C. 443 (1980)

Foreign-source capital losses used to offset U. S. -source capital gains must be allocated to foreign-source income when computing the foreign tax credit limitation.

Summary

In Theo. H. Davies & Co. v. Commissioner, the U. S. Tax Court addressed how foreign-source capital losses should be treated in calculating the foreign tax credit limitation under Section 904(a) of the Internal Revenue Code. The taxpayer, Davies, incurred capital losses from foreign sources but had no corresponding foreign-source capital gains. These losses were used to offset U. S. -source capital gains. The court held that such foreign-source losses, when used to offset U. S. gains, should be included in the numerator of the fraction used to compute the foreign tax credit, as they are deductions properly allocated to foreign-source income under Section 862(b). This decision ensures that the foreign tax credit does not inadvertently relieve U. S. tax on domestic income.

Facts

Theo. H. Davies & Co. , Ltd. , and its subsidiaries (Davies) filed consolidated federal income tax returns for 1972 and 1973. During these years, Davies had ordinary income and capital losses from sources outside the United States but no capital gains from such sources. Davies used these foreign-source capital losses to offset capital gains from sources within the United States. The dispute centered on whether these foreign-source capital losses should be considered in calculating the numerator of the fraction used to determine the foreign tax credit limitation under Section 904(a).

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Davies' income tax for the years in question. Davies petitioned the U. S. Tax Court, which heard the case and issued its opinion on December 29, 1980, upholding the Commissioner's position on the treatment of foreign-source capital losses in the foreign tax credit calculation.

Issue(s)

1. Whether foreign-source capital losses, used to offset U. S. -source capital gains, should be considered in computing the numerator of the fraction under Section 904(a) for the foreign tax credit limitation?

Holding

1. Yes, because such losses are deductions properly apportioned or allocated to

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gross income from sources without the United States under Section 862(b), and thus must be included in the numerator of the fraction used to calculate the foreign tax credit limitation.

Court’s Reasoning

The court focused on the interpretation of Section 862(b), which defines taxable income from sources without the United States as gross income minus expenses, losses, and other deductions properly apportioned or allocated to such income. The court rejected Davies’ argument that Section 63, which defines taxable income, should govern the treatment of these losses. Instead, it emphasized that the foreign-source capital losses retained their character as foreign losses even when used to offset U. S. -source gains. The court reasoned that failing to allocate these losses to foreign-source income would potentially allow the foreign tax credit to offset U. S. tax on domestic income, which is contrary to the purpose of Section 904. The decision was influenced by the policy of preventing the foreign tax credit from eliminating U. S. tax on domestic income, as articulated in the legislative history and prior case law.

Practical Implications

This decision clarifies that foreign-source capital losses used to offset U. S. -source capital gains must be included in the calculation of the foreign tax credit limitation. Practitioners must ensure that such losses are properly allocated to foreign-source income, which may reduce the foreign tax credit available to taxpayers. The ruling has implications for multinational corporations managing their tax liabilities across jurisdictions. It also underscores the importance of accurate source attribution in tax planning. Subsequent amendments to the Internal Revenue Code have rendered this specific issue moot for taxable years beginning after January 1, 1976, but the principles established remain relevant for understanding the broader application of the foreign tax credit rules.

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