NOTES & COMMENTS

FOREIGN TAX CREDITS: THE RECENT DECISION IN *PROCTOR & GAMBLE V. UNITED STATES* ALLOWS PROCEDURE TO OVERRIDE THE STATUTORY INTENT

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INTRODUCTION

THE Internal Revenue Service (IRS) requires U.S. citizens and domestic corporations to report both income earned within the United States and abroad.[1] Similar to some other countries' tax systems, this tax system potentially subjects the taxpayer to multiple taxations because every nation taxes income earned within its borders.[2] From the perspective of a U.S. taxpayer, multiple taxation occurs when that taxpayer pays U.S. income tax on an income stream which has already been taxed by the foreign country in which that income stream was earned.[3] In order to eliminate this potential conflict, the Internal Revenue Code allows U.S. citizens and domestic entities to claim a credit or take a deduction on their domestic tax liability for taxes paid abroad on a given stream of income.[4] The purpose of this credit is to minimize or eliminate the effect of double taxation on income earned abroad.[5] While Treasury Regulation § 1.901-2 defines the requirements which must be met in order to claim a foreign tax credit under § 901 of the U.S. Code,[6] varying tax treaties forged by the United States define different forms of income for which a taxpayer can claim a credit if taxed abroad.[7] Under the regulation, the taxpayer may only receive a foreign tax credit

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1. United States v. Goodyear Tire & Rubber Co., 493 U.S. 132, 135 (1989).
2. *Id.*
3. *Id.*
4. Burnet v. Chi. Portrait Co., 285 U.S. 1, 12 (1932).
5. JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS ¶ 15.21(1)(a) (2011).
6. 26 C.F.R. § 1.901-2 (2011).
7. *See, e.g.*, Convention Between the United States of America and the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on

for "compulsory" foreign tax liabilities.[8] While earlier courts have studied the merits of each case to determine the compulsory element of a tax, recent case law shows courts have allowed the procedural requirements under the regulation to overtake the merits and intent of the statute as it was defined in 1918.[9]

The crux of this article stems from a recent case, *Proctor & Gamble* (P&G) *v. United States*, in which a U.S. District Court denied the taxpayer's otherwise meritorious claim for a foreign tax credit due to the court's misinterpretations of the regulation's requirements and potential avenues of relief available under tax treaties.[10] Between the presentation of this case and its analysis, this article will give a general overview of the foreign tax credit system.[11] This discussion will lead to the factors or merits used to determine whether a tax is compulsory and thus allowable as a foreign tax credit.[12] The procedural requirements, which involve the invocation of a competent authority, and the two distinct definitions of competent authority, that exist in treaties and regulations will then be discussed.[13] Lastly, the article analyzes the *P&G* case, a case in which a company's alleged failure to exhaust competent-authority procedures barred it from receiving a foreign tax credit on an otherwise meritorious claim.[14]

I. PRESENTATION OF *PROCTOR & GAMBLE V. UNITED STATES*

Recently, the United States determined P&G improperly claimed a foreign tax credit for taxes paid to South Korea because it did not exhaust all remedies in seeking a refund for that amount from Japan, which also taxed P&G on that same stream of income.[15]

During the relevant time, P&G's Northeast Asian subsidiary (P&G NEA) located its principal office in Japan, although formation of P&G NEA occurred in Singapore.[16] P&G NEA entered an Intellectual Properties Licensing Agreement with P&G.[17] Under the terms of the agreement, P&G licensed all of its intellectual property to P&G NEA for use in Japan and South Korea in exchange for royalty payments in an amount between 5 and 7% of sale price for specified

Income and the Encouragement of International Trade and Investment, U.S.-S. Kor., June 4, 1976, 30.4 U.S.T. 5253 [hereinafter "U.S.-S. Korea Tax Treaty"]; Convention Between the United States and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Japan, Nov. 6, 2003, S. TREATY DOC. NO. 108-14 (2003) [hereinafter "U.S.-Japan Tax Treaty"].

8. 26 C.F.R. § 1.901-2(e)(5)(i) (2011).

9. *See, e.g.*, Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747 (S.D. Ohio July 6, 2010).

10. *Id.*

11. *See infra* Part II.

12. *See infra* Part III.

13. *See infra* Part III.D.

14. *See Infra* Part IV.

15. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *2.

16. *Id.* at *4.

17. *Id.* at *5.

products.[18] Between 2000 and 2005, pursuant to the U.S.–Japan Tax Treaty, P&G NEA paid 10% of this royalty payment to Japan for a withholding tax since P&G NEA's principal office was located there.[19] P&G claimed foreign tax credits for the amounts paid by P&G NEA to Japan and the IRS examined, audited, and approved the credits at that time.[20]

Within South Korea, neither P&G nor P&G NEA employed individuals in Korea, so neither paid tax on the royalty payments paid[21] from P&G NEA to P&G.[22] In 2006, however, Korea's tax authority issued a deficiency notice to P&G NEA.[23] The tax authority attributed the deficiency notice to a withholding tax due for the royalties paid to P&G.[24] The authority assessed this tax pursuant to the terms of the U.S.–Korea Tax Treaty.[25] Under the applicable tax treaty, royalties derived from sales within Korea were subject to a 15% tax rate.[26] The Korean tax authority then sent the relevant tax assessment to P&G, along with a 10% late penalty and a 10% local surcharge.[27] Pursuant to Korean tax law, P&G paid the full assessment before filing a notice of appeal.[28] P&G then sought legal advice from a well-known Korean law firm; however, the firm advised P&G that under Korean law, the tax authority issued a correct statement.[29] Upon determining that there was no reasonable basis to appeal the assessment of the Korean authority, or to invoke the competent-authority procedure under the U.S.–Korea Tax Treaty, P&G filed for a foreign tax credit based on the taxes paid to Korea less the penalty charges.[30] The U.S. rejected the foreign tax credit claimed by P&G for the Korean taxes because P&G had failed to invoke competent-authority procedures.[31] As will be discussed in the analysis below, this ruling both confused the two distinct definitions of "competent authority" that exist in treaties and regulations, and put forth a previously unheard of requirement upon the taxpayer.[32]

The court classified the Korean tax liability as compulsory.[33] Unfortunately, in relation to the previously paid Japanese liability, the court held P&G's failure to exhaust all remedies barred it from claiming a credit on this

18. *Id.*
19. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *5-6 (S.D. Ohio July 6, 2010).
20. *Id.* at *2-3.
21. *Id*. at *6.
22. *Id.*
23. *Id.* at *7.
24. *Id.* at *6.
25. *Id.* at *9-10.
26. U.S.-S. Korea Tax Treaty, *supra* note 7, at art. 14(1).
27. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *7.
28. *Id.* at *8.
29. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *8 (S.D. Ohio July 6, 2010).
30. *Id.* at *2.
31. *Id.*
32. *See infra* Part IV.B.4.
33. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *28.

particular liability.[34] In regard to the failure to exhaust all remedies, the court specifically noted P&G did not invoke the assistance of competent authorities as provided for in the U.S.–Japan Tax Treaty.[35] P&G claimed the IRS had already audited and approved the foreign tax credits related to the Japanese withholding tax.[36] The court, however, ruled the United States was not procedurally barred from raising P&G's failure to exhaust competent-authority assistance.[37] The court allowed this review because the court did not view each claim separately as a set-off claim against the Japanese and Korean taxes, respectively; rather, it viewed the case as a whole and rendered judgment accordingly.[38]

As more fully discussed below, the rendered judgment in *P&G* reflects an unnecessary deviation from the standard of judgment previously used to assess foreign tax credits. The court accepted the possibility that multiple foreign countries could tax a single stream of income that was generated abroad by a U.S. taxpayer and taxed pursuant to the respective tax treaties.[39] While accepting this possibility, however, the court refused to determine whether P&G's payments to both Korea and Japan were compulsory payments in the form of an income tax, which would have allowed P&G to claim the credits related to these payments.[40] Rather, the court denied review of the merits due to an alleged procedural misstep by P&G.[41] In its denial, however, the court intertwined the analysis of two distinctly different forms of competent authority.[42] This erroneous analysis led the court astray in its determination of when each competent-authority process should be invoked in a given situation. Further, this analysis put forth a previously unheard of requirement upon the taxpayer. Namely, the court admonished *P&G* for its failure to assert rights under the U.S.–Japan Tax Treaty that simply do not exist. In sum, the court's faulty analysis precluded P&G from claiming an otherwise meritorious foreign tax credit. Most importantly, however, the decision leaves future taxpayers, who may face a similar situation, with little guidance as to how to comply with the elements set forth in § 901 of the U.S. Code.

II. GENERAL OVERVIEW OF THE U.S. FOREIGN TAX CREDIT SYSTEM

The purpose of the foreign tax credit is simple: to eliminate the effect of multiple taxations on income earned abroad.[43] The regulations necessitate the

34. *Id.* at *19.
35. *Id.* at *21.
36. *Id.* at *25.
37. *Id.* at *26.
38. *Id.* at *25.
39. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 8374, at *14, 16 (S.D. Ohio July 6, 2010).
40. *Id.* at *19.
41. *Id.* at *29.
42. *Id.* at *20-24.
43. 47B C.J.S. *Internal Revenue* § 486 (2011).

fulfillment of certain requirements in order to claim the credit.[44] The U.S. Department of Treasury puts forth these regulations to ensure its fair share of taxes and to minimize the amount of credits allowed.[45] The Treasury fears that without certain requirements, U.S. taxpayers may over-rely on allowable foreign tax credits and disregard any attempts to minimize their foreign tax liabilities.[46] The net effect will result in the U.S. Department of Treasury subsidizing foreign governments through the allowance of the foreign tax credit.[47] While some describe the foreign tax credit system as a "byzantine structure of staggering complexity," in general, § 901 promulgates three main rules with respect to foreign credits:[48]

1. The foreign tax must be in the form of an income tax; excise taxes, property taxes, value-added taxes, and other similar taxes do not qualify.[49]
2. The taxpayer who is entitled to the credit is the one who bears the liability for the foreign tax, rather than one who merely bears the economic burden.[50]
3. The taxpayer may claim a credit only on compulsory taxes.[51]

As discussed below, the regulations require the claimed foreign tax to take the form of an income tax, rather than a tax required to receive an economic benefit.[52] Also briefly discussed below, § 901 stipulates who may claim the credit.[53] More germane to this article, however, the last promulgated rule has birthed varying definitions of what qualifies as a compulsory tax. Before delving into the necessary requirements for claiming a foreign tax credit, a quick overview of the effects of a foreign tax credit may help clarify the concept in general.

The foreign tax credit system allows the taxpayer to reduce its U.S. tax liability by the amount of taxes paid to a foreign country.[54] To illustrate how this works, one can look at a simple example in which U.S. Corporation *A* earns $100 in a foreign country that taxes that income at 25%, amounting to $25 in taxes paid to that foreign country.[55] Since Corporation *A* is a U.S. entity, it would then have to claim that $100 of income on its U.S. tax return, thus subjecting itself to a further $35 in taxes on that same stream of income, assuming a U.S. tax rate of

44. Paul Rooney & Neal Suit, *Competent Authority*, 49 TAX LAW. 675, 679-80 (1996).
45. *Id.*
46. *Id.*
47. *Id.*
48. EUSTICE, *supra* note 5, ¶ 15.21(1)(a).
49. *Id.*
50. *Id.*
51. *Id.*
52. Treas. Reg. § 1.901-2(e)(5)(i) (2012).
53. 26 U.S.C. § 901 (2010).
54. *Id.*
55. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *14 (S.D. Ohio July 6, 2010).

35%.[56] Without the allowance of a foreign tax credit, Corporation *A* subjects itself to double taxation from the United States and the foreign country in the amount of $60.[57] The availability of the foreign tax credit, however, avoids this result by allowing the taxpayer to deduct the amount of foreign taxes paid from its U.S. tax liability for that particular stream of income.[58] In other words, the taxpayer can reduce its U.S. tax liability of $35 by the credit allowed for the foreign taxes already paid on that stream of income, which is $25.[59] After subtracting the $25 foreign tax credit, the corporation would be left with a $10 U.S. tax liability.[60] The end result leaves Corporation *A* with a total tax liability of $35, the same amount as would be realized if the corporation were taxed only once at the U.S. tax rate of 35%.[61]

The above illustration, which shows the effect of an allowable tax credit, assumes that all of the necessary elements to claim the credit are met. If a taxpayer's foreign tax credit is questioned by the IRS, however, the taxpayer must prove certain criteria in order to affirm the allowance of the credit.[62] To do so, a taxpayer must first determine whether the foreign country in question has a tax treaty with the United States and, if so, what forms of income tax are creditable under the provisions of that treaty.[63] Second, the taxpayer must determine its actual foreign tax liability that is allowed to be credited under the treaty and if it is entitled to it.[64] Lastly, and most difficult, the taxpayer must determine whether or not, based on any available information, the claimed credit relates to a compulsory tax, as interpreted under foreign law.[65] In general, a foreign tax credit reduces a U.S. taxpayer's domestic tax liability by an amount that is proportional to the taxpayer's foreign-sourced income as compared to their worldwide income.[66] Therefore, Federal Regulation § 1.901-2 serves to limit the application of allowable credits to foreign-sourced income only, rather than allowing a taxpayer to transfer accumulated credits to taxes on income earned within the United States.[67]

Furthermore, the regulations put forth an overall limit on the credits an entity may claim in any given tax year. Per § 901(a), if a taxpayer earns $100 within the United States and $100 outside of it, the foreign tax credits may not exceed $100, the amount earned abroad.[68] While overall worldwide income

56. *Id.* (using the standard corporate rate of 35% on the $100 of income).
57. *Id.*
58. 26 U.S.C. § 901(a) (2010).
59. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *14.
60. *Id.* at *15.
61. *Id.*
62. Treas. Reg. § 1.901-2 (2012).
63. EUSTICE, *supra* note 5, ¶ 15.21(1)(a).
64. *Id.*
65. Treas. Reg. § 1.901-2(e)(5)(i).
66. RICHARD E. ANDERSEN, ANALYSIS OF UNITED STATES INCOME TAX TREATIES § 19.01(2)(d)(i) (2011).
67. Pritired 1, LLC v. United States, 816 F. Supp. 2d 693, 728 (S.D. Iowa 2011).
68. JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ B4.16(1) (2011).

equals $200, the credits are limited by the proportion of income earned abroad and thus may not be applied to income earned within the United States.[69]

Lastly, within its negotiated tax treaties, the United States institutes certain limits upon various "baskets" of transactions, or kinds of income.[70] For example, Article 14 of the U.S.–Korea Tax Treaty enacts a 15% ceiling for tax on royalty payments made from one country to another.[71] Other baskets include: dividends, passive income, shipping and air transport, capital gains, and others.[72] Similar to the overall limitation which allows the deduction of credits only from income earned abroad, a taxpayer may only use credits generated within one basket to apply to other streams of income that fall into that same basket.[73]

III. THE FOREIGN TAX CREDIT DEFINED

A. *Bilateral Tax Treaty Between Countries*

Before claiming a foreign tax liability as a credit, the taxpayer should first determine if the relevant foreign country entered into a tax treaty with the United States.[74] If found, the taxpayer may look to the treaty to determine what potential rights or limitations pertain to it.[75] Regarding the application of treaties, the United States Supreme Court has stated the "clear import of treaty language" should be used in the application of the treaty, unless the obvious meaning creates a result the signatories to the treaty did not intend.[76] Parties give careful consideration before entering into treaties; they are drawn by highly competent people who diligently choose the precise words necessary to convey the meaning that the parties to the treaty wish to convey.[77]

In *Xerox Corp. v. United States*, the Federal Circuit Court announced the above standard for review of rights and obligations under a tax treaty.[78] Although the IRS subsequently issued a nonacquiescence announcement in regard to the ultimate determination, that announcement left the standard for review of treaties untouched.[79] In *Xerox*, the parties asked the court to determine if an indirect foreign tax in the form of an Advanced Corporation Tax (ACT), paid in the United Kingdom by a Xerox-affiliated entity, qualified for a foreign tax credit.[80]

69. *Id.*
70. *Id.* ¶ B4.16(9).
71. U.S.-S. Korea Tax Treaty, *supra* note 7, at art. 14.
72. ANDERSEN, *supra* note 66, § 19.01(2)(d)(ii).
73. KUNTZ & PERONI, *supra* note 68, ¶ B4.16(9).
74. *See id.* ¶ B4.03(3)(c)(vi).
75. *Id.*
76. Compaq Computer Corp. v. Comm'r, 113 T.C. 363, 369-70 (1999).
77. Rocca v. Thompson, 223 U.S. 317, 332 (1937).
78. Xerox Corp. v. United States, 41 F.3d 647, 652 (Fed. Cir. 1994), *nonacq*. 1997-1 C.B. 1.
79. I.R.S. Announcement, 1997-1 C.B. 1.
80. *Xerox*, 41 F.3d at 649.

After reviewing the issue at bar, the court sided with the taxpayer's interpretation of its rights under the U.S.–U.K. Tax Treaty and accompanying U.S. tax regulations.[81] Upon agreeing with the taxpayer's interpretation, the court stated that parties should accord treaty terms their ordinary meaning within the context of the treaty and in a way that "best fulfills the purposes of the treaty."[82] It further held when terms or provisions appear clear and unambiguous, courts should rarely rely on extrinsic evidence to define those terms.[83] In its conclusion, the court determined the restriction on the credit that the government attempted to put forward failed to exist within the text of the treaty.[84] Since the treaty failed to express the restriction the government requested, the court stated the purpose of the treaty, which is the elimination of double taxation, urged the court to adopt the taxpayer's interpretation of the U.S.–U.K. Tax Treaty.[85]

Upon determining the applicable tax treaty, the taxpayer may look to that treaty to define any rights or limitations with respect to various taxes and levies imposed in each country.[86] For example, Articles 8-24 of the U.S.–Korea Tax Treaty endeavor to define the various types of income that are eligible for tax credits between the two countries.[87] In respect to P&G's claimed credits for its Korean tax liability, Article 14 of the U.S.–Korea Tax Treaty defines the proscribed treatment of royalty payments between the two countries.[88]

As for P&G's claimed credit in relation to its Japanese tax liability, originally P&G claimed the credit under Article 12 of the U.S.–Japan Tax Treaty, which pertains to royalties.[89] While not a point of contention in this case, the import of Article 12's language insinuates that Article 7, which deals with business profits, may have been the proper claim for the credit.[90] This potential classification arises because although P&G NEA generated the base revenue of the royalty from within Korea, its principal office operates out of Japan, thus subjecting it to taxes under Japanese law.[91] Article 12, the royalty article, compels the beneficial owner of royalties with a permanent establishment in the foreign country to claim potential credits under Article 7, the business profits article.[92] Whether claimed under Article 7 or 12 of the U.S.–Japan Tax Treaty, however, the IRS denied that claimed credit not because P&G misclassified it, but because the government asserted P&G failed to request a rebate from Japan

81. *Id.* at 660.
82. *Id.* at 652.
83. *Id.*
84. *Id.* at 660.
85. *Id.*
86. KUNTZ & PERONI, *supra* note 68, ¶ B4.03(3)(c)(vi).
87. U.S.-S. Korea Tax Treaty, *supra* note 7, at arts. 8-24.
88. *Id.* at art. 14.
89. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *11 (S.D. Ohio July 6, 2010).
90. U.S.-Japan Tax Treaty, *supra* note 7.
91. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *20.
92. U.S.-Japan Tax Treaty, *supra* note 7, at art. 12(3).

on the portion of the tax liability that could be attributed to sales from within Korea.[93] Although the United States is not a party to it,[94] the Vienna Convention on the Law of Treaties provides guidance for multilateral treaties.[95] Multilateral treaties may be used to facilitate agreements among three or more parties.[96] Although the United States considers many provisions from the Convention customary,[97] such as the article about multilateral treaties, it chooses to enter into bilateral tax treaties, rather than multilateral ones.[98] Logically, a U.S. taxpayer in a similar scenario to P&G who earns income from multiple countries may not claim any benefits under the Japan–Korea Tax Treaty, even though the United States has bilateral tax treaties with both countries.[99] Rather, the taxpayer may claim the benefits only under the U.S.–Korea Tax Treaty with respect to Korean-sourced income and only under the U.S.–Japan Tax Treaty for benefits related to Japanese-sourced income.[100] A U.S. taxpayer who earns income from multiple foreign countries must endeavor to reconcile the rights and obligations in respect to the multiple treaties between the United States and the countries where it earns the income.

As the court stated in *P&G*, "it may well be that multiple countries can claim tax on a single source of income and the IRS is required to grant credits for those claims."[101]

Unless the U.S. government negotiates multilateral tax treaties or persuades its partners to include third-party beneficiary rights into their outstanding treaties, U.S. entities must endure exposure to the potential multi-taxation scenario described above.

B. Who Can Claim the Tax Credit

The party upon whom the foreign tax authority levies a tax retains the benefit of the foreign tax credit.[102] In other words, an incurred liability, alone, does not justify claiming a credit.[103] In *Continental Illinois Corp. v.*

93. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *28.

94. *See Vienna Convention on the Law of Treaties*, U.S. DEP'T OF STATE, http://www.state.gov/s/l/treaty/faqs/70139.htm (last visited Dec. 14, 2012).

95. Vienna Convention on the Law of Treaties art. 40, May 23, 1969, 1155 U.N.T.S. 331.

96. *Id.*

97. *Vienna Convention on the Law of Treaties*, *supra* note 94.

98. *See generally* U.S.-S. Korea Tax Treaty, *supra* note 7 (a bilateral tax treaty); U.S.-Japan Tax Treaty, *supra* note 7 (also a bilateral tax treaty).

99. Convention Between Japan and the Republic of Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Japan-S. Kor., 1998, *available at* http://www3.mofa.go.jp/mofaj/gaiko/treaty/pdf/A-H11-999_1.pdf.

100. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *20 (S.D. Ohio July 6, 2010).

101. *Id.*

102. Biddle v. Comm'r, 302 U.S. 573 (1938) (taxpayer may not derive credits from tax payments by a British corporation of which taxpayer is a shareholder, when corporate taxes paid to British government); Treas. Reg. § 1.901-2(f) (2012).

103. Cont'l Ill. Corp. v. Comm'r, 998 F.2d 513, 517 (7th Cir. 1993).

Commissioner, the taxpayer argued it could claim a credit for a foreign tax liability incurred, but not yet paid.[104] The court rejected the plaintiff's contention due to the potential for less-than-scrupulous shifting of tax liability by U.S. businessmen who may negotiate deals solely to circumvent their U.S. tax liability—an outcome which falls short of the legislative intent behind the regulations.[105] Furthermore, in order to stem further potential misuse of foreign tax credits, the IRS recently proposed amending the regulations to ensure that only the entity that actually incurs the liability can claim the credit, versus an entity that specifically contracts to pay for the tax liability solely to accumulate the credits.[106]

Although the regulations allow for any "taxpayer" to apply for a credit, bilateral U.S. tax treaties take the extra step in defining who is a taxpayer.[107] The U.S.–Japan Tax Treaty, for example, states eligible taxpayers include an individual, a company, or any other body of persons. Arguably similar, the U.S.–Korea Tax Treaty further defines a taxpayer as an individual, a partnership, a corporation, an estate, a trust, or any other body of persons.[108] Furthermore, the U.S. government also allows a shareholder who owns 10% or more of the outstanding voting stock of an entity to claim a foreign tax credit on the amount of liability that is proportional to that shareholder's ownership stake.[109]

In the central case, *P&G v. United States*, the parent company, P&G, owned 100% of the voting stock of P&G NEA.[110] This full ownership stake, therefore, entitled P&G to claim 100% of all allowable credits incurred by P&G NEA through its payment of foreign taxes.[111] As neither party disputed that P&G could claim all allowable credits generated from P&G NEA operations, the allowance of potential credits actually hinged on whether or not the taxes paid were compulsory.[112]

While the definitional article of a treaty puts forth the definition of a "person" under the treaty, further guidance, in the form of subsequent articles, stipulates not only how to determine the fiscal domicile of an entity, but also how to determine the sourcing of certain types of income.[113] One's fiscal domicile

104. *Id.*

105. *See id.*; Mediterranean Ref. Co. v. United States, 442 F. Supp. 946, 948 (S.D.N.Y. 1977) (even though the taxpayer paid 1962 U.S. taxes, court held credit did not accrue in 1996 when the Lebanese government delivered a deficiency assessment for the 1962 tax year since the taxpayer was still contesting the assessment).

106. Stafford Smiley, *Treasury Department Proposes New Regulations in Continuing War Against Abusive Tax Credit Transactions*, 34 WGL-CTAX 34, 34 (2007).

107. U.S.-Japan Tax Treaty, *supra* note 7, at art. 3; U.S.-S. Korea Tax Treaty, *supra* note 7, at art. 2.

108. U.S.-S. Korea Tax Treaty, *supra* note 7, at art. 2.

109. Rev. Rul. 84-6, 1984-1 C.B. 178.

110. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *5 (S.D. Ohio July 6, 2010).

111. *See* Guardian Indus. Corp. v. United States, 65 Fed. Cl. 50 (2005).

112. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *29.

113. *Compare* U.S.-S. Korea Tax Treaty, *supra* note 7, at art. 3 (articulating the definition of fiscal domicile), *with id.* at art. 6 (discussing sources of income).

pertains to where one files its domestic taxes and thus where a party may apply any accumulated tax credits.[114]

C. The Tax Must Be a Compulsory Payment in the Form of Income Tax

If, pursuant to a foreign jurisdiction's authority, a compulsory payment is levied, it is likely considered a tax per U.S. tax rules.[115] The foreign levy must come in the form of an income tax or in lieu of an income tax to fall into the category of allowable foreign tax credits. In sum, the U.S. Treasury states a foreign levy is considered an income tax if it passes a two-part test:[116]

1. It is a tax, and
2. The predominant character of that tax is an income tax in the U.S. sense.[117]

1. *In the Form of an Income Tax*

If a foreign government directly assesses a tax on a stream of income, treaty articles readily define if the tax is creditable.[118] In the case of *P&G,* the court identified the Korean tax as a tax on royalty income, which is creditable under that treaty.[119] When, however, questions arise as to whether a foreign tax resembles a U.S. income tax, courts then turn to the "predominant-character test" to determine its creditability.[120]

In *PPL Corp. v. Commissioner*, after the newly privatized utilities industry outperformed expectations, the U.K. government imposed a one-time tax of 23% on the difference of "profit-making value" and "flotation value" of each new company, which the taxpayer contended was a tax on profits.[121] In spite of the fact that the tax indirectly included profits as a component of the tax computation, however, the court sided with the Commissioner who argued the tax, which used imputed values on each company, was designed to account for what the public believed to be artificially low sales prices of the public companies to private investors.[122] In its decision, the court articulated the predominant-character test.[123] This inquiry, necessarily, asks the court to look at the substance of the imposed tax rather than the form of it reflected in a statute.[124]

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114. *Id.* at art. 3.

115. DAN SCHEAFFER, 12 MERTENS LAW OF FEDERAL INCOME TAXATION § 45D:16 (ThomsonWest rev. 2012).

116. *Id.*

117. Treas. Reg. § 1.901-2 (2011).

118. Nat'l Cash Register Co. v. United States, 400 F.2d 820, 823 (6th Cir. 1968).

119. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *7 (S.D. Ohio July 6, 2010).

120. PPL Corp. v. Comm'r, 665 F.3d 60, 64 (3d Cir. 2011).

121. *Id.* at 62-63.

122. *Id.* at 63.

123. *Id.* at 64.

124. *Id.* at 65.

A foreign assessment passes the predominant-character test if it is "likely to reach net gain in the normal circumstances in which it applies."[125] Using this test, the court concluded that while the tax may reach a certain multiple of gross receipts, since imputed values of gross receipts were used in the computation, regardless if the company actually achieved that value, the tax was not based on the *realization* income and was thus not creditable.[126] As stated by the lower court in *PPL Corp.*, the Secretary first adopted the predominant-character test in § 1.901-2(a)(1) of the 1983 regulations.[127] In the preamble to the regulations, the Secretary stated it derived the criterion for the test from previous case law which investigated similar issues.[128]

One should give careful consideration when distinguishing between a foreign levy that resembles an income tax, in the U.S. sense, and a levy that is excised for an economic privilege. For example, in *Motland v. United States*, the plaintiff challenged a determination that a 2% tax imposed by the Cuban government on exported capital did not amount to an income tax.[129] The court, which agreed with the U.S.'s position, stated the Cuban government imposed the levy for the privilege of exporting the capital from Cuba, not for any income generated within the country, thereby denying the credit.[130]

In *P&G*, the disputed credit stemmed from a tax under the treaty.[131] If the assessed tax failed to appear in the U.S.–Japan Tax Treaty, however, one could determine its creditability by using the predominant-character test. Using this test, the inquiry is whether or not, regardless of the form of the levy, the levy endeavors to, and in fact does, reach net gains.[132] In this case, the tax in question took aim at all profits generated by the P&G NEA office, which was situated in Japan, and therefore classifies this tax as an income tax. The court disregarded this analysis in its determination of creditability, however, since the nature of the Japanese tax was not an issue in this case.

2. *Tax Is Compulsory*

If an amount paid exceeds the amount of liability under foreign tax law, then the IRS considers the excess amount non-compulsory and thus not creditable.[133] Treasury Regulation § 1.901-2(e)(5)(ii) stipulates that an amount does not exceed the amount of liability if the amount paid is reasonably and

125. 26 C.F.R. § 1.901–2(a)(3)(i) (2012).

126. *PPL Corp.*, 665 F.3d at 66.

127. PPL Corp. v. Comm'r, 135 T.C. 304, 321 (2011).

128. Creditability of Foreign Taxes, T.D. 7918, 48 Fed. Reg. 46272-01 (1983), *criterion derived from* Inland Steel Co. v. United States, 677 F.2d 72 (Ct. Cl. 1982); Bank of Am. Nat'l Trust & Sav. Ass'n v. United States, 459 F.2d 513 (Ct. Cl. 1972).

129. Motland v. United States, 192 F. Supp. 358, 361 (N.D. Iowa 1961).

130. *Id.* at 367.

131. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *1 (S.D. Ohio July 6, 2010).

132. Treas. Reg. § 1.901-2(a)(3)(i) (2012).

133. Treas. Reg. § 1.901-2(e)(5)(i).

consistently derived from the applicable foreign law.[134] The policy rationale behind this element is the fact the U.S. Treasury desires to compel taxpayers to expend all reasonable and necessary efforts in order to limit the credits that a taxpayer applies to its U.S. tax liability.[135] If the Treasury failed to promulgate such standards, taxpayers might pay any assessed tax without argument and rely on the U.S. Treasury to reimburse them in the form of credits. This, in turn, would lead to the U.S. Treasury potentially subsidizing foreign governments, an outcome the Treasury is loath to accept.[136]

In order to prevent this outcome, the Treasury designates certain payments to foreign governments as per se barred from receiving a credit.[137] For instance, payments resulting in direct or indirect subsidies given to a taxpayer reduce available foreign tax credits by a corresponding amount.[138] In *PNC Financial Services Group v. Commissioner*, the taxpayer asked the court to consider whether an indirect subsidy given to PNC, through the Brazilian Central Bank, should lessen the amount of the claimed foreign tax credit for that year.[139] The court held the taxpayer must deduct any amount received, whether directly or indirectly through a third person, from the allowable foreign tax credits generated within that country.[140]

The burden lies with the taxpayer to determine if a payment is compulsory, as defined by the regulation.[141] A taxpayer's interpretation fails if actual or constructive knowledge exists which may refute that interpretation.[142] The regulation urges the taxpayer to determine its foreign liability in a way which will reduce it over time.[143] However, it also expressly allows the taxpayer to forgo remedies that fail to provide practical and effective relief as reasonably compared to the cost of pursuing that relief and the likelihood of success if pursued.[144] When determining if an amount paid exceeds a foreign tax liability, the regulation provides a safe harbor for taxpayers who, in good faith, seek advice from competent foreign tax advisers.[145] As described below, this type of competent-authority assistance vastly differs from the competent-authority assistance defined in the relevant tax treaties.

134. *Id.*
135. Rooney & Suit, *supra* note 44, at 683-84.
136. *Id.*
137. Treas. Reg. § 1.901-2(e)(5)(i).
138. *See, e.g.*, PNC Fin. Servs. Grp., Inc. v. Comm'r, 503 F.3d 119 (D.C. Cir. 2007).
139. *Id.* at 122.
140. *Id.* at 124-25.
141. Treas. Reg. § 1.901-2(e)(5)(ii).
142. *Id.*
143. *Id.*
144. *Id.*
145. *Id.*

D. *Who Qualifies as a Competent Authority*

The court admonished P&G for its failure to seek competent authority when assessed the Korean tax. The court, however, interweaved discussion of two distinctly different competent-authority elements.[146] Thus, its analysis leaves future taxpayers with little guidance as to avoiding P&G's shortcomings. In its admonishment, the court first eluded to P&G's failure to invoke competent-authority procedures prescribed under the relevant treaties.[147] Competent-authority procedures under the treaty refer to one's domestic competent authority, which for U.S. domestic taxpayers refers to the U.S. Secretary of Treasury, or its delegate.[148] In the very next breath, the court said P&G's failure to seek foreign counsel, in opposition to the Japanese assessment, provided the foundation for P&G's failure.[149] This competent-authority measure, however, pertains to the procedure described in the regulations, which compels a taxpayer to seek advice from foreign counsel when interpreting foreign tax law.[150]

In regard to the first variation of competent authority, the domestic competent authority, if a taxpayer believes it has received an assessment not in accord with treaty provisions, the relevant treaty will urge the taxpayer to invoke assistance from the Secretary of Treasury as soon as possible.[151] In fact, Revenue Proceeding 2006-54 states a taxpayer's failure to invoke competent-authority proceedings *may* constitute a failure to exhaust all effective and practical remedies.[152] The ruling, however, does not affirmatively state a failure to invoke competent authority is in itself a reason to deny the credit. After foreseeing a potential issue, the treaty urges the taxpayer to determine whether or not the foreign country has a tax treaty with the United States that would articulate any privileges or rights the taxpayer may have in respect to assessed taxes between the two countries.[153] After determining if a tax treaty exists, the taxpayer must find the applicable provision in the treaty that specifies the allowance of the desired tax credit.[154] Lastly, upon determining the need for competent-authority assistance, the taxpayer should request the assistance of the Secretary of Treasury by sending a detailed letter that outlines all of the relevant information including the treaty country, applicable provisions, nature of relief sought, and more.[155] This letter may or may not compel the Secretary to negotiate on the taxpayer's behalf, subject to the Secretary's discretion.[156]

146. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *8-9 (S.D. Ohio July 6, 2010).

147. *Id.* at *23.

148. *See generally* U.S.-S. Korea Tax Treaty, *supra* note 7, at art. 2(1)(f) (defining "competent authority" for both U.S. and Korean taxpayers).

149. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *24.

150. *See* Treas. Reg. § 1.901-2(e)(5)(i) (2012).

151. Rev. Proc. 2006-54, 2006-2 C.B. 1035.

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.*

156. KUNTZ & PERONI, *supra* note 68, ¶ C4.21.

If the Secretary agrees with the taxpayer's contention, relevant treaty provisions merely empower the Secretary to initiate negotiations with its counterpart.[157] These negotiations, which have an eye towards alleviating issues of double taxation, shall endeavor to define ambiguous terms as they exist under a treaty.[158] However, since the Secretary may not amend a treaty, if a foreign government assesses a tax in accord with the treaty, the tax likely stands.[159] In other words, unless the taxpayer finds a treaty article to bolster its argument, failure to invoke this variation of competent authority will not constitute a failure to "exhaust all effective and practical remedies."[160] As discussed below, courts have not traditionally required a taxpayer to take futile additional administrative steps when a foreign country properly assesses a tax liability in accord with a tax treaty.[161] Rather, the domestic competent-authority procedure, as found under tax treaty language, merely compels a U.S. taxpayer to seek assistance from the Secretary of Treasury to the extent the taxpayer may reasonably assert its enumerated rights under a given tax treaty.[162]

As for the second variation of competent authority, Treasury Regulation § 1.901-2(e)(5)(i) contains the only mention of competent-authority procedures in the relevant regulations.[163] The competent authority referenced in the regulation refers to a competent *foreign* tax advisor, which the regulation urges the domestic taxpayer to rely on when interpreting foreign tax law.[164] The regulation does not require the competent foreign authority to hold a governmental office.[165] The taxpayer may, in good faith, reasonably rely on any foreign tax adviser, such as a law firm or accountant, based in the foreign country and fluent with its tax law.[166] Therefore, from the viewpoint of a U.S. taxpayer, while tax treaty language refers to *the* competent-authority procedure as the invocation of assistance from the Secretary of Treasury to assert rights under a treaty, the regulations' only reference to *a* competent authority points to a taxpayer's duty to seek a foreign tax advisor when interpreting foreign tax law.[167]

In regard to a corporation's reliance on a foreign tax professor to provide a reasonable interpretation of foreign tax law, the *IBM v. United States* court stated: "Plaintiff … satisfied the second element of Treas. Reg. § 1.901-2(e)(5)(i), namely that it relied in good faith on a reasonable interpretation of

157. U.S.-S. Korea Tax Treaty, *supra* note 7, at art. 27(1).

158. *Id.* at art. 2(2).

159. U.S. CONST. art. 2, § 2 ("He shall have the Power, by and with the Advice and Consent of the Senate, to make Treaties ….").

160. Int'l Bus. Machs. Corp. v. United States, 38 Fed. Cl. 661, 675 (1997).

161. Schering Corp. v. Comm'r, 69 T.C. 579, 602 (1978).

162. *See* U.S.-Japan Tax Treaty, *supra* note 7, at art. 25 (advising the taxpayer to seek the assistance of the competent authority of the Contracting State in which the taxpayer resides), art. 3(K)(ii) (defining the U.S. competent-authority as the Secretary of Treasury).

163. Treas. Reg. § 1.901-2(e)(5)(i) (2012).

164. *Id.*

165. *Id.*

166. *Int'l Bus. Machs. Corp.*, 38 Fed. Cl. at 668.

167. *See generally* U.S.-S. Korea Tax Treaty, *supra* note 7, at art. 2(1)(f). *But see* Treas. Reg. § 1.901-2(e)(5)(ii) (2011).

Italian law provided by a competent Italian tax advisor."[168] The court further stated the regulations do not require a taxpayer to exhaust all litigation remedies when minimizing foreign tax liability, as that requirement fails to appear in the regulations.[169] Rather, the court announced it will hold a taxpayer only to the exhaustion of all *practical* and *effective* remedies.[170] The court defined practical remedies as those remedies whose costs are reasonable in light of the likelihood of success and the cost of obtaining that success.[171] As stated, if the drafters of the regulation desired to require a taxpayer to exhaust all remedies, regardless of their potential for success, the drafters could have stated this requirement in the regulations.[172] Without this requirement, however, a taxpayer need only rely on a competent foreign adviser in good faith, as promulgated by the regulation.

The competent-authority procedures under the treaty and the competent-authority requirement under the regulation present two very different standards of judgment. While earlier courts and revenue rulings point to this distinction, the *P&G* court exemplifies an evolution of the judgment standard used to assess the validity of a foreign tax credit.[173] This evolution erroneously combines the elements of both standards.

For instance, the regulation urges taxpayers to consult a foreign competent authority for help in interpreting foreign tax law, primarily in the tax planning stage.[174] On the other hand, the regulation compels a taxpayer to invoke domestic competent-authority assistance, which is allowed under the treaty, only when the taxpayer receives a foreign tax assessment that is not permissible under the relevant treaty.[175] The *P&G* court, however, admonished the taxpayer for not consulting a foreign competent authority in Japan when it received the Korean assessment.[176] In other words, the court felt P&G should have sought Japanese counsel to dispute a previously paid tax assessment which the United States had already certified as eligible for a foreign tax credit. Invocation of foreign competent assistance at this point falls well past the tax-planning stage. Furthermore, the regulation expressly allows a taxpayer to forgo a potential remedy if the cost is not reasonable in light of the likelihood of success.[177] In the case of *P&G*, the Japanese tax assessment fell within the provisions of the U.S.–Japan Tax Treaty and the U.S. government both audited and approved the assessment. If P&G had sought foreign competent assistance, at the point the

168. *Int'l Bus. Machs. Corp.*, 38 Fed. Cl. at 673.

169. *Id.* at 675.

170. Treas. Reg. § 1.901-2(e)(5)(i); Int'l Bus. Machs. Corp. v. United States, 38 Fed. Cl. 661, 673 (1997).

171. *Int'l Bus. Machs. Corp.*, 38 Fed. Cl. at 668-69.

172. *Id.* at 675.

173. *Id.* at 661; Rev. Proc. 2006-54, 2006-2 C.B. 1035. The case and the revenue ruling discuss the difference between procedures put forth under tax treaties and the I.R.S.

174. Treas. Reg. § 1.901-2(e)(5)(i).

175. *Id.* § 1.901-2(e)(5)(ii).

176. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *24 (S.D. Ohio July 6, 2010).

177. Treas. Reg. § 1.901-2(e)(5)(ii) (2011).

court urged, it would have been neither practical nor effective since the likelihood of success was nearly nonexistent.

IV. DOCUMENTED CHANGE FROM MERIT BASED ADJUDICATION TO PROCEDURAL-BASED ADJUDICATION

Since 1918, the U.S. legislature has allowed taxpayers to claim foreign tax credits on their domestic tax liability.[178] The statute intends to limit the effects of double taxation arising from compulsory taxes paid to other nations.[179] While the intent behind § 901 of the U.S. Code has remain unchanged, courts' interpretations of what qualifies as "compulsory" has evolved. A comparison of two similar cases, *Schering Corp. v. Commissioner* and *P&G v. United States*, exemplifies this evolution.

A. Schering*: A Case Based on the Merits of the Claim*

In 1978, Schering Corp. (Schering) challenged the Commissioner's determination that a Swiss withholding tax, which Schering's wholly-owned Swiss subsidiary paid, was not a compulsory tax in nature.[180] Schering had earlier transferred patents and licensing rights to its subsidiary, Scherico.[181] Schering owned 100% of Scherico, which sold Schering products throughout the world.[182] As advised by its Swiss counsel, pursuant to a closing agreement with the commissioner regarding the reallocation of income for tax purposes, Scherico chose to pay a dividend to Schering to account for the claimed deficiency.[183] Upon payment of the dividend, Scherico withheld 5% to pay the Swiss withholding tax.[184] Scherico withheld 5%, rather than the statutorily mandated 30%, because of the limitation in the U.S.–Swiss Income Tax Treaty.[185]

After the dividend was paid, Schering sent its deficiency payment to the Commissioner, pursuant to the previously agreed closing agreement, less the 5% withheld for the Swiss tax, which it claimed as a foreign tax credit.[186] The Commissioner sent a notice to the taxpayer informing it that the claimed foreign credit was not allowed for the full amount.[187] In its notice, the Commissioner advised the taxpayer to seek competent authority, as allowed under the tax treaty,

178. *See* Burnet v. Chi. Portrait Co., 285 U.S. 1, 7 (1932).
179. *Id.* at 276.
180. Schering Corp. v. Comm'r, 69 T.C. 579 (1978).
181. *Id.* at 580.
182. *Id.*
183. *Id.* at 590.
184. *Id.*
185. *Id.* at 585; Convention Between the United States of America and The Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income art. 10(2)(a), Oct. 2, 1996.
186. *Schering*, 69 T.C. at 589.
187. *Id.*

if it believed that the tax failed to conform to the treaty.[188] The taxpayer never sought competent-authority assistance.[189]

In court, the Commissioner argued the taxpayer failed to exhaust all remedies whether in the form of administrative proceedings in Swiss courts or competent-authority procedures prescribed under the treaty.[190] In response to this argument, the court stated the taxpayer is not required to take futile additional administrative steps to avoid preclusion from a foreign tax credit.[191] More specifically, in regard to the failure to challenge the tax in Swiss administrative proceedings, the court found the Swiss Withholding Tax Act, as interpreted under Swiss tax law, required the taxpayer to withhold the 5%, which Schering did.[192] In its analysis, the court found the taxpayer's reliance on Swiss counsel, when it *first* withheld the 5%, justified a reasonable interpretation of Swiss tax law.[193] Schering's reliance on Swiss counsel, which occurred before the Commissioner advised Schering to seek competent-authority assistance, mirrors the reliance P&G used in submitting its original tax liability to Japan, as discussed below.

The Commissioner also challenged the taxpayer's failure to seek competent-authority assistance as provided under the tax treaty and advised in the Commissioner's letter.[194] The court, however, disagreed with this argument.[195] The court elaborated that since the taxpayer was entitled to the credit pursuant to the tax treaty, there was "no double taxation from which it might have sought relief through competent authority proceedings."[196] It further opined that the taxpayer is entitled to forgo potential benefits available under competent-authority proceedings to seek judgment from the courts on the merits of the taxpayer's claim under U.S. tax law.[197]

After determining the paid tax was compulsory and entitled to a credit, the court briefly stated the policy rationale behind its decision.[198] The court first recognized the Treasury's need to scrutinize and challenge some claims since the U.S. government declines to subsidize foreign governments through the allowance of all claimed credits.[199] It then stated, however, the government should not ask taxpayers to shoulder the burden that may arise from failures of negotiation between treaty countries.[200] Upon reviewing the U.S.–Switzerland Tax Treaty, the court refused to apply the restriction the Commissioner

188. *Id.* at 588.
189. *Id.* at 589.
190. Schering Corp. v. Comm'r, 69 T.C. 579, 601-02 (1978).
191. *Id.* at 602.
192. *Id.*
193. *Id.*
194. *Id*. at 602-03.
195. *Id.* at 603.
196. *Id.*
197. *Id.*
198. *Id.* at 604.
199. *Id.*
200. Schering Corp. v. Comm'r, 69 T.C. 579, 604 (1978).

wanted.[201] Since this restriction appeared in other treaties, aside from the one at bar, the court concluded the Commissioner, not the taxpayer, bears the burden for the inherent failings of a tax treaty.[202] Furthermore, the court looked to the terms of the treaty which allowed the competent authority, on its own volition, to compel proceedings with the Swiss government with a "view to negotiating a bilateral solution" to the inherent flaws of the treaty.[203] Upon the merits presented, the court concluded the taxpayer paid a compulsory income tax under the terms of the treaty and was therefore allowed to claim the credit allowed under § 901, regardless of whether it asked the relevant competent authority for assistance.[204]

The *Schering* court's basis for final judgment, which rested on the merits of the taxpayer's claim, provides a stark contrast to the current method employed by the courts, as evidenced in *Proctor & Gamble v. United States.* The method used in that case heavily relied on the procedural mechanisms undertaken by the taxpayer.[205] As shown above, historically, a taxpayer's failure to invoke competent-authority assistance merely precluded the taxpayer from the benefits that assistance may have provided.[206] As shown below, however, courts have begun to require the invocation of competent-authority assistance before proceeding to analyze the merits of an individual claim.[207] This evolution allows the government to use the available procedural mechanisms as a shield to protect itself against otherwise meritorious claims.

B. P&G's Otherwise Meritorious Claim Denied Due to Procedural Shortcomings

In *P&G*, the IRS claimed P&G, upon receiving a tax deficiency notice from South Korea on a stream of income generated within South Korea, failed to invoke competent-authority assistance to dispute taxes which had already been paid to Japan, on the same stream of income, even though the IRS had already audited and approved the credits related to the Japanese tax. Due to P&G NEA's physical presence in Japan, P&G paid the Japanese withholding tax on the royalty income at issue from 2000 through 2004.[208] It did not pay a withholding tax to Korea during this time.[209] P&G claimed a foreign tax credit on these payments, which the IRS granted after auditing the filings.[210] In 2006, the

201. *Id.*

202. *Id.*

203. *Id.*

204. *Id.*

205. *See generally* Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747 (S.D. Ohio July 6, 2010) (granting summary judgment to the government because P&G failed to exhaust administrative remedies available under Japanese tax law).

206. *See* text accompanying *supra* note 197.

207. *See* text accompanying *infra* note 208.

208. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *20.

209. *Id.*

210. *Id.* at *2.

Korean government issued a deficiency notice to P&G for withholdings due on the royalty income at issue.[211] P&G invoked foreign competent-authority assistance in Korea to investigate the deficiency notice; however, it determined the assessment was correct and therefore paid the deficiency.[212] P&G then claimed a foreign tax credit for this payment.[213] The IRS, however, barred the claim because P&G did not invoke competent authority to dispute the payments made to Japan, which had already been audited and approved by the IRS.[214]

As stated in *Schering*, a taxpayer's failure to invoke competent-authority assistance should only bar it from the potential benefits it may have gained if it used that procedure.[215] If the *P&G* court had used the same analytical method employed by the *Schering* court, the issue would have been whether or not P&G's claim would have survived on its merits, regardless of whether it invoked competent-authority assistance. The *P&G* court determined "while Korea and Japan may indeed both ultimately uphold their claims on the same source of income," P&G's claim failed because "the onus [wa]s on P&G to exhaust all practical and effective remedies, in both countries, before claiming a foreign tax credit."[216] Since that court determined the Korean tax was creditable, a proper analysis of this case lies in analyzing the merits of P&G's claim in regard to the withholding tax of Japan.

1. *P&G's Claimed Credit Falls Under Provision in U.S.–Japan Tax Treaty*

The analysis begins with a look at the U.S.–Japan Tax Treaty. As the income stream in question arose from royalties paid pursuant to the activities of P&G NEA's office in Japan,[217] Article 12, which defines royalties, directs the taxpayer to determine its liability under Article 7:

> The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.[218]

Article 7 compels a U.S. taxpayer, who has a permanent establishment in Japan, to pay a profit tax to Japan for profits attributed to that establishment.[219] P&G NEA, whose principal office was located in Japan at the relevant time, sold

211. *Id.* at *20.
212. *Id.*
213. *Id.* at *11.
214. *Id.* at *12, 17.
215. Schering Corp. v. Comm'r, 69 T.C. 579, 603 (1978).
216. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *24 (S.D. Ohio July 6, 2010).
217. *Id.* at *5.
218. U.S.-Japan Tax Treaty, *supra* note 7, at art. 12.
219. *Id.* at art. 7.

products throughout North East Asia, including Korea.[220] Since P&G NEA located its principal offices in Japan, any profits derived from the activities of that office, including overseas sales in Korea, should have been taxed pursuant to Article 12 of the U.S.–Japan Tax Treaty. Furthermore, after claiming this credit on its U.S. tax liability from 2000 to 2004, the IRS upheld the credits. At that time, the IRS did not ask P&G to provide further evidence of competent-authority assistance, presumably because the payment to Japan was creditable under the tax treaty.

2. *P&G Entitled to Credits Generated by P&G NEA*

After finding the relevant provisions under the treaty, the next question is whether or not P&G is entitled to any allowable credit. As defined by Article 3(1)(h) of the U.S.–Japan Tax Treaty, P&G is a U.S.-based "enterprise of a contracting state," which means it ultimately pays taxes on its worldwide income to the U.S. government.[221] P&G NEA, P&G's wholly-owned subsidiary, carries on business in Japan, therefore subjecting that entity to profits taxes in Japan.[222] Accordingly, since P&G is the parent company with fiscal domicile in the United States, any allowable credits generated by P&G NEA can be utilized by P&G on its U.S. tax liability.[223]

3. *P&G's Tax Payment to Japan Was Compulsory*

In 2006, the Korean tax authority issued a notice to P&G that included deficiencies for the royalty income tax, a local municipal surcharge, and penalties.[224] When it filed for the foreign tax credit, P&G included only the liabilities related to the royalty income tax and the local municipal surcharge, but not any included penalties.[225] P&G correctly excluded the penalties pursuant to Treasury Regulation § 1.901-2(e)(5)(ii).[226] Upon submitting the foreign credit claim, the IRS informed P&G the credit was not allowed due to a failure to comply with Internal Revenue Code § 901.[227] This failure did not stem from the addition of the local surcharge; rather, it arose from P&G's tax liability as related to Japan.[228]

The IRS argued, and the court agreed, that P&G failed to comply with § 901 for a failure to invoke competent-authority assistance in relation to the tax

220. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *4-5.
221. U.S.-Japan Tax Treaty, *supra* note 7, at art. 3(1)(h).
222. *Id.* at art. 7.
223. *See generally* Guardian Indus. Corp. v. United States, 65 Fed. Cl. 50 (2005).
224. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *6.
225. *Id.* at *9.
226. Treas. Reg. § 1.901-2(e)(5)(ii) (2011).
227. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *12 (S.D. Ohio July 6, 2010).
228. *Id.* at *26.

liability P&G incurred from 2000 to 2004.[229] The IRS stated that once P&G received the deficiency notice from Korea in 2006, in regard to income generated from within Korea, P&G should have then endeavored to reduce the tax liability it incurred in Japan from 2000 to 2004.[230] Although P&G engaged foreign competent-authority assistance in an effort to dispute the new Korean assessment, it did not invoke that assistance in relation to the previously claimed and audited credits related to Japan.[231] The IRS contends that a taxpayer's payment to a foreign nation is not compulsory unless the competent-authority procedure is invoked.[232] This argument fails, however, in the face of the plain language of the regulation, previous case law, and the U.S.–Japan Tax Treaty.

In regard to the regulation and previous interpretations of it, the IRS specifically points to the language which states, "effective and practical remedies including invocation of competent authority procedures."[233] The *P&G* court, however, vastly differs in its interpretation of this phrase as compared to the *Schering* court. In its interpretation, the *Schering* court explicitly stated taxpayers should not be required to take futile additional procedural steps when they are entitled to a credit pursuant to a treaty.[234] Instead, the court stated this failure precludes the taxpayer from only the benefits of that process, rather than preventing it from presenting the merits of its case to the courts.[235] The *P&G* court, on the other hand, interprets Treasury Regulation § 1.901-2(e)(5)(ii) as requiring the invocation of competent-authority assistance in order to present a case to the courts on its merits.[236]

This interpretation, however, disregards the plain language of the regulation. While the regulation requires taxpayers to engage all effective and *practical* remedies if faced with double taxation, it also defines a noncompulsory payment as one that exceeds a foreign liability.[237] If the legislature wanted the taxpayer to procedurally dispute each and every tax assessment, one presumes it would have explicitly included this requirement in the definition of a "noncompulsory" payment. Rather than stating that a noncompulsory payment is merely one that exceeds foreign liability, it might have stated that a noncompulsory payment is either one that exceeds foreign tax liability or one which is paid without exhausting all procedural remedies, regardless of the merits of the assessment. Furthermore, the *P&G* court's interpretation of the competent-authority requirement opens the door to unwieldy results for any taxpayer as it may erroneously compel a taxpayer to needlessly dispute a

229. *Id.* at *25-26.

230. *Id.*

231. *Id.*

232. *Id.* at *20.

233. *Id.* (citing Treas. Reg. § 1.901-2(e)(g)(i)).

234. Schering Corp. v. Comm'r, 69 T.C. 579, 602 (1978).

235. *Id.* at 603.

236. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *20-21.

237. *See generally* Treas. Reg. § 1.901–2(5)(i) ("An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax.").

legitimate tax assessment merely to comply with the foreign competent-authority requirement.

Presumably, the *Schering* court failed to require a taxpayer to exhaust futile procedural remedies due to the inexorable results this it might yield. If a taxpayer is required to dispute all tax liabilities, regardless of whether they were properly assessed, the amount of money spent on compliance would overtake the intent of § 901. If the statute intends to minimize the burden related to foreign taxes, surely it cannot concurrently require the taxpayer to expend unnecessary money on futile procedural remedies if the tax assessment is both correct under foreign law and stipulated in a tax treaty.

In *P&G*, the IRS did not allege, nor did the court determine, whether the payment to Japan was made pursuant to a reasonable interpretation of the Japanese tax law.[238] Presumably, however, the IRS made this determination when P&G first filed for the credit and the IRS allowed it.[239] The IRS was correct to argue that Revenue Ruling 2006-54 allows it to reopen a prior case if a later claimed credit is related to it. However, this ruling also stipulates that the IRS may not reopen a case to make an unfavorable adjustment to the taxpayer except for fraud or exceptional cases.[240] Despite Revenue Ruling 2006-54, the *P&G* court stated the denial pertained to the singular income stream and is therefore allowed, thus disregarding the fact that the credits arose from two different countries.[241]

In sum, the IRS did not argue, nor did the court find that P&G's payment to Japan exceeded the company's actual tax liability; rather, it determined the credit failed due to a failure to invoke competent-authority assistance under the treaty.

4. *P&G Invoked All Practical and Effective Remedies Within Its Control*

Upon receiving the deficiency notice from the Korean tax authority, P&G promptly sought foreign competent assistance from a well-known Korean tax firm.[242] The court concluded this satisfied the competent-authority requirement for the Korean credit.[243] The invocation of Korean counsel, however, did not satisfy the court's desire for competent authority with regard to the Japanese credit.[244] Although discussion of competent authority may relate to either a foreign authority interpreting foreign tax law or the U.S. authority negotiating

238. *See generally* Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747 (S.D. Ohio July 6, 2010), which contains no discussion about whether the Secretary of Treasury had a basis to compel the Japanese government to give P&G a refund, had the competent-authority been invoked.

239. *Id.* at *2-3.

240. Rev. Proc. 2006-54, § 3.05, I.R.B. 49.

241. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *20.

242. *Id.* at *21.

243. *Id.*

244. *Id.*

with its foreign counterpart, the court failed to distinguish between the two, as more fully described below.[245]

The U.S. Treasury puts forth advice for taxpayers to seek foreign competent assistance to help with interpretation of foreign tax law.[246] This kind of assistance may be necessary to help the U.S. taxpayer reasonably assess the foreign tax liability. In fact, the regulation provides a safe harbor for those who reasonably seek foreign assistance; however, in this case, the question relates to when P&G was required to seek this assistance. Presumably, P&G sought to correctly determine its Japanese liability when it first filed its 2000 to 2004 tax filings. In fact, the IRS correctly determined this fact to be true when it first allowed the credit.[247] If the court insinuates the competent authority P&G failed to seek was the foreign competent assistance prescribed under the regulations, the logical conclusion is the court required P&G to seek that assistance not when it first filed for the Japanese credit but, rather, after the Korean authority sent its notice. This is considering the fact the taxes and accompanying credits were claimed under two different treaties. While requiring a taxpayer to seek foreign assistance when first filing makes sense and serves to steer the taxpayer from overreliance on domestic credits, requiring the taxpayer to further dispute an accepted liability—when it has already been determined as correct—is illogical.

On the other hand, the court also pointed to Article 25 in the U.S.–Japan Tax Treaty as evidence the taxpayer was required in invoke domestic competent-authority proceedings to dispute the Japanese liability:[248]

> Where a person considers that the action of one or both of the Contracting States results or will result for him in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident.[249]

The court's interpretation, however, directly conflicts with the interpretation put forth in *Schering*. Similar to *Schering*, P&G asserts the Japanese liability conforms to the tax treaty, whether under Article 7 or 12.[250] As the *Schering* court announced, if the foreign tax liability is in accord with the treaty, there is no double (in P&G's case, triple)[251] taxation from which the taxpayer may seek relief.[252] Rather, the domestic competent authority serves to work with its counterpart when instances arise in which the taxpayer feels it is subjected to a liability that is not accord with the treaty. In this case, P&G argued the Japanese

245. *See id.*

246. Treas. Reg. § 1.901-2(e)(5)(i) (2012).

247. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *2.

248. Proctor & Gamble v. United States, No. 1:08-cv-00608, 2010 U.S. Dist. LEXIS 83747, at *17 (S.D. Ohio July 6, 2010).

249. U.S.-Japan Tax Treaty, *supra* note 7, at art. 25.

250. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *5-6.

251. This note refers to the potential taxation of a single stream of income from Korea, Japan, and the United States.

252. Schering Corp. v. Comm'r, 69 T.C. 579, 603 (1978).

tax liability conformed to the requirements of the treaty;[253] therefore, invocation of domestic competent-authority assistance would have been futile.

If P&G had invoked domestic competent-authority assistance, what rights were potentially violated under the treaty? Both the Japanese and Korean tax liabilities conformed to the respective treaties those countries have with the United States.[254] Neither the IRS nor the court argues this point. Although the outcome remains unfortunate, neither the IRS nor the court point to a statute, case, or treaty that prohibits a taxpayer from claiming two separate tax credits on a single stream of income.[255] While not expressly ruling on the issue, both the *Schering* and *P&G* courts admit this practice may be allowed under the current law.[256] Although careful not to place an affirmative onus on the domestic authority, the *Schering* court further articulates the relevant articles under a treaty allow the Secretary of Treasury itself to initiate multi-party negotiations in order to solve problems to which the treaties are silent.[257]

The Vienna Convention on the Law of Treaties proposes the allowance of multilateral treaties among nations, which could have helped P&G assert a right against double taxation if the United States, Japan, and Korea were all signatories.[258] Further, the United States could negotiate with Japan and Korea to include a third-party-beneficiary article in the Japan–Korea treaty which could extend benefits allowed under that treaty to an entity, such as P&G, which conducts business in both countries. To date, however, the United States has failed to assert any such stance which may protect future taxpayers confronted with this same situation. Only the U.S. government, not P&G, can initiate treaty negotiations with foreign nations. Similarly, when a foreign counterpart taxes a domestic entity in accord to the respective treaty, the burden should be on the Secretary of Treasury to resolve the issue, not on the taxpayer to urge the Secretary to fundamentally alter the provisions of the treaty.

CONCLUSION

In conclusion, the *P&G* court barred an otherwise meritorious credit claim due to a procedural shortcoming which would have been neither effective nor practical since the Japanese tax liability was correct under both Japanese law and the corresponding treaty. This decision melds together two distinctly different analyses and leaves future taxpayers in doubt as to how to comply with either competent-authority analysis without expending unnecessary resources. Further, as the court required the taxpayer to assert rights that had not previously existed under the treaty, it leaves future taxpayers without direction as to the scope of the

253. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *11.

254. *See generally Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747. Unfortunately, the court never reached the merits of the claim due to P&G's alleged shortcomings.

255. *Id.*

256. *Proctor & Gamble*, 2010 U.S. Dist. LEXIS 83747, at *20; *Schering*, 69 T.C. at 603.

257. *Schering*, 69 T.C. at 604.

258. *See generally* Vienna Convention on the Law of Treaties art. 40, May 23, 1969, 1155 U.N.T.S. 331.

resistance they must put forth in minimizing their foreign tax burdens. Until the legislature clarifies its intent, whether through treaty or statutory amendments, U.S. entities must endure a banner of uncertainty which will only increase the costs paid for compliance.