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The Treatment Of Foreign Income Taxes Under the California Bank and Corporation Tax Law

ERIC J. COFFILL*

Numerous articles have addressed the manner and circumstances under which foreign income taxes paid may be either credited against United States income tax or deducted against the gross income of a taxpayer for federal tax purposes. However, little attention has been given to the states' treatment of foreign income taxes paid by a taxpayer subject to state taxation.

This article will examine how California treats foreign income taxes paid by taxpayers who are subject to the California Bank and Corporation Tax Law. California, unlike the federal tax system, does not allow either a credit or a deduction for the payment of foreign taxes on or according to or measured by income. However, payments made to the government of a foreign country which are in the nature of something other than an "income" tax, such as royalties or other

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2. The Bank and Corporation Tax Law is found in the California Revenue and Taxation Code, Division 2, Part 11, §§23001-26491.
types of taxes, may be allowed as a deduction. Thus, the classification of a levy by a foreign government as an income tax has a significant impact upon a California taxpayer because any payments made under that levy are not deductible for California state tax purposes.

Central to the issue of whether a payment of taxes to a foreign country will be allowed as a deduction is whether that payment is of a tax on or according to or measured by "income" as that term is used in California Revenue and Taxation Code\(^3\) section 24345. This article will identify the significant elements of an "income" tax as those elements have evolved under section 24345 and the California statutory scheme. A discussion also follows of why that statutory scheme is consistent with the method used in California of taxing on a source basis as opposed to a residence basis, and why it is unnecessary for California to allow either a deduction or a credit for the payment of income taxes to the government of a foreign country.

This article will also identify those areas which have been, and should continue to be, the more frequent sources of controversy and litigation in this area. Finally, the article will discuss the definition of "income" as contained in the final federal foreign tax credit regulations of 1983, and the impact, if any, of those federal regulations upon the California scheme which disallows a deduction for foreign income taxes.

**Section 24345 and the California Statutory Framework**

The issue of the deductibility of a foreign income tax may arise in computing the net income of a taxpayer subject under the Bank and Corporation Tax Law to either the California franchise tax\(^4\) or the California corporation income tax.\(^5\) The basic statutory provision

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3. All references hereinafter to code sections are to the California Revenue and Taxation Code, except where otherwise noted.

4. **Cal. Rev. & Tax. Code**, §§23101-23364(a). Generally speaking, the franchise tax is imposed on corporations which are "doing business" in California and are not expressly exempted under the Bank and Corporation Tax Law or the Constitution of California. *Id.* §23151(a). "Doing business" means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." *Id.* §23101. A minimum franchise tax is imposed on such corporations regardless of the corporation's activity or its profitability, and on corporations qualified to do business in California.

5. **Cal. Rev. & Tax. Code**, §§23501-23572. Generally speaking, the corporation income tax is imposed on all general corporations which, while not "doing business" in California, have income "derived from sources within this state . . . ." A corporation may be subject to the minimum franchise tax (because of qualification) and the income tax (because of deriving income from California sources though not "doing business"). In this case, the minimum franchise tax is allowed as an offset against the income tax. *Id.* §23503.
which governs the deductibility of foreign taxes paid by a California corporate taxpayer is section 24345, which provides in pertinent part:

There shall be allowed as a deduction— (a) Taxes or licenses paid or accrued during the income year except:

(1) Taxes paid to the State under this part.
(2) Taxes on or according to or measured by income or profits paid or accrued within the income year imposed by the authority of
(A) The Government of the United States or any foreign country; or
(B) Any state, territory, county, school district, municipality, or other taxing subdivision of any state or territory.

Thus, section 24345 disallows a deduction for “taxes on or according to or measured by income or profits” paid or accrued within the income year and imposed by authority of a foreign country. This disallowance of a deduction for foreign income taxes is an exception to the statutory general rule set forth in section 24345 that taxes paid are allowed as a deduction. As originally enacted in 1929, the predecessor to section 24345 disallowed as a deduction only taxes paid “on income or profits.” The current language “on or according to or measured by income or profits” was added by amendment in 1933. The purpose of this amendment was to make nondeductible all taxes measured by income no matter what they were levied upon. It should also be noted that California is not the only state which denies by statute a deduction from the taxable base for corporate net income tax purposes for foreign taxes on or measured by income.

6. “Corporate taxpayer” refers herein to a taxpayer subject to either the California franchise tax or the California corporation income tax.
7. Section 24345 was added by 1955 CAL. STAT. c. 938, §20, at 1581, eff. June 6, 1955, and amended by 1957 CAL. STAT. c. 544, §§ at 1602, eff. May 30, 1957.
8. 1929 CAL. STAT. c. 13, §8 at 21.
9. 1933 CAL. STAT. c. 209, §1(c) at 687.
11. The Multistate Tax Commission recently surveyed all fifty states and the District of Columbia regarding whether they allowed a deduction from the taxable base for corporate net income tax purposes for foreign taxes on or measured by net income. The responses indicate that as of December 1983, five states (Nevada, South Dakota, Texas, Washington and Wyoming) do not impose a tax on net income. Twenty-two jurisdictions (Alaska, California, District of Columbia, Georgia, Indiana, Kansas, Kentucky, Massachusetts, Michigan, Mississippi, Montana, Nebraska, New Hampshire, New York, North Carolina, North Dakota, Oklahoma, Pennsylvania, South Carolina, Utah, Virginia and West Virginia) responded that no deduction was allowed. Ten states (Alabama, Arkansas, Connecticut, Delaware, Hawaii, Louisiana, Missouri, New Jersey, New Mexico and Wisconsin) responded that a deduction was allowed. Eleven states (Maine, Maryland, Tennessee, Vermont, Florida, Idaho, Illinois, Iowa, Minnesota, Ohio and Rhode Island) reported the allowance of a deduction for foreign taxes only if taken

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As will be seen in the following section, the California Franchise Tax Board, the California State Board of Equalization ("the Board"), and the California courts have often interpreted section 24345 by looking to interpretations of statutory counterparts under the California Personal Income Tax Law. The deductibility of foreign income taxes under the Personal Income Tax Law is now governed by section 17220, which provides that no deduction shall be allowed for "foreign income" taxes.

Section 17220 was recently added to the Code, and is operative for taxable years beginning on or after January 1, 1983. Its predecessor was first enacted in 1943 as former section 17305, which provided generally for the deduction of all taxes except those specifically enumerated to be nondeductible. Among those made nondeductible were "(b) Taxes on or according to or measured by income or profits ... imposed by the authority of (1) the Government of the United States or any foreign country. . . ." This crucial language was retained through several revisions and amendments, including when the section was renumbered to section 17204 in 1955.

as a deduction, not a credit, on the federal return. Arizona responded that a deduction was allowed in the amount of foreign tax used to offset federal income tax liability, unless the credits are attributable to dividends received from controlled corporations which are subtracted under other provisions of state law. Colorado does not allow a deduction for foreign taxes paid to foreign countries, but does not have a provision requiring the adding back to federal net income of deductions taken for taxes paid to political subdivisions of foreign countries. Oregon allows a deduction for foreign taxes upon dividends, interest, or royalties if they are included in the tax base. Survey of States Regarding Deduction for Payment of State, Local, Federal & Foreign Taxes, 1 MULTISTATE TAX COMMISSION REVIEW 22, March 1984.

12. The California Franchise Tax Board is charged by statute with the administration and enforcement of the Personal Income Tax Law and the Bank and Corporation Tax Law. CAL. REV. & TAX. CODE, §§19251, 26422. While the Franchise Tax Board has the power pursuant to this authority to issue rulings, few recent rulings have been issued in the area of foreign taxes. Legal Ruling No. 343, dated October 5, 1970, CCH Cal. Tax Reports ¶204-419 states: "In the future, Legal Rulings will normally not be issued on the subject of particular foreign taxes, since any decision regarding the tax law of a foreign country must, of necessity, be very limited in its application and is therefore of little precedent value."

13. The California State Board of Equalization (hereinafter referred to as "the Board") hears and determines appeals of taxpayers from deficiency assessments and from the denial by the Franchise Tax Board of claims for refund. CAL. REV. & TAX. CODE, §§18593-596, 19057-61, 25666-67, 26075-77.


15. CAL. REV. & TAX. CODE, §17220 provides in pertinent part: "No deduction shall be allowed for . . . (a) state, local, and foreign income, war profits, and excess profits taxes . . . ." Reenacted from former §17204 by 1983 CAL. STAT. 488, operative for taxable years beginning on or after January 1, 1983.


17. 1943 CAL. STAT. c. 659, §1.

Between 1955 and the time of its repeal in 1983, former section 17204, in language identical to that still found in section 24345, provided that no deduction was allowed for "taxes on or according to or measured by income or profits" imposed by authority of a foreign country. The existence of this key identical language in sections 17204 and 24345 often led the Board and the courts to the conclusion that the interpretation of this language in one section controlled in the interpretation of the other. However, this common approach to both statutes may no longer be appropriate in all circumstances. Section 17220, which in 1983 replaced section 17204, now more closely resembles the predecessor to section 24345, which disallowed as a deduction only taxes "on income or profits," than it does the present version of section 24345. Thus, an issue exists with respect to whether section 17220 which now denies a deduction for "foreign income" taxes should be interpreted differently than its predecessor, section 17204, and differently from section 24345, both of which deny a deduction for taxes "on or according to or measured by income or profits" imposed by authority of a foreign country.

THE DEFINITION OF AN INCOME TAX

A. Introduction

The question of when a foreign tax is "on or according to or measured by income" has generated a small body of case law in the California appellate courts, and a modest number of opinions by the Board. Indeed, this question has generated as much California law as any issue surrounding the treatment of foreign income taxes.

The deductibility of a foreign tax is determined by an examination of the nature of the tax. Prior to the 1977 decision of the California Supreme Court in Beamer v. Franchise Tax Board, the majority of

19. Prior to its repeal by 1983 CAL. STAT. c. 488, operative for taxable years beginning on or after January 1, 1983, section 17204 provided in pertinent part:

(c) No deduction shall be allowed for the following taxes:

(2) Taxes on or according to or measured by income or profits paid or accrued within the taxable year imposed by the authority of any of the following:

(A) The government of the United States or any foreign country.

20. For example, in MCA, Inc. v. Franchise Tax Board, 115 Cal. App. 3d 185, 193, 171 Cal. Rptr. 242, 247 (1981), the Court of Appeal concluded that "since these statutes are obviously in pari materia, the interpretation of a sentence in one controls the interpretation of virtually the same sentence in the other." In re Phyle, 30 Cal. 2d 838, 845, 186 P.2d 134 (1947). The common interpretation of these corresponding sections of the Personal Income Tax law and the Bank and Corporation Tax Law will be discussed in the following section.

the decisions of the Board had focused upon the issue of whether the tax was being imposed on "income" instead of being imposed upon a return of capital. A tax imposed on a return of capital cannot be an "income" tax because a return of capital does not constitute income to the recipient. Thus, the payment of a tax imposed upon a return of capital is generally a deductible tax under section 24345 because a tax on a return of capital is not an income tax. After Beamer, however, the focus of the opinions of the Board in this area shifted to an inquiry of whether the tax was imposed on gross income under the general income tax law. The consequence of this analytical approach is that a tax imposed on gross income is an "income" tax made nondeductible by section 24345.

The following discussion traces the development of these theories before the Board and in the California courts, with emphasis on the key judicial decisions in the area. A discussion also follows concerning the issue of the degree of realization required in order to generate "income" as that term is used in section 24345.

B. The Guettler and Meltzer Decisions

Some insight into the current meaning of "income" for purposes of section 24345 may be gained from an examination of how that term has been interpreted in the past. The meaning of "income" was first discussed in depth by the Board not under section 24345, but under former section 17305 of the Personal Income Tax Law. In the companion cases of Appeal of Georgica Guettler and Appeal of Meltzer, both decided in 1953, the Board held that taxes imposed upon a California resident under the Canadian Income War Tax Act were not limited to income or profits, but were imposed to some extent upon gross receipts. The Board concluded the tax imposed upon gross receipts was deductible under former section 17305 because the tax on gross receipts was not a tax imposed on "income."

The subject of Guettler and Meltzer was the deductibility of taxes...

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22. Id. at p. 479.
23. Perhaps the small number of California court decisions addressing the treatment of foreign taxes can be explained, in part, by the fact that a taxpayer's recourse to the courts is limited in the sense that a deficiency assessment cannot be challenged in court without first making payment to the Franchise Tax Board. After payment of the assessment, plus interest, and the filing and denial of a claim for refund, a taxpayer may then bring a suit for refund against the Franchise Tax Board for the recovery of the whole or any part of the amount paid. CAL. REV. & TAX. CODE, §§19081-92, and 26101-97.
25. Id.
paid pursuant to section 27(1) of the Canadian Income War Tax Act, which imposed a special tax on nonresidents. The measure of that tax was the gross amount of rents, royalties and similar payments for anything used or sold in Canada. The taxpayer in *Guettler* claimed the Canadian tax paid as a deduction against her California personal income tax where the Canadian tax had been imposed upon income from patent royalties received from Canadian licensees. The taxpayers in *Meltzer* claimed a deduction against their California personal income tax for the Canadian tax imposed upon rental income received from an interest in Canadian real estate.

The Board concluded in both *Guettler* and *Meltzer* that the meaning of the words "income or profits" as used in section 17305 was to be determined by the criteria of "our" general revenue law. Under that criteria, the Board noted "income" includes only gain or profits and excludes receipts which constitute a return of capital. The Board concluded in both opinions that because the Canadian tax could have been imposed on payments received as consideration for the sale of property, and that because part of such receipts would represent a return of capital, the Canadian tax imposed under Section 27(1) was not limited to income or profits. Interestingly enough, the fact that no sale transaction had been taxed in either *Guettler* or *Meltzer* apparently did not enter into the Board's decision that the Canadian Income War Tax was not an income tax for purposes of former section 17305. The fact that the tax could have been imposed on a return of capital led the Board to conclude the tax was not an income tax.

The *Guettler* and *Meltzer* decisions were followed by the Board in 1963 in *Appeal of Don Baxter, Inc.* The taxpayer in *Baxter* claimed deductions under section 24345 for various taxes paid to Brazil, Italy, Mexico, Argentina, and the Philippines on royalties received from sources within those countries. The Board in its opinion in *Baxter* cited *Guettler* and *Meltzer* for the proposition that gross receipts include a return of capital where such receipts were consideration for the sale of property, while "income" does not include a return of capital. The Board then declared in *Baxter* that the burden of proof rests upon the taxpayer to prove "the nature of the foreign tax law," and that the taxpayer therein had failed to establish that any of the

26. *Id.*
27. *Id.*
29. *Id.*
foreign taxes imposed a tax upon gross receipts as opposed to a tax on or according to or measured by income. Accordingly, the Board in Baxter denied a deduction under section 24345 for the various foreign taxes paid. Baxter is a prime example of a burden-of-proof case in which the taxpayer's failure to prevail may be directly attributable to a failure to establish the nature of the foreign tax.

The Board in 1966 again adhered to its analysis of "income" as set forth in Guettler and Meltzer, and ruled in Appeal of William E. and Esperanza B. Mabee that the Mexican Income Tax Law on dividends received from a corporation operating in Mexico was a tax on income. The opinion concluded that the distributive profits tax imposed on the dividends, when considered in conjunction with the entire Mexican Income Tax Law, was a tax on "income" as that term is generally understood in the United States, "namely, a tax on gain or profit and not a tax on the return of capital." The Board's opinion also stressed that receipts which constitute a return of capital are excluded from the statutory concept of income under Mexican law.

Guettler and Meltzer were again followed by the Board in 1969 in Appeal of R.M. and Kathryn L. Blankenbeckler. There the Board remarked that the mere fact no deductions were allowed under the Mexican Income Tax Law in arriving at taxable income did not convert a tax on income into a tax on gross receipts. The Board concluded in Blankenbeckler that the Mexican tax imposed upon the taxpayer's interest income was not a tax imposed upon a return of capital, but was a tax on income and nondeductible under section 17204.

C. The Shift Away from Guettler and Meltzer

In 1973, the Board in Appeal of Charles T. and Mary R. Haubiel began to depart from its previous position taken in the Guettler and Meltzer opinions that the deductibility of foreign income taxes could be determined by a review of the foreign tax law without reviewing the specific tax for which a deduction is claimed. As discussed above,

30. Id.
32. Id.
34. Id.
Guettler and Meltzer held the Canadian Income War Tax Act to be a gross receipts tax and not an income tax on the basis of a provision which taxed gross receipts from the sale of property without a deduction for cost of goods sold. Neither Guettler nor Meltzer involved any tax withheld from the sale of property. Yet the Board concluded in those cases the tax was something other than an "income" tax and was a deductible tax, on the basis that Canadian law imposed a tax upon specific items of gross receipts where payments received were consideration for the sale of property. The result of this line of analysis was that the Board, when ruling on the deductibility of a foreign tax payment, focused upon the general nature of the foreign tax law instead of upon the specific foreign tax for which a deduction was claimed. This generalized approach led to unusual results, as demonstrated by Guettler and Meltzer, where the portion of the foreign tax law instrumental in having that tax classified a deductible tax was not even the portion of the foreign tax law under which the payment had been made and the deduction claimed by the taxpayers in California.

Haubiel concerned the deductibility of a tax paid under the South West African Tax Act of 1962 on dividends the taxpayers received from a South West African corporation. The issue before the Board was whether the South West African nonresident shareholder's tax was a tax "on or according to or measured by income or profits." The taxpayers argued in Haubiel that the nonresident foreign shareholder's tax was a deductible tax on specific items of gross receipts. This argument was based upon the fact that the tax was imposed not only upon cash dividends, but also upon stock dividends and the full amount of annuity payments which constituted a return of capital as opposed to gross income. The taxpayers argued under the authority of Guettler and Meltzer that in such circumstances the tax was a deductible gross receipts tax and not an income tax.

The Board rejected the argument of the taxpayer in Haubiel by first noting that the deductions were allowed in Guettler and Meltzer on the basis of a foreign tax law which imposed a tax upon specific items of gross receipts. Where payments were consideration for the sale of property, then a part of those receipts represented a return of capital. However, the Board in Haubiel also noted that in neither Guettler (involving royalties) nor Meltzer (involving rents) did the taxpayers pay any tax on the sale of property. The Board then held

36. Id.
in *Haubiel* that notwithstanding the fact the South West African Income Tax could be imposed on annuities or stock dividends, the specific tax for which the taxpayers claimed a deduction was an application of that foreign tax to cash dividends paid out of earnings. The Board concluded that the tax on cash dividends paid was clearly a tax on income and was not a deductible tax under section 17204.37

*Haubiel* was followed by *Appeal of Lloyd W. and Ruth Bochner*,38 a 1974 decision in which the Board expressly overruled those portions of *Guettler* and *Meltzer* which took the overly broad approach of classifying an entire section of a foreign tax law on the basis of the characteristics of a portion of that law not even at issue. The taxpayers in *Bochner* had claimed a deduction for the amount of tax withheld under the Canadian Income Tax Act from cash dividends, distributions from an estate, and interest from Canadian sources. The Board concluded that with respect to the dividend income, the payments fit within the concept of income because under Canadian law the payments could only have been paid out of the company’s profits. The Board also concluded the tax paid on the estate distributions was also a tax on income because Canadian law excluded capital payments from taxable estate distributions. Finally, the Board ruled the interest income did not include an element of capital, but was income earned from invested capital, and was also a nondeductible tax measured by income instead of by gross receipts.39

Thus, by 1974, the Board opinions had begun to focus upon two principles. First, the Board had settled upon a procedural approach to the issue which called for the deductibility of a foreign tax to be determined by looking to the specific foreign tax on the specific item in issue. This is in contrast to the approach taken in the earlier Board decisions where a general examination was made of how the foreign tax law conceivably could be applied. Second, the Board had settled upon a substantive approach to the issue which focused upon the distinction between the receipt of income and the return of capital. The *Beamer* decision in 1977 was to emphasize this distinction by comparing gross receipts with gross income.

37. *Id.*
39. *Id.*
D. Beamer and MCA and the Focus on Gross Income

In 1977, the California Supreme Court decided Beamer v. Franchise Tax Board,40 a decision that to some degree reshaped the Board’s previous line of analysis for determining whether a tax was or was not a nondeductible foreign income tax. In Beamer, a California resident taxpayer paid a Texas “occupation tax” on the business of producing natural gas and crude petroleum. The amount of the tax was a specified percentage of the “market value” of all the oil and gas “as and when produced,” and was levied upon all producers and purchasers of oil and gas in Texas. The Texas statute provided that when the minerals were sold for cash only, the tax was to be computed upon the producer’s gross cash receipts. The taxpayers in Beamer received only royalty income from Exxon Corporation, who was the operator of the field of which the taxpayer’s land was a part. Exxon had purchased for cash the oil and gas that was the taxpayer’s share under the oil and gas lease, and had collected for Texas the “occupation” tax on the taxpayer’s interest by deducting the amount of the tax from the purchase price of the minerals.41

The position taken by the Franchise Tax Board in Beamer was that because the measure of the tax was the proceeds from the sales to Exxon, which was also the amount of the taxpayers’ royalty income, the occupation tax was, in effect, “measured by” that income and not deductible under section 17204. The taxpayers argued the proceeds from the sales to Exxon constituted gross receipts and that under general tax law, gross receipts from the production of oil and gas are not the same as the gross income from such production.42

The California Supreme Court in Beamer read the statutory language, “taxes on or according to or measured by income,” in section 17204 to use the term “income” in the sense of “gross income under general tax law as currently operating.”43 The court held the Texas “occupation tax” was not a tax “on or according to or measured by income” and thus, was deductible under section 17204 because it was measured by gross receipts instead of gross income. The court in reaching this conclusion reasoned that the taxpayers were to be treated as if they were in the business of mining because the Texas

41. Id. at 470, 475-76, 138 Cal. Rptr. at 199, 203, 563 P.2d at 238, 242.
42. Id. at 476, 138 Cal. Rptr. at 203-04, 563 P.2d at 242-43.
43. Id. at 479, 138 Cal. Rptr. at 206, 563 P.2d at 245.
tax was imposed upon them as "producers" of oil and gas. The court
looked to the regulations of both the Franchise Tax Board and the
Internal Revenue Service which provided that gross income in a
manufacturing, merchandising or mining business is defined as the
"total sales, less the cost of goods sold." As applied to the mining
business, the court concluded these regulations meant that "lifting
costs" incurred in the production of oil and gas were required to
be subtracted from the gross receipts in order to determine gross in-
come. However, because such costs were not deducted from the gross
receipts in order to compute the Texas tax, the court concluded in
Beamer that the Texas tax was not measured by income and was deduc-
tible under section 17204.44

The Supreme Court decision in Beamer was first addressed by the
Board in Appeal of MCA, Inc.,45 where the Board concluded that
Beamer required the Board to modify its previous approach for deter-
mining whether a foreign tax is "on or according to or measured
by income." The Board in MCA declared that under Beamer, the
initial inquiry must be whether the foreign income received by the
taxpayer falls within the definition of gross income under "our"
general revenue law as currently operating. If the income does con-
stitute gross income as defined by "our" tax law, then the Board
concluded the inquiry ceases and the foreign tax must be considered
a tax "on or according to or measured by income" regardless of the
composition of the item taxed. If, on the other hand, the foreign
tax is imposed on gross receipts, including a return of capital, the
Board concluded the tax will not be considered a tax "on or accord-
ing to or measured by income."46 Thus, the Board concluded in
MCA, and again in Appeal of Paramount Pictures Corp.47 that foreign
taxes paid are not deductible under section 24345 where such taxes
are imposed on or measured by gross income rather than gross receipts.
The inquiry is to be made under principles of California tax law.

The decision of the Board in Appeal of MCA, Inc. was challenged
by the taxpayer, who brought an action in superior court against the
Franchise Tax Board to recover taxes paid. The trial court concluded
the foreign taxes were not deductible under section 24345 and entered

44. Id. at 476-80, 138 Cal. Rptr. at 203-06, 563 P.2d at 242-45.
Reports ¶205-790.
46. Id.
47. Appeal of Paramount Pictures Corp., CAL. ST. BD. OF EQUAL., August 18, 1890, CCH
Cal. Tax Reports ¶206-433.
judgment for the Franchise Tax Board. The taxpayer appealed, and in 1981 the Court of Appeal in *MCA, Inc. v. Franchise Tax Board* affirmed the decision of the trial court.\(^48\)

The Court of Appeal in *MCA* addressed two contentions raised by the taxpayer. First, the taxpayer argued that *Beamer* was not controlling for purposes of determining the deductibility of a foreign income tax under section 24345 paid by a corporate taxpayer. This argument was based upon the factual distinction that *Beamer* was decided under section 17204 of the Personal Income Tax Law. The taxpayer contended that notwithstanding *Beamer*, the only foreign taxes made nondeductible by section 24345 were those imposed on a tax base comparable to the California income tax, i.e., *net* income taxes. The Court of Appeal in *MCA* rejected this argument, and recognized that both the Personal Income Tax Law and the Bank and Corporation Tax Law contain definitions of gross income which are identical in pertinent part. Accordingly, the court concluded that the deductibility of foreign income taxes under section 24345 is governed by the rule stated in *Beamer* which was decided under section 17204, and foreign income taxes are not deductible if they are taxes on or measured by gross income.\(^49\)

The second contention raised by the taxpayer in *MCA* was whether the taxes in issue were gross receipts taxes and deductible, or taxes measured by gross income and not deductible. The court noted that under California tax law, gross income includes all income unless expressly excluded by law. The court found the taxpayer had made no showing of any "cost of goods sold," and for this reason the taxpayer's "gross income" and "gross receipts" from rents and royalties were the same. Accordingly, the court concluded that the gross rentals and royalties of *MCA*'s gross income and the Canadian tax imposed upon them was a tax on or measured by income made nondeductible by section 24345 and *Beamer*. The court stressed this result was not changed by the fact that MCA could recoup the costs of wasting assets used in generating the income, because a deduction from gross income in computing net income is permitted pursuant to statute.\(^50\)

The distinction between a tax imposed on gross income as opposed to a tax imposed on gross receipts was also discussed recently by the Court of Appeal in *Robinson v. Franchise Tax Board*.\(^51\) The plain-


\(^{49}\) *Id.* at 192-96, 171 Cal. Rptr. at 246-49.

\(^{50}\) *Id.* at 196-99, 171 Cal. Rptr. at 249-50.

tiffs in *Robinson* were California residents and beneficiaries of a Hawaii trust who claimed a deduction for purposes of California income tax for the amounts paid by the trust under a "Hawaii General Excise Tax." The Hawaii tax was multifaceted in its application. As applied to retail sales, the excise tax was a sales tax not measured by gross income. As applied to mining activities, the tax was a gross receipts tax, rather than a gross income tax, similar to that considered in *Beamer.*

The taxpayers contended in *Robinson* that the Hawaii tax must be characterized, without reference to its specific application, as a gross receipts tax. The argument was based upon the theory that the tax measured the income to be taxed without the deduction of costs or expenses, regardless of the nature of the business enterprise taxed. The *Robinson* court rejected the contention that the Hawaii tax must be examined in terms of its general application, and found the tax must be analyzed "by reference to the specific income activity taxed." This focus on the application of the Hawaii tax to the specific tax on the particular item in issue is consistent with the approach adopted by the Board in *Haubiel.*

With respect to the argument that the Hawaii tax was a tax on gross receipts, the Court noted the taxpayer's income in issue was primarily derived from interest, real property rents, and royalties from "rock sales." The court found the rental and interest income were items specifically listed in the California and federal statutes defining gross income. No deduction is required from interest income before the interest income can be included in gross income, and the court noted that rent, by definition, excludes a return of capital or cost of goods sold. Thus, the Court found immaterial the fact that the Hawaii law did not permit a deduction of such items from rent.

The Court in *Robinson* also found that if the taxpayer's royalties from "rock sales" were part of a mining activity, then gross income as defined by statute should exclude cost of goods sold. Thus, if the Hawaii tax was imposed upon a mining activity and no deduction was allowed from gross proceeds for cost of goods sold, then the Hawaii tax would be imposed on gross receipts, not gross income, and would be deductible in California because the Hawaii tax would

52. *Id.* at 79-81, 174 Cal. Rptr. at 440-42.
53. *Id.* at 80-81, 174 Cal. Rptr. at 441-42.
54. *Id.* at 81-82, 174 Cal. Rptr. at 442.
not be an "income" tax. However, the Court held that the taxpayers had failed to carry their burden of showing the Hawaii tax was imposed on a mining activity within the meaning of Hawaii tax law. Accordingly, the Court concluded the Hawaii taxes paid on the taxpayers' income from interest, real property rents and royalties were nondeductible income taxes under section 17204.55

The most recent decision regarding the distinction between gross income and gross receipts, and the most recent decision by the Board regarding foreign income taxes, is *Appeal of Huntington Alloys, Inc.*56 *Huntington Alloys* involved the deductibility under section 24345 of amounts paid for Ontario and Manitoba mining taxes. Under the Ontario mining tax law, a tax was imposed at three graduated rates on profits determined by deducting specified mining expenses from the gross revenue from production. The gross revenue was determined by one of three methods. If the ore was sold, gross revenue was the gross receipts from the sale of the ore. If the ore was processed at the mine, gross revenue was the amount of the actual market value of the output at the mouth of the mine. If the ore was processed at the mine and there was no means of ascertaining the actual market value of the output at the mouth of the mine, gross revenue was the amount at which the mine assessor appraised such output. The provisions of the Manitoba mining tax law were substantially similar in their application to those of the Ontario mining tax.57

The issue raised in *Huntington Alloys* was whether the Ontario and Manitoba mining taxes, which did not allow a deduction for cost depletion, were taxes measured by gross receipts rather than by gross income. The taxpayer argued the regulation of the Franchise Tax Board which defined "gross income" as the total sales, less cost of goods sold, excluded from the calculation of the cost of goods sold only percentage depletion. Thus, the taxpayer argued that the regulation recognized cost depletion as a component of the cost of goods sold in the mining industry. The taxpayer's argument concluded that because the California tax scheme required the subtraction of the cost of goods sold from gross receipts to calculate gross income, and because the foreign mining laws did not allow a deduction for cost depletion that was a part of cost of goods sold under the California tax scheme,
the foreign mining taxes were taxes on gross receipts instead of taxes on gross income.\textsuperscript{58}

The Board in \textit{Huntington Alloys} rejected these arguments and ruled the California regulation provided that in the mining business, items not ordinarily used in computing the cost of goods sold cannot be subtracted in determining gross income. The Board declared that if cost depletion was not ordinarily used by the taxpayer in its computation of cost of goods sold, then allowance of such a deduction was not necessary for the foreign mining tax law to be classified as a tax measured by gross income. The Board concluded the taxpayer had made no showing that its accounting method normally included cost depletion in the computation of cost of goods sold. Accordingly, the Board held the taxpayer had failed to carry the burden of demonstrating the mining taxes were measured by gross receipts which included, as did the Texas tax in \textit{Beamer}, a direct return of capital invested as cost of goods sold.\textsuperscript{59}

\textbf{E. A Current Approach to a Definition of “Income” as Opposed to A Return of Capital}

Perhaps the most appropriate place to begin an examination of the current approach to a definition of “income” as opposed to a return of capital is with the early decisions in \textit{Guettler} and \textit{Meltzer}. Three points require emphasis. First, these opinions by the Board recognized the fundamental principle of tax law that “income” by definition includes only gain and excludes receipts which constitute a return of capital. This principle remains valid, and consistently has been followed in all subsequent opinions by the Board. Second, an analysis of a foreign tax law must focus on the specific tax and item in question. According to the original approach followed by the Board, the determination of income versus return of capital was to be made on the basis of a review of the foreign tax law without reference to the specific portion of the tax law at issue in the case. This broad approach typified by \textit{Guettler} and \textit{Meltzer} was curtailed by the Board in \textit{Haubiel} and its progeny in favor of an analysis which looked to the specific tax and item under review.

The third point to be emphasized is that the analysis of the foreign tax law should focus upon whether the tax is imposed upon “gross”

\begin{footnotesize}
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\item \textsuperscript{58} Id.
\item \textsuperscript{59} Id.
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income. The Beamer and MCA opinions clarified the meaning of "income" under section 24345 and former section 17204 by holding the term meant gross income under the general tax laws as currently operating. This approach calls for an examination of the nature of the foreign tax law under federal and California tax law principles, as opposed to an analysis from the perspective of the tax law of the foreign country. This approach has been followed by the Board in all decisions subsequent to Beamer and MCA.

The Beamer and MCA line of analysis relies once again upon the distinction between income and a return of capital by distinguishing between gross income and gross receipts. "Gross receipts" is a broader term than gross income, and is generally used to describe gross proceeds which include a return of capital in the form of cost of goods sold or the equivalent.\(^6\) Gross income, in contrast, is defined by statute and regulation in California and does not include a return of capital. Section 24271\(^6\) defines gross income under the Bank and Corporation Tax law in terms substantially identical to those found under the federal statutory definition of gross income in Section 61 of the Internal Revenue Code. At one time, regulations promulgated by the Franchise Tax Board\(^6\) interpreted and defined many aspects of section 24271. However, the majority of those regulations were repealed in 1982,\(^6\) and regulations promulgated under the Internal Revenue Code were incorporated by reference into California Tax Law in instances where the Bank and Corporation Tax Law conforms to the Internal Revenue Code.\(^6\) The remaining regulations promulgated by the Franchise Tax Board under section 24271 remain in effect. Except for certain provisions relating to capital assets and individuals, these remaining regulations are substantially the same as the federal

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60. See 1 Mertens, LAW OF FEDERAL INCOME TAXATION, §5.10; see also Appeal of MCA, Inc., Cal. St. Bd. of Equal., October 18, 1977, CCH Cal. Tax Reports ¶205-790, n.3.


62. The Franchise Tax Board is empowered, pursuant to REV. & TAX CODE, §23004, to issue regulations with respect to the Bank and Corporation Tax Law.

63. Title 18, CAL. ADMIN. CODE, §§24271(a)-(c), 24271(f) and 24271(g) were repealed by Repealer filed September 3, 1982, effective the thirtieth day thereafter (Register 82, No. 37).

64. Id. §26422 provides in full: "In the absence of regulations of the Franchise Tax Board and unless otherwise specifically provided, in cases where the Bank and Corporation Tax Law conforms to the Internal Revenue Code, regulations under the Internal Revenue Code shall, insofar as possible, govern the interpretation of conforming state statutes, with due account for state terminology, state effective dates, and other obvious differences between state and federal law pertaining to, but not limited to, such matters as tax rates, income and taxable years, jurisdiction, and cross-references to other related statutes and regulations." (New section filed September 30, 1975 (Register 75, No. 40).)
regulations promulgated for Internal Revenue Code section 61. Thus, the California definition of gross income, with minor exceptions, conforms to the federal definition, and federal law will be relevant in interpreting the meaning of gross income for California tax purposes.

As can be seen in recent decisions of the Board such as Huntington Alloys, as well as in recent judicial decisions such as MCA and Robinson, much of the analysis in this area now consists of a formalistic approach as to whether the foreign tax was imposed upon gross income as defined under California tax law. A recurring point in such decisions is whether the taxpayer has carried the burden of demonstrating that the foreign tax falls on something other than gross income. The significance of the burden-of-proof issue cannot be overemphasized, for this issue is one of the most important themes consistently running through the decisional law in this area by both the Board and the courts.

In summary, the framework is now firmly in place to distinguish between a foreign tax on gross income and a foreign tax on a return of capital. Only the latter would qualify as a deductible tax under section 24345. In situations where this issue will subsequently arise, the analysis should focus upon the factual nature of the foreign tax and the item in issue, and whether the taxpayer has carried the burden of characterizing the foreign tax as something other than a tax on or according to or measured by gross income. Other issues which surround the meaning of “income” for purposes of section 24345 are far less settled than the gross income-gross receipts distinction, and the majority of future controversy and litigation in this area will most likely center upon these other issues.

F. The Need for Realization and Economic Gain

A major unsettled issue surrounding the interpretation of section 24345 is the relationship between income and realization, and the need for economic gain. Specifically, the issue presented in several of the more recent decisions by the Board and the courts is whether there can be “income” without realization or economic gain.

Generally speaking, it is a well recognized principle of tax law that a mere increase in the value of property is not income, but only an unrealized increase in capital. Among the policy justifications com-

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65. Id. §§24271(d) on Gains Derived From Dealings in Property, 24271(e) on Interest, and 24271(h) on Income From Discharge of Indebtedness are substantially the same as TREAS. Reg. §1.61 (1957).

66. 1 Mertens, Law of Federal Income Taxation, §5.05.
monly advanced for taxing only realized income are that (1) a tax on an unrealized increment in value would be awkward from the administrative point of view, (2) the tax ordinarily would be a hardship for the taxpayer who would not have a source from which the tax could be paid, and (3) the tax might result in deductions for losses as yet unrealized.57

The concept of "realization" seems to defy precise definition, and definitional problems are usually resolved in the narrow context of the facts present in a specific case. For example, the Court in Beamer was presented with the argument that the term "gross income" includes any economic benefit received by a taxpayer and the reduction to possession of oil and gas by the taxpayers therein constituted gross income. The Court rejected this argument and stated that while the types of events which constitute realization have been expanded over the years, the requirement that there be such an event before income arises for tax purposes has been emphasized in case law for many years.68

The most expansive discussion of the issue of realization and economic gain, with regard to the deductibility of foreign taxes, is the decision of the Board in Appeal of Occidental Petroleum.69 Occidental Petroleum involved the deductibility under section 24345 of payments made by the taxpayer to Libya. The taxpayer's combined report70 filed in California for 1970 claimed a deduction for a part of the taxes paid to Libya in that year by Occidental Petroleum's unitary subsidiary, Occidental of Libya, Inc. ("Oxy Libya"). The amount deducted was the portion of Libyan taxes based on the "posted price" of Libyan crude oil, to the extent that this posted price exceeded the actual market price for which Libyan crude oil was sold. The taxpayer contended that a tax based upon an artificial figure as the posted price, which bore no relationship to the actual gross receipts Oxy Libya realized from the sale of Libyan crude oil, was deductible.

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57. Id.
70. The "combined report" in California describes the procedure of culminating the results of commonly controlled legal entities engaged in a single unitary business into a single report. The combined report is not a return, and is used to determine the proper amount of income reportable by each entity engaged in a single unitary business and includable in its individual return. Miller, WORLDWIDE UNITARY COMBINATION: THE CALIFORNIA PRACTICE, CH. 4 THE STATE CORPORATION INCOME TAX (C. E. McLure Jr., ed., 1984) pp. 132, 136.
under section 24345 because the tax was not a tax on or according to or measured by income or profits.\textsuperscript{71}

In the opinion, the Board stated that under the Libyan tax scheme for the pertinent years, the Libyan Petroleum Law and the Concession Form required all oil companies operating in Libya to pay "such income tax and other taxes and imposts as are payable under the laws of Libya." They also required that if the total annual fees, rents, income tax, other direct taxes and royalties paid by the oil company to Libya fell short of fifty percent of profits from all its petroleum concessions in Libya, the company was required to pay Libya a "surtax" sufficient to make its total payments equal to fifty percent of its profits. For this purpose, "profits" were defined as the income resulting to the company from its operations in Libya after deducting certain enumerated expenses.\textsuperscript{72}

The Libyan Concession Form defined "income resulting from the operations of the company in Libya" to include the total gross receipts realized by the company from the export of Libyan crude oil. However, such receipts could not be less than the amount which resulted from multiplying the number of barrels of such crude oil exported by the applicable posted price per barrel of crude oil exported (less certain marketing allowances). The Board stated in the opinion that during the years in issue, Libya was unilaterally fixing the posted price without regard to the actual market prices for oil and that for 1970, the average posted price was approximately $0.50 per barrel higher than the actual market price.\textsuperscript{73}

The Board in \textit{Occidental Petroleum} agreed for two reasons with the taxpayer's argument that the Libyan tax based upon the difference between the posted price and the amount Oxy Libya actually received from their sales of Libyan crude oil was not a tax on income. First, the Board stated that in order to have gross income, a taxpayer must first receive "economic gain" in some form. The Board found that Oxy Libya did not obtain any economic benefit or gain from "a purely fictitious amount of Libyan 'income'" which the company never received. Thus, to the extent the Libyan tax was imposed on the difference between the posted price and the actual sales price of Libyan crude oil, the Board concluded that the Libyan tax was levied upon an ar-


\textsuperscript{72} Id.

\textsuperscript{73} Id.
tificial tax base and was not a tax on or measured by “income” as that term is used “in general United States tax law.”

In addition, the Board concluded in *Occidental Petroleum* that the Libyan tax was not imposed on “realized” income. Since the “income” subject to the tax could not be less than the number of barrels of crude oil exported multiplied by the posted price, the Libyan tax could be triggered by the export of crude oil regardless of whether a sale or other disposition had taken place. The Board found the mere act of exporting oil did not constitute a sufficient realization of income for general tax purposes. The Board in reaching this conclusion rejected the argument of the Franchise Tax Board that any increase in the posted price by Libya over the prevailing market price constituted, in substance, nothing more than a method for Libya to increase the rate of tax and royalties of oil concessionaires without violating the resource concession agreements signed by the companies.

The issue of realization was also discussed in the context of foreign taxes in the recent decision of the Board in *Appeal of Huntington Alloys, Inc.* There the Board recognized the Ontario and Manitoba mining taxes in issue were multifaceted and provided three alternative ways to tax one business. The Board concluded that no income was realized at the point at which both mining taxes imposed a tax on unsold inventory under one of the alternatives. Thus, the Board reasoned the taxes should have been deductible under section 24345 because they were not measured by income to the extent they were imposed on unsold ore. Nevertheless, the taxpayer was denied a deduction because the Board reasoned the taxpayer had not demonstrated which portion of the mining taxes paid, if any, actually had been imposed upon unsold ore.

Several conclusions may be drawn from the opinions in *Occidental Petroleum* and *Huntington Alloys*. First, the Board has concluded that the concept of gross income is premised upon gain and that without such a gain there is no “income” for purposes of defining a nondeductible “income” tax under section 24345. A second conclusion to be drawn is that the Board is of the opinion that income cannot exist without realization. Both these conclusions, however, bear further examination.

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74. *Id.*
75. *Id.*
77. *Id.*
The Board in *Occidental Petroleum* relied to a substantial degree on Rev. Rul. 78-63\(^7\) in reaching the conclusion that the act of exporting oil does not constitute a sufficient realization of income for general income tax purposes. Rev. Rul. 78-63 was also relied upon by the Board in reaching its conclusion in *Occidental Petroleum* that the Libyan petroleum tax was not a tax on or according to or measured by "income" to the extent the tax was levied upon an artificial base as calculated by the differential between the posted price and the actual sales price of Libyan crude oil. However, Rev. Rul. 78-63 is no longer followed at the federal level, which raises an issue regarding the continued vitality of the *Occidental Petroleum* opinion.

As will be discussed in the following section, the Treasury in late 1983 issued final regulations regarding the creditability of a foreign tax under sections 901 and 903 of the Internal Revenue Code. A portion of the final regulations state that the "realization" requirement for a creditable income tax may be satisfied by a transfer, processing or export of readily marketable property.\(^7\) This broadening of the concept of "realization" clearly is contrary to the conclusion of both Rev. Rul. 78-63 and *Occidental Petroleum* that the mere export of oil does not constitute sufficient realization to amount to "income." Perhaps in response to the final regulations, the Internal Revenue Service has now declared Rev. Rul. 78-63 obsolete and no longer determinative with respect to future transactions.\(^8\)

Notwithstanding the fact that the Franchise Tax Board has not adopted the final treasury regulations on the federal foreign tax credit, those regulations which recognize income even in the absence of traditional "realization" cast doubt upon the position of the Board that no income will be found without realization. In contrast to the previously discussed issue of whether a foreign tax is imposed upon gross profits or gross receipts, the issues of realization and economic gain may be the cause of future litigation because of their unsettled nature. The ability of foreign nations to reshape their tax laws also suggests a virtually unlimited number of variations on the issue of how a foreign tax can be classified for purposes of section 24345. The analysis of these issues is also complicated by the fact that the concession or operating agreements between the host country and the taxpayer often are drafted to provide special tax treatment for the

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taxpayer's operations. An illustration of a major reason for a foreign government and a taxpayer to structure such an agreement or law is to allow the taxpayer to successfully claim a foreign tax credit for federal income tax purposes.81

The distinction between form and substance should also be kept in mind in analyzing the nature of a foreign tax, and this distinction appears particularly applicable to issues surrounding realization. For example, the Franchise Tax Board argued in *Occidental Petroleum* that the manipulation of the posted price constituted, in substance, nothing more than a method for Libya to increase the rate of tax and royalties on oil concessionaires without violating the concession agreements.82 While the Franchise Tax Board did not prevail on this argument in that case, the Board did not quarrel with the general proposition that substance governs form in matters of taxation.83 The distinction between substance and form becomes more significant when considered in conjunction with the purpose of section 24345. As stated by the Court of Appeal in *MCA*, the purpose of the amendment adding to section 24345 the language "on or according to or measured by income or profits" was to make nondeductible all taxes measured by income, no matter what they are levied upon.84 *MCA* declared it was not necessary for the tax to be on income, as long as the tax was "measured" by income. Accordingly, the fact that a foreign tax does not bear the form of a tax on income under principles of California and United States tax law does not necessarily answer the true issue of whether the substance of that foreign tax establishes a tax which is on or according to or measured by income or profits.

No general rule has been created which will resolve all of the issues surrounding the relationship of economic gain and realization to "income" under section 24345. One general rule of analysis that can


83. Id. The Board has also recognized in numerous other decisions that substance governs over form in matters of taxation. Recent examples include Appeal of Donald E. and Judith E. Liederman, Cal. St. Bd. of Equal., October 26, 1983, CCH Cal. Tax Reports ¶400-210, and Appeal of Paul and Nancy Falkenstein, Cal. St. Bd. of Equal., February 1, 1983, CCH Cal. Tax Reports ¶400-388, in which the Board looked to the decisions in Commissioner v. Court Holding Company 324 U.S. 331 (1945), and Gregory v. Helverling 293 U.S. 465 (1934) for the same principle under federal tax law.

be suggested is that where a foreign tax law attempts to place the incidence of tax upon an event other than a traditional event of realization, the Board has indicated in the *Occidental Petroleum* and *Huntington Alloys* decisions that no "income" is generated and any foreign tax imposed upon that "income" may qualify for a deduction under section 24345 as a tax on something other than income. However, the fact the *Occidental Petroleum* and *Huntington Alloys* opinions were decided by the Board, not a court, must also enter into the assessment of whether the views expressed in those opinions will prevail in other disputes involving similar issues. Opinions by the Board are not controlling in a court proceeding involving the same taxpayer, another taxpayer, or even the same issues. However, opinions by the Board which are contemporary administrative constructions of statutes are entitled to great weight. Thus, the significance of the *Occidental Petroleum* approach to realization and economic gain may be somewhat diminished by the fact that opinion does not create binding precedent to be followed by the courts.

**THE RELATIONSHIP BETWEEN THE FEDERAL FOREIGN TAX CREDIT SCHEME AND THE TREATMENT BY CALIFORNIA OF FOREIGN INCOME TAXES**

**A. Introduction**

As discussed above, section 24345 denies a taxpayer who is subject to the Bank and Corporation Tax Law a deduction for the payment of foreign taxes on or according to or measured by income. Unlike federal law, California law does not currently allow a credit against tax liability for foreign income taxes paid or accrued, although a credit was once allowed in California under the Personal Income Tax Law.

Apart from this obvious distinction, the California and federal systems raise a number of parallel issues. For example, both systems require an analysis of whether a foreign tax is imposed on "income." However, such an analysis will be quite different for determining whether a foreign tax is a deductible tax under section 24345 or whether the foreign tax is a creditable tax under the federal system.

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85. *See, e.g.*, Borchers v. Franchise Tax Board, 151 Cal. App. 3d 504, 507, 198 Cal. Rptr. 734, 736 (1984), where the court stated: "Our view is buttressed by a line of decisions of the State Board of Equalization. Contemporary administrative constructions of statutes are entitled to great weight."

86. A credit for net income taxes paid to a foreign country was allowed by former section 18001 of the Personal Income Tax Law prior to its amendment in 1957. See Appeal of Leman and Petronella Druyf, CAL. ST. BD. OF EQUAL., March 17, 1964, CCH Cal. Tax Reports ¶202-412.
There are two key statutes to the federal tax credit scheme. First, Internal Revenue Code section 901 provides a credit for the amount of income, war profits, or excess profits taxes paid or accrued by or on behalf of a taxpayer to a foreign country or possession of the United States. Second, Internal Revenue Code section 903 provides that the term “income, war profits, and excess profits taxes” shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or possession of the United States.

B. The Source Principle and Formula Apportionment

A major distinction between the federal and California schemes for the treatment of foreign income taxes is that the purposes and policies underlying the two schemes are quite different. In order to understand these differences, an understanding of the manner by which California measures tax liability under the Bank and Corporation Tax Law is essential. The reliance by California upon the source principle, as opposed to residency, to measure the tax base, is a basic difference between the California and federal schemes.

California provides by statute that when a taxpayer derives income from sources both within and without California, the taxpayer is required to measure California franchise tax liability by net income “derived from or attributable to sources within California.” This reliance upon a source basis for California taxation, as opposed to a residence basis which taxes residents on all income earned regardless of the source, is consistent with the principle that under both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of the United States Constitution, a state may not, when imposing an income tax, “tax value earned outside its borders.”

Difficulties may arise in arriving at a precise territorial allocation of “value” where an integrated business enterprise is operating in more than one state. The approach utilized by California to achieve such a territorial allocation is the unitary business principle. This principle is not new, and has been a familiar concept in tax cases for

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88. Id. §903.
89. CAL. REv. & TAX. CODE §25101.
90. U.S. CONST. Art. I, sec. 8, cl.3.
over 50 years. The California scheme provides that if a taxpayer is engaged in a single unitary business with an affiliated corporation or corporations, the amount of "business income" attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. Formula apportionment under the unitary business principle is not used by California alone. All states which levy corporate income taxes use formula apportionment to some degree to determine their respective portion of taxable income of a unitary business which operates both inside and outside their boundaries. More than one test has been recognized for determining whether a unitary business exists.


94. CAL. REV. & TAX. CODE, §25120(a), defines "business income" as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." "Nonbusiness income" is defined by CAL. REV. & TAX. CODE, §25120(d), as "all income other than business income."

95. California in 1966 adopted the Uniform Division of Income for Tax Purposes Act (UDITPA) which is now found in CAL. REV. & TAX. CODE, §§25120-40. (STATs. 1966, c. 2.) UDITPA provides for the use of a three factor formula utilizing the average of the taxpayer's percentage of total payroll, total property, and total sales that are attributable to California. See Miller, WORLDWIDE UNITARY COMBINATION: THE CALIFORNIA PRACTICE, Ch. 4, THE STATE CORPORATION INCOME TAX (C.E. McLure Jr., ed., 1984) pp. 131, 133.

96. See Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472, 183 P.2d 16 (1947) and Butler Brothers v. McColgan, 17 Cal.2d 664, 111 P.2d 334, affd. 315 U.S. 501 (1942) for general discussions of formula apportionment in California as distinguished from the separate accounting approach. Generally speaking, if business within a state is "truly separate and distinct" from business outside a state "so that the segregation of income may be made clearly and accurately," then separate accounting may be used. Butler Brother, supra, at pp. 667-68.

97. The Final Report of the Worldwide Unitary Taxation Working Group, Chairman's Report and Supplemental Views (Office of the Secretary, Department of the Treasury, August 1984), p. 1, reported all forty-five states which levy corporate income taxes use formula apportionment to divide the taxable income of a single corporation operating a unitary business across state or national borders. Roughly one-half of the corporate income tax states, according to the Final Report, also use the apportionment method to determine their share of the income of multicompany firms operating across state lines through subsidiaries. These states apply their apportionment formula to the combined income and business activities of related U.S. corporations forming a unitary business. The Final Report indicated that approximately one-half of these states that combine domestic corporations engaged in a unitary business also include foreign corporations that are part of a unitary business in the company's "combined report" of income. These latter states, which include California, use the so-called worldwide unitary method of taxation.

98. The California Supreme Court has recognized two tests of unity. Under the "three unities" test of Butler Brothers, a unitary business is established by the presence of the unities of ownership, operation, and use. Butler Brothers v. McColgan, 17 Cal. 2d 664, 678, 111 P.2d 334, 341, affd. 315 U.S. 501 (1942). Under the "contribution and dependency" test of Edison California Stores, a business is unitary if the operation of the business done within California
In contrast to the California scheme of taxing only income derived from or attributable to sources within California, the United States as a general rule imposes a federal income tax on domestic corporations, citizens of the United States wherever resident, and resident alien individuals, based upon worldwide income without regard for the source of the income. Taxation based upon residency presents the possibility of double taxation. For this reason, the primary objective of the foreign tax credit at the federal level is to prevent double taxation. The tax credit found in Internal Revenue Code section 901 is the device designed to eliminate double taxation on income generated in a "foreign country" as defined by regulations.

One commentator has suggested that the chief determinative factor in deciding whether a tax qualifies for the federal foreign tax credit should be whether or not the tax is shifted or passed along by the person paying the tax. Under this theory, double taxation of a taxpayer's income occurs only if the taxpayer has borne the burden of both the United States income tax and the foreign tax for which a credit is claimed. The theory concludes that the federal tax credit system is based upon assumptions about the economic incidence of creditable taxes because, strictly speaking, a foreign tax should be credited only if the taxpayer could demonstrate the incidence of the foreign tax and of the United States tax against which the credit would be taxed, and could prove that potential income was in fact reduced by both taxes. However, in a purely economic analysis, this distinction between direct and indirect taxation is often blurred.

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99. TanAs. REo. 1.1-1(b)(1956).
100. 26 U.S.C. §901(b)(1) provides a credit to United States income taxpayers for the "amount of any income, war profits and excess profits taxes paid or accrued during the taxable year to any foreign country. . . ."
101. See Inland Steel Co. v. United States, 677 F.2d 72, 79-80 (Ct. Cl. 1982), and cases cited therein.
103. Id.
104. Id. at 83-84.
105. See e.g., Inland Steel Co. v. United States, 677 F.2d 72, 82-83 (Ct. Cl. 1982), where
Thus, the policy behind the federal foreign tax credit is that without such a credit, double taxation may occur. This policy, however, is inapplicable to a state system of taxation such as that found in California where tax imposed on a corporate taxpayer is based upon the source principle instead of residence. Under section 25101, California taxes only that income which is derived from or attributable to sources within California. At first glance, California may appear to tax foreign income either in instances where a corporation subject to the California franchise tax or a unitary subsidiary of a corporation subject to California franchise tax conducts business and earns income in a foreign country. However, such foreign income will not be taxed in California, but the foreign income may be included in the calculations to determine the amount of the taxpayer's income "derived from or attributable to sources in California." Accordingly, neither a deduction nor a credit need be provided by California where a corporate taxpayer has paid foreign income taxes.

Under a purely economic analysis, the corporate income tax serves different purposes at the federal and state levels, and these differences should be reflected in the design of two tax bases, with the state base including only that income that is sourced within the state. Again, such a source base need not provide for either a deduction or credit paid for foreign income taxes, because the foreign income upon which that foreign tax is based is not being subjected to California tax.

These theoretical justifications for a state tax based upon the source rule, and for the absence of the need for either a foreign income

the court stated, "every traditionally indirect tax would have some persons who are the first and final taxpayers, and conversely, every direct tax may on occasion be shifted to another." The distinction between direct and indirect taxes was explained by John Stuart Mill, as quoted in Inland Steel as follows: "Taxes are either direct or indirect. A direct tax is one which is demanded from the very persons who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another, such are the excise or customs. The producer or importer of a commodity is called upon to pay a tax on it, not with the intention to levy a peculiar contribution upon him, but to tax through him the consumers of the commodity, from whom it is supposed that he will recover the amount by means of an advance in price." Id. at 82-83 n.28.

106. See Peggy B. Musgrave, Principles for Dividing the State Corporate Tax Base, C. 6, The State Corporation Income Tax (C.E. McClure, Jr., ed., 1984) p. 228. Peggy Musgrave argues the federal government must have as one of its functions the fair distribution of the tax burden and for this purpose, income taxes must be applied at the federal level to global income in accordance with the residence principle. The states, however, do not have a major distributive function requiring the use of personal income taxation on the residence principle. Also, Musgrave argues the federal government, not the states, has the primary responsibility for countercyclical stabilization policy. For these reasons, Musgrave concludes it remains necessary for the states to apply a different form of corporate tax. Id. at 230-33.
tax deduction or credit by California, are matters more appropriate for consideration by an administrative agency such as the Franchise Tax Board or the California Legislature, than by the Board or the California courts. California has, by statute, chosen to deny a deduction (and credit) for foreign taxes paid on or according to or measured by income or profits. Thus, apart from policy arguments which may be made, a question remains as to under what circumstances federal law in this area will be relevant in interpreting section 24345 and the language of that section that denies a deduction for foreign income taxes.

C. Internal Revenue Code Section 901 and Section 24345

The fundamental differences in policy underlying the California and federal corporate tax laws should be kept in mind whenever attempting to apply precedent involving the creditability of a foreign tax under federal law to a situation involving the deductibility of a foreign tax in California under section 24345. However, this is not to suggest federal precedent cannot be applied in appropriate circumstances to issues involving the foreign tax deduction under section 24345. For example, the Board in *Appeal of Don Baxter, Inc.* stressed the fact that the Brazilian tax in question had been ruled an income tax by the Internal Revenue Service, in concluding the tax was a tax on income for California purposes. A further example is found in *Appeal of Occidental Petroleum Corporation* where the Board virtually adopted by reference to a revenue ruling the position of the Internal Revenue Service that the act of exporting oil did not constitute a sufficient realization of income for general income tax purposes.

One of the most striking examples of the differences between the treatment of a foreign income tax under the federal and California schemes is found in the recent opinion of the Board in *Appeal of Huntington Alloys, Inc.* There the taxpayer argued the Ontario mining tax was measured by gross receipts, not gross income, and was deductible in California under section 24345. The taxpayer argued that because the Court of Claims had ruled in *Inland Steel* that

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110. Inland Steel Co. v. United States, 677 F.2d 72 (Ct. Cl. 1982).
the same Ontario mining tax was not a creditable income tax under the Internal Revenue Code, the tax should not be declared an income tax under section 24345 for California purposes. The Board rejected this argument and stated that the finding of the Court of Claims that the Ontario mining tax is not an income tax under federal law "is not decisive for the purposes of Revenue and Taxation Code section 24345." The Board found that in order to be a creditable income tax, a foreign tax must reach net gain as that term is understood in the United States, and Inland Steel was decided on the basis of what the Court of Claims concluded was the omission from the Ontario tax of significant costs of the mining business. The Board concluded in Huntington Alloys that while the absence of these deductions was significant in Inland Steel in determining the Ontario tax was not a tax on net income under the Federal standard, their absence was not determinative in deciding whether that tax was a tax on gross income under the California standard.111

Huntington Alloys illustrates the worst of all possible worlds for a taxpayer where a tax is found not to be a creditable income tax and is denied a federal tax credit, and is found to be an income tax for California purposes and denied as a deduction. While such a result may appear incongruous, the result is nothing more than the application of differing bodies of law. On the other hand, an income tax creditable under Internal Revenue Code section 901 for federal purposes has in the past often been denied the foreign tax deduction under section 24345 because of the significant overlap between the definition of an income tax for federal and California purposes. This trend may not continue, however, after the advent of the final Regulations issued by Treasury in 1983 in the area of foreign tax credits, for these regulations magnify the differences between the California and federal treatment of foreign income taxes.

D. The Impact of the Final Federal Foreign Tax Credit Regulations on the Treatment of Foreign Income Taxes By California

The Treasury Department had at various times before 1983 issued both temporary regulations and proposed regulations with respect to

the creditability of foreign taxes under Internal Revenue Code sections 901 and 903. This series of proposed and temporary regulations culminated in the issuance of final Regulations on October 6, 1983. The final Regulations are effective for taxable years beginning after November 14, 1983, but a taxpayer may elect to have them applied to any prior open taxable year on a country-by-country basis. The election to apply the final Regulations to earlier taxable years had to have been made by October 12, 1984, except for taxpayers who had deducted, rather than credited, foreign taxes on an earlier federal return. Once an election is made, however, it may not be revoked.

The final Regulations made numerous and substantive changes to the previously issued proposed and temporary regulations. While this article will not attempt an in-depth examination of the final Regulations, some of their more significant aspects will be highlighted.

The final Regulations provide that a foreign levy is an income tax only if (1) the levy is a tax, and (2) the predominant character of that tax is that of an income tax in the United States sense. The predominant character of a foreign tax is that of "an income tax in the United States sense" if the foreign tax is likely to reach net gain in the normal circumstances in which the tax applies. A foreign tax is likely to reach net gain in the normal circumstances in which the tax applies if the tax, judged on the basis of its predominant character, satisfies each of the requirements for (1) realization, (2) gross receipts, and (3) net income as set forth in the final Regulations.

One of the most striking features of the final Regulations is the "realization" requirement which may be satisfied even where a tax is levied on the occurrence of an event prior to an event which would give rise to taxation under United States law, such as a traditional

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112. Proposed regulations were issued on April 5, 1983, 48 Fed. Reg. 14641; temporary and proposed regulations were issued on November 17, 1980, 45 Fed. Reg. 75747 and 75695; and proposed regulations were issued on June 20, 1979, 44 Fed. Reg. 36071.
115. Id. §1.901-2(h)(2)(i).
116. Id. §1.901-2(h)(2)(iv).
117. Id. §1.901-2(h)(2)(v).
118. Id. §1.901-2(a)(1).
119. Id. §§1.902-2(a)(ii) and 1.901-2(a)(3).
120. Id. §1.902-2(b)(1).
sale or exchange. Under the final Regulations, a foreign tax may satisfy the realization requirement where the events giving rise to the tax liability occur prior to events that result in realization under the general tax law, if the prerealization event is the transfer, processing or export of readily marketable property. In addition, the Regulations require that the foreign country not impose a second tax with respect to the income on which the tax is imposed by reason of the prerealization event, upon the occurrence of a later event.\textsuperscript{121}

Under the final Regulations, a foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, the tax is imposed on the basis of actual gross receipts, or gross receipts “computed under a method that is likely to produce an amount that is not greater than fair market value.”\textsuperscript{122}

The third element, net income, will meet the requirement under the final Regulations if, judged on the basis of the predominant character of the foreign tax, the base of the tax is computed by reducing gross receipts to permit (1) recovery of the significant costs and expenses attributable, under reasonable principles, to such gross receipts, or (2) recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.\textsuperscript{123}

A major element of the final Regulations is the provision for “dual capacity taxpayers.” A person who is subject to a levy by a foreign state and who also receives or will receive a “specific economic benefit”\textsuperscript{124} from the foreign state, is referred to as a dual capacity taxpayer.\textsuperscript{125} Dual capacity taxpayers are subject to special provisions of the final Regulations which determine what portion of the foreign levy is creditable. As a rule, no credit is allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer unless the person claiming such a credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is an income tax. A foreign levy is not a tax to the extent a person subject to the levy receives or will receive a direct or indirect specific economic

\textsuperscript{121} \textit{Id.} \S1.901-2(b)(2).
\textsuperscript{122} \textit{Id.} \S1.901-2(b)(3)(i)(B).
\textsuperscript{123} \textit{Id.} \S1.901-2(b)(4).
\textsuperscript{124} \textit{Id.} \S1.901-2(a)(2)(i)(A). This section defines a “specific economic benefit” as “an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general.” \textit{Id.}
\textsuperscript{125} \textit{Id.} \S1.901-2(a)(2)(ii)(A).
benefit from the foreign country in exchange for payment pursuant to the levy.126

Even this brief overview makes clear that many provisions of the final Regulations are at variance with the current California standards regarding the deductibility of foreign taxes under section 24345. The provisions for dual capacity taxpayers and "income" taxes levied on prerealization income are two of the major differences which now exist between the California and federal schemes. The question which will inevitably arise is whether California should adopt the final Regulations for purposes of defining an income tax under section 24345.

First, California has not expressly adopted the final Regulations, nor has section 24345 been amended in response to those regulations. California law is well settled that deductions are a matter of legislative grace, and that exemptions from taxation must be found in the statute.127 A taxpayer has the burden of showing that the requirements of the exemption are clearly met, and any doubt is to be resolved against the right to the exemption.128 Based upon these standards and the language of section 24345, no persuasive argument can be made that section 24345 itself incorporates the final Regulations.

An argument can be made, however, that the Franchise Tax Board has by reference incorporated the final Regulations into the California regulatory scheme which interprets the Bank and Corporation Tax Law. Although the Franchise Tax Board has promulgated regulations interpreting some portions of section 24345, no regulations have been issued with respect to subdivision (a)(2)(A) which denies a deduction for foreign taxes "on or according to or measured by income or profits..." 129 Any argument that California has impliedly adopted the final Regulations would necessarily have to rely upon California regulation 26422,130 which provides that in the absence of regulations of the Franchise Tax Board, regulations of the Internal Revenue Service shall govern the interpretation under specified circumstances of...

126. Id. §1.901-2(a)(2)(i).
129. The Franchise Tax Board has issued regulations interpreting only the following portions of section 24345; Deduction for Taxes or Licenses in General, Title 18, CAL. ADMIN. CODE, §24345-1; Taxes for Local Benefits, Title 18, CAL. ADMIN. CODE, §24345-2; Federal Stamp Taxes, Title 18, CAL. ADMIN. CODE, §24345-3; Sales and Gasoline Taxes, Title 18, CAL. ADMIN. CODE, §24345-4; Federal Social Security Taxes and State Unemployment Insurance Contributions, Title 18, CAL. ADMIN. CODE, §24345-5; and Taxes of Shareholder Paid by Corporation, Title 18, CAL. ADMIN. CODE, §24345-6.
130. Title 18 CAL. ADMIN. CODE §26422, is set forth in full, supra note 64.
conforming California statutes found in the Bank and Corporation Tax Law.

Regulation 26422, however, is quite limited in scope, and provides that Internal Revenue Service regulations will only govern the interpretation of "conforming" California statutes, and only "insofar as possible," with "due account" given for "obvious differences between state and federal law. . . ." \footnote{131} Section 24345 and Internal Revenue Code section 901, apart from a common reference to "income," have little else in common, and section 24345 should not be deemed to constitute a "conforming" statute. In addition to the policy differences underlying state and federal taxation and the fundamental differences between a tax based upon source and one based upon residence, decisions such as \textit{Huntington Alloys} illustrate the substantive differences between "income" as defined under the California and federal foreign tax schemes. Differences such as these weigh heavily against any argument that the final Regulations should be interpretative of section 24345 for purposes of determining the deductibility of a foreign tax paid or accrued.

\textbf{CONCLUSION}

The treatment of foreign income taxes under section 24345 is an issue which has undergone numerous changes in recent years. Many of these changes are the result of the increasingly complex analyses undertaken by the Board and the courts in determining the nature of a foreign tax. The analysis of \textit{Guettler} and \textit{Meltzer} on the distinction between income and a return of capital, the analysis of \textit{Haubiel} and \textit{Bochner} which focuses on the specific foreign tax in issue, the analysis of \textit{Beamer} and \textit{MCA} on the distinction between gross income and gross receipts, and the analysis of \textit{Occidental Petroleum} on realization and economic gain have all been attempts to clarify increasingly more complex issues in this area. Other issues, such as the impact of the final Federal Regulations on the California scheme, are far from settled. The treatment of foreign income taxes under the Bank and Corporation Tax Law remains a hybrid of state and federal tax law principles.

\footnote{131} \textit{See supra} note 65.