P&G Northeast Asia (‘P&G NEA’), a corporation incorporated in Singapore was generally responsible for marketing and selling P&G products in Japan and Korea. P&G NEA’s principal office was located in Kobe, Japan, and it managed both its Japanese and Korean operations from that office. P&G NEA had no physical location or employees in Korea. Instead, it contracted with a contract manufacturer to manufacture products in Korea. The finished products were then sold by P&G NEA into the Korean marketplace through a wholly-owned distributing subsidiary.

P&G NEA made numerous sales of P&G products in Japan and Korea, and it paid royalties on these sales to P&G. Because P&G NEA conducted its business from Japan, it was required to withhold and pay 10% of the royalty payment as tax in Japan. Because P&G NEA was based in Japan, rather than Korea, and it had no employees in Korea, neither P&G NEA nor P&G paid tax to Korea on the royalty income paid by P&G NEA to P&G during the 2001-2005 years.

In 2006, however, Korea’s National Tax Service (“NTS”) conducted an audit of P&G’s business in Korea, in which it determined that a portion of the royalties paid by P&G NEA to P&G was subject to tax in Korea. Specifically, the Korean NTS determined that the royalties attributable to sales in Korea were “Korean sourced income” to P&G, and were subject to Korean corporate income tax at a rate of 15%. P&G and P&G NEA determined that there was no reasonable basis to appeal the assessment of the Korean NTS or to invoke the grievance processes provided under the US-Korea Tax Treaty, and it did not do so. P&G neither contested this conclusion nor sought a redetermination of the source of the royalty income under Japanese law or competent authority proceedings.

P&G should have sought a redetermination of the source of the royalty income under Japanese law or competent authority proceedings with regards to P&G’s liability in Japan. The requirement that taxpayers exhaust their remedies before claiming a foreign tax credit is a core component of the statutory foreign tax credit scheme. The availability of a tax credit for foreign taxes ameliorates the burdens of double taxation on American corporations and fosters international trade. However, a system under which the United States Treasury pays out foreign tax credits without first demanding that American companies effectively and practically reduce their foreign tax payments would create a moral hazard. Taxpayers would have no incentive to challenge any foreign tax whether or not properly imposed, thereby leaving the United States to foot the bill through the credit system.

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