

THE CASE AGAINST FOREIGN TAX CREDITS

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I. INTRODUCTION

Perhaps no feature of modern income tax systems has gained such consistent – and unmerited – approval from commentators as the foreign tax credit, under which tax payments to one’s own government with respect to foreign source income are reduced, dollar for dollar, by income taxes paid to foreign governments. This provision’s treatment of paying a dollar of tax to someone else as equivalent to paying it to oneself is so “extraordinarily generous” that T.S. Adams, its inventor at the U.S. Treasury Department in 1918, was skeptical that Congress would even consider it, and shocked when it passed easily.¹ Adams might have been even more surprised had he gotten to witness the foreign tax credit’s almost unchallenged intellectual and political entrenchment during the more than ninety years since he proposed it.

The foreign tax credit undoubtedly would be eliminated if the U.S. exempted foreign source income. Short of that perhaps remote contingency, however, its intellectual prestige could scarcely be greater. Commentators almost universally agree that, if we impose any tax on foreign source income, the foreign taxes paid on such income must be creditable.² In this respect, foreign tax creditability is virtually on a par with the idea that ordinary business expenses must generally be deductible, so that

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¹ Graetz and O’Hear, “The ‘Original Intent’ of U.S. International Taxation,” 46 Duke L.J. 1021, 1046 (1997).

² But see Graetz-Grinberg as a notable though limited exception.

income taxes will fall on net rather than gross income.³ In fact, however, the case for foreign tax creditability is far shakier than that for taxing net rather than gross income.

There may be no better illustration of foreign tax credits' intellectual entrenchment than the consistent support they receive even from strong proponents of taxing foreign source income. From Stanley Surrey writing in the 1950s,⁴ to the U.S. Treasury in 1962 and thereafter right through 2009,⁵ to the writings of leading contemporary proponents of increased worldwide taxation of U.S. firms,⁶ the target has always been deferral, under which U.S. companies generally avoid paying current U.S. tax on their foreign subsidiaries' unrepatriated foreign earnings. With regard to the foreign tax credit, the only whisper of consistent criticism concerns perceived misuses⁷ of an otherwise accepted tax benefit.

Few commentators appear to recognize that clear thinking about foreign tax credits requires distinguishing between two margins at which they affect taxpayer incentives and behavior. The first concerns the making of outbound investments by U.S. taxpayers. Here, credits greatly reduce the expected tax burden that prospective investors would face, relative to that which would result from charging the full U.S. rate but making foreign taxes merely deductible. However, credits are not the exclusive means for reducing the tax burden that would result from unmitigated double taxation. Lowering the U.S. tax rate on outbound investment would accomplish this as well, even

³ [And note that Graetz-Grinberg are talking about gross withholding taxes, which ignore deductions as well.]

⁴ Cite Surrey articles.

⁵ Cite 1962 proposal; Office of Tax Policy, Department of the Treasury, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study (December 2000) (henceforth, “2000 Treasury Study”); Obama 2009.

⁶ E.g., Avi-Yonah and Peroni.

⁷ Examples of asserted misuse include, e.g., cross-crediting, strategic repatriation of high-tax income, and getting credits without the associated income or burdens of ownership.

with mere deductibility for foreign taxes. Thus, disliking the overall tax burdens on outbound investment that would result from unmitigated double taxation does *not* require supporting creditability for foreign taxes paid.

A second, distinct margin at which foreign tax credits affect taxpayer incentives and behavior relates to incurring foreign tax liabilities. Foreign taxes may be a variable, even if the amount of foreign investment is fixed, due to taxpayers' ability both to invest in low-tax rather than high-tax jurisdictions, and to engage in foreign tax planning no matter where they actually invest. To the extent that a U.S. taxpayer can claim foreign tax credits, however, it becomes utterly indifferent at the margin to how much tax it pays abroad. After all, the taxes at issue will be refunded in full by the U.S. Treasury anyway.

Suppose that all one needed to show, in order to claim foreign tax credits, was that one in fact had made a given income tax payment to a foreign government, whether it was one's own liability or someone else's. In that case, a U.S. taxpayer who was offered \$1, in exchange for agreeing to pay someone else's billion dollar foreign income tax liability, would have every reason to say yes. After all, the billion dollar outlay would effectively be refunded by the U.S. Treasury, while the dollar in pocket, though presumably taxable, would otherwise remain.

Obviously, foreign tax credits are not quite as easy as that to gin up. The U.S. rules impede this type of transaction both by requiring that the foreign income tax liability be deemed one's own and through foreign tax credit limits that put a cap on how far one can go. Yet there are in fact transactions not that far removed from the above.⁸ The takeaway point remains that a 100 percent marginal reimbursement rate (MRR) for foreign taxes paid – even if it shifts abruptly to 0 percent when the foreign tax credit limit

⁸ Compaq-style transactions, perhaps Guardian Industries, etc.

is reached – is highly unlikely to represent optimal national policy, even if one is concerned about the overall worldwide tax rate on double-taxed foreign source income.

Foreign tax deductibility, by contrast, creates exactly the right marginal incentive, from a national welfare standpoint, to engage in foreign tax planning. Under it, taxpayers will have reason to pay up to a dollar, whether in reduced receipts or increased outlays, to save a dollar of foreign taxes, thus maximizing their after-foreign-tax return, which presumably is the thing of interest from a U.S. national welfare standpoint.⁹ This is precisely the marginal incentive that exemption of foreign source income gives them, and indeed one could reasonably call exemption a variant of foreign tax deductibility in which the domestic rate on foreign source income happens to be zero. After all, exemption is almost indistinguishable from a worldwide system in which foreign taxes are merely deductible but the tax rate on foreign source income is, say, 0.01 percent.

For these reasons, I believe that, if we assume that the overall U.S. tax burden on outbound investment will remain fixed, current law is dominated by a burden-neutral alternative in which (a) credits are replaced by mere deductibility, but (b) the impact of this change on outbound investment by U.S. firms is offset by sharply reducing the U.S. tax rate on foreign source income – perhaps to the neighborhood of about 5 percent.¹⁰ Moreover, while one can question whether the shift is actually practical, given likely treaty and political economy problems, it has important implications for how we think about present law, even if not adopted.

For example, the case for exemption is strengthened if, as a practical matter, it is the only feasible system that does away with foreign tax credits. Moreover, the problems

⁹ Assume US shareholders, note the point that when foreign taxes are paid we don't get the money.

¹⁰ [I get this back of the envelope figure from Grubert & Mutti.]

with foreign tax credits may illuminate the relative desirability of alternative means of imposing a given level of U.S. tax burdens on resident multinationals' outbound investment. In particular, it may indicate that limiting the use of foreign tax credits is preferable to burdening U.S. taxpayers' overseas tax planning, such as by giving them subpart F income when they shift income out of high-tax countries abroad.

The rest of this article further develops this argument as follows. Section II expands on the argument against allowing foreign tax credits. Section III explores why they receive such strong support, in both practical tax politics and the policy literature, notwithstanding their excessive generosity at the foreign tax planning margin. Section IV compares my preferred burden-neutral approach to present law, and considers its policy implications if the main contours of such law remain in place. Section V offers a brief conclusion.

II. THE ARGUMENT AGAINST ALLOWING FOREIGN TAX CREDITS

In evaluating foreign tax credits, a crucial first step is deciding whether one should focus on national economic welfare or – as is more common in the international tax policy literature – global welfare. One's underlying normative perspective always is crucial in tax policy debate, but perhaps never more so than when one is considering foreign taxes. In the domestic setting, the fundamental reason for typically favoring tax neutrality is that tax liabilities, while a cost to those bearing them, are socially a transfer, as the Treasury gets to spend the money on someone's behalf. This analysis does not apply to foreign taxes, however, unless one counts the benefit to foreign individuals from having their governments obtain revenue.

From a strict ethical standpoint, if one accepts that all human beings' welfare matters equally, the case for focusing on global rather than merely national welfare is compelling. Nations do not commonly act this way, however. Neither do individuals, even with respect to their fellow citizens. For example, tax policy writers (myself included) who examine distributional policy through a utilitarian lens and emphasize the importance of declining marginal utility nonetheless do not typically give away all their money to the poor. Doing so would be commendable, but within limits we accept and expect a degree of self-directedness both from ourselves and others.

If self-interest is an acceptable standard in practice for individuals, then surely it is permissible as well for countries. What is more, in the national setting, efforts to impose (other than through open advocacy) policies that are more globally altruistic than the voters favor would raise principal-agent issues. As Michael Graetz has observed, U.S. government actors' "higher obligation to U.S. citizens and legal residents" implies caring about "where enhanced economic output occurs, whom it benefits, and what national treasury obtains the tax revenues," and thus seeking primarily to promote domestic economic output and wellbeing, rather than that of the entire world.¹¹

In any event, the conventional divide in international tax policy debate between global and national welfare analyses is overstated.¹² Proponents of the global standard typically do not take the next step and urge that the U.S. give trillions of dollars away to poorer countries. Indeed, they appear to believe that a global welfare standard in international tax policy is also best for the U.S. over the long run. Thus, the U.S. Treasury has argued against "establish[ing] policies that promote national short-term

¹¹ Michael Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 Tax L. Rev. 261, 279 (2000).

¹² See Daniel Shaviro, FIXING THE U.S. INTERNATIONAL TAX RULES, chapter 4.

interests at the expense of global economic welfare,” because other countries will reply in kind, and deems this all the more important for a country that “is often looked upon to provide global leadership in the policies it adopts.”¹³

The real dispute, then, is not so much about global versus national welfare as about how best to pursue national welfare. Globalists argue for a cooperative strategy, based on assuming (often with little in the way of concrete demonstration) that others will either respond in a tit-for-tat fashion or else simply follow the U.S. lead. Critics of that approach respond that unilateral pursuit of national welfare, based on the assumption that others will not respond strategically at all, is at least a significant possibility.¹⁴

With the question of reciprocity’s potential thus in mind, suppose we now consider foreign tax credits, but looking purely at the foreign tax planning margin, without regard to the level-of-outbound-investment margin (since the tax burden at that margin can be similarly adjusted with or without credits). Can a plausible level of reciprocity make a 100 percent MRR, up to the point where the foreign tax credit limit applies, nationally optimal?

With complete reciprocity, the answer is potentially yes. After all, for all countries considered together, foreign tax credits are a zero-sum game. Every time one country loses a dollar, another gets to impose a dollar of tax without its affecting inbound investors’ marginal incentives. Thus, if two identical countries, following identical

¹³ 2000 Treasury Study at 25-26.

¹⁴ See, e.g., Graetz and Grinberg, arguing from the unilateral standpoint for mere foreign tax deductibility with respect to portfolio assets, and then assessing whether the prospect of retaliation by other countries should change the result.

policies, each impose their own source-based tax and credit that imposed by the other, they end up in the same place as if they were not granting foreign tax credits.¹⁵

Even with differences between countries, full reciprocity conceivably could make foreign tax credits nationally optimal for all. To be sure, without foreign tax credit limits, high-tax countries like the U.S. would benefit relative to low-tax countries by reason of getting larger reimbursements (although this hardly seems a stable equilibrium). With limits, however, this balances out, as each country credits no more than the level of taxes that it is itself imposing.

In practice, however, reciprocity generally is not required for other countries' taxes to be creditable. The U.S., for example, initially granted foreign tax credits long before anyone else had them, and continues not to condition them on reciprocal creditability.¹⁶ And without such conditioning, even the fact that other countries are likewise mitigating double taxation – for example, through exemption – does not suffice to make the granting of foreign tax credits nationally optimal.

Thus, suppose that the U.S. has a foreign tax credit system, Germany has an exemption system,¹⁷ and Bermuda is a tax haven into which residents of either country can shift foreign taxable income.¹⁸ Foreign tax credits potentially cost the United States

¹⁵ Based on a model somewhat like this, Mihir Desai and Dhammika Dharmapala conclude that foreign tax credits for outbound portfolio investment can be nationally optimal. See Desai and Dharmapala, *Investor Taxation in Open Economies* (2009).

¹⁶ International tax treaties typically include a commitment to mutual creditability of source-based taxes. For passive income, however, they typically call off source-based taxes and provide for exclusively residence-based taxation.

¹⁷ For purposes of this example, to make the U.S. and Germany equal in the overall tax burdens they impose on foreign source income, differing only in the method used, suppose that the U.S. grants just enough credits above the limit to match the German exemption system's zero net revenue. This restricts the difference between the two systems to that of their incentive effects with respect to foreign tax liabilities.

¹⁸ The choice of Bermuda for this example may suggest that no real economic cross-border activity shifts out of the U.S. or Germany. The example works equally well, however, if we posit that the low-tax jurisdiction (like, say, Ireland or Singapore) can host real activity that shifts there for tax reasons.

after-foreign-tax income by eliminating U.S. companies' incentive to save foreign taxes by shifting taxable income from Germany to Bermuda. If Germany were a foreign tax credit country, this detriment to the U.S. might be offset by Germany's eliminating the incentive for German companies to do the same as between the U.S. and Bermuda. However, a German exemption system eliminates the offset at this margin by keeping German firms cost-conscious with respect to U.S. taxes.

In principle, the U.S. foreign tax credit rules could be revised to limit the benefit to reciprocally credit-granting countries (with, say, a rate cut taking its place for non-participating countries, to keep constant the U.S. tax burden on foreign source income). This seems politically unlikely, however, and would be hard to administer even if otherwise feasible. One problem is that, even as between nominally foreign tax credit-granting countries, actual reciprocity is hard to assess unless one carefully studies the actual system details.¹⁹ A second is that, for purposes of the credit limit in reciprocating countries (as well as the rate cut, if any that applied elsewhere), one would have to determine the countries in which foreign source income arose, thus multiplying the source problems of current law.

Thus, foreign tax credits probably cannot be entirely reciprocal in practice, and one must consider the unilateral perspective when evaluating their desirability from a national welfare standpoint. From such a perspective, a 100 percent MRR, entirely eliminating resident taxpayers' incentive to be foreign tax-conscious until they near the

¹⁹ For example, countries can use a restrictive definition of foreign source income to make their foreign tax credit limits more restricting than they might otherwise appear. See Daniel Shaviro, Why Worldwide Welfare as a Normative Standard in U.S. Tax Policy? 60 Tax L. Rev. 155 (2007). In addition, if they allow deferral for foreign source income, the extent to which they counter foreign tax planning depends on whether they have rules like those in subpart F of the U.S. rules that create deemed dividends for transactions that suggest its presence (such as the use of foreign base companies in countries where little economic activity occurs). See Daniel Shaviro, The Obama Administration's Tax Reform Proposals Concerning Controlled Foreign Corporations, 4 Brit. Tax Rev. 331 (2009).

credit limit, cannot possibly be optimal. Indeed, the only reimbursement rate that gives resident taxpayers the right incentive, when deciding how much to pay (in the form of lost receipts or added outlays) to avoid a dollar of foreign taxes, is the U.S. marginal tax rate for foreign source income, which applies automatically if foreign taxes are deductible.

This result should not be considered either surprising or novel. It has been known since at least 1963, when Peggy Richman Musgrave set forth the unilateral national welfare standard of national neutrality (NN), according to which, absent strategic interactions with other countries, one should tax the foreign source income of all residents at the full national rate, with foreign taxes merely being deductible.²⁰ NN, though commonly treated as a single unitary standard, in fact makes two distinct claims. First, it asserts that countries should tax the worldwide income of their residents, so that investing abroad, rather than at home, will not result in a loss of tax revenue – as it would, under an exemption system, if outbound investment came at the expense of net domestic investment. Second, NN holds that foreign taxes should merely be deductible, in measuring foreign source income, since they are just like any other expense, from a national welfare standpoint, given that the money goes to a foreign treasury rather than the domestic one.

The first of NN's two claims has been significantly weakened or even refuted, as applied to corporate income taxation, based on evidence and arguments contradicting its assumption that outbound investment comes at the expense of net domestic investment.²¹ Lying behind this empirical issue are two important points that traditional international

²⁰ See Peggy Richman, *TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS* (1963).

²¹ See Shaviro, *FIXING THE U.S. INTERNATIONAL TAX RULES*, *supra*, chapter 4.

tax policy thinking generally ignored. First, a country that is pursuing NN can determine the overall incentives only of its own residents, who are interacting in world capital markets with other investors. Thus, even a net investment outflow by residents has no effect on net domestic investment if it triggers a matching net inflow – as may happen, for example, if appealing location-specific investment opportunities are subject to congestion.²² Second, the main actors in cross-border investment are corporations, which are taxed at the entity level. Corporate residence, unlike that of individuals, verges on being elective for newly created corporations, potentially making residence-based tax rules close to meaningless. In addition, since corporations can raise new equity on world capital markets, they are not subject to the same type of budget constraint as that faced by individuals. For an individual with \$X of savings that are available to invest, sending a dollar abroad may mean foregoing its use to invest at home. But well-established corporations can finance all demonstrably meritorious projects by issuing equity. This permits their prospective domestic and foreign projects, while surely substitutes for each other in some cases (e.g., in deciding where to locate fixed production capacity), to be unrelated in other cases, and complements in yet others. Thus, it perhaps should not be surprising that recent empirical studies predominantly find that outbound investment by resident corporations tends not to reduce even their net domestic investment, much less that of the taxing country as a whole.²³

While NN's claim about taxing residents' worldwide income has thus been (at a minimum) seriously undermined, it remains unchallenged, because it is almost indisputably correct, with regard to the unilateral national welfare implications of a

²² E.g., as to good production sites, workers, and local consumer demand for particular products.

²³ See Shaviro, *FIXING THE U.S. INTERNATIONAL TAX RULES*, supra, chapter 4, for discussion and cites to empirical studies.

resident's paying a dollar of foreign taxes.²⁴ Consider again the point that an exemption system, while reflecting rejection of NN's first claim, follows its counsel with respect to the choice between paying a dollar of foreign taxes or otherwise losing a dollar of net after-tax income. And recall again that exemption can logically be viewed as merely one point along the continuum of foreign tax deductibility systems, where the tax rate could be set anywhere from zero (or a negative rate) to the full domestic rate (or higher).

Whenever the MRR for foreign taxes exceeds the otherwise applicable marginal tax rate, taxpayers presumably will be unwilling to spend as much as a dollar to avoid a dollar of foreign tax liabilities. The incentive problem would be less acute, however, if the MRR were less than 100 percent. To be sure, even at 100 percent, taxpayers do not affirmatively profit from incurring foreign tax liabilities (all else equal) – as they would, say, from cost-plus reimbursement, or that exceeding 100 percent. (This is why cost-plus reimbursement – say, in government contracts with private suppliers of goods and services, is rightly notorious.²⁵) Even with an MRR of “only” 100 percent, however, a taxpayer would hypothetically benefit from paying any amount whatsoever of creditable foreign taxes that otherwise would be paid by a foreigner, in exchange for even trivial compensation from that foreigner.

For a real world illustration, albeit with otherwise pointless transaction costs taking the place of net payments to foreigners, consider the notorious case of *Compaq v. Commissioner*,²⁶ in which the taxpayer effectively paid out of pocket for the right to be

²⁴ Assume US SHs if a resident corporation. Note the usual reductive assumption that we aren't concerned about anything else, such as who gets the money & what they'll do with it.

²⁵ Cite on cost-plus.

²⁶ 113 T.C. 214 (1999), rev'd, 253 F.3d 350 (8th Cir. 2001). I discuss the *Compaq* case at length in Daniel Shaviro, Economic Substance, Corporate Tax Shelters, and the *Compaq* Case, 88 Tax Notes 221 (2000), and Daniel Shaviro and David Weisbach, The Fifth Circuit Gets It Wrong in *Compaq v. Commissioner*, 94 Tax Notes 511 (2002).

treated as the payor of foreign withholding taxes that would have been due in any event. In *Compaq*, Royal Dutch Petroleum (RDP) had declared dividends that would be subject to a 15 percent Dutch withholding tax. Evidently, the marginal investor in the market for RDP stock was not able to claim foreign tax credits, as shown by the fact that the ex dividend price was generally lower than the immediately preceding cum dividend price by only the after-withholding tax amount of the dividend payment.

Compaq needed foreign tax credits to lower its U.S. tax bill, and was also in other respects well-situated to take advantage of the opportunity to buy foreign tax credit claims that otherwise would go to “waste” (i.e., not get reimbursed by the U.S. Treasury). In particular, it had substantial capital gains for the year, permitting it not to worry about the capital loss limitation (under which net capital losses are generally nondeductible).²⁷ At the prompting of an investment bank’s solicitation letter, it therefore did the following. First, it purported to buy \$888 million worth of cum dividend RDP stock, on which \$22.5 million of previously declared dividends (\$19 million after subtracting withholding tax) were immediately due. Second, within an hour, Compaq purported to sell the now ex dividend stock for \$19 million less than the purchase price. It thus would have about broken even before considering the U.S. federal income tax consequences (with the \$19 million in cash from the dividend offsetting the \$19 million capital loss), except that it also incurred transaction costs (such as the investment bank’s fee) of about \$1.5 million. But this detriment was more than offset by the value of getting to use \$3.4 million worth of foreign tax credits against otherwise due U.S. tax liability.²⁸

²⁷ Internal Revenue Code section 1211.

²⁸ This net tax benefit from engaging in the transaction was slightly offset by the fact that Compaq’s taxable income increased by reason of the transaction, insofar as the \$3.4 million in Dutch withholding taxes (included in income, since they were creditable rather than deductible) exceeded the \$1.5 million in

Overall, *Compaq* amounts to a case in which the taxpayer simply paid \$1.5 million for the right to be treated, for U.S. income tax purposes, as the party that had paid the Dutch withholding taxes. This effect aside, the transaction amounted to little more than paper-shuffling. Suppose one were to strip away all the hurdles that made engaging in it a challenge – for example, the need to find cum dividend foreign stock that one could pretend to own for an hour, rather than simply paying foreigners' tax liabilities directly – and also eliminated the foreign tax credit limit. Under these circumstances, the allowance of foreign tax credits would be a nuclear weapon potentially eliminating all U.S. income tax revenues. After all, anyone who potentially owed any U.S. tax could simply offer, for nominal compensation, to pay taxes to foreign governments otherwise due from foreigners.

In practice, the ability to play *Compaq*-style games is so hemmed in by restrictions of various kinds that the actual revenue threat is relatively minor. Nonetheless, the fact that (as *Compaq* illustrates) foreign tax credits are so dangerously over-generous helps to explain why they must be restricted in multiple ways. Yet these restrictions do not so much eliminate the fundamental incentive problems with offering a 100 percent MRR, as impose either arbitrary limits on its availability or frictions that make it costlier to exploit. Examples, both from present law and prominent reform proposals, include the following:

- 1) The foreign tax credit limit ensures that only the U.S. tax otherwise due on foreign source income, rather than all U.S. income tax liability, can be eliminated by using credits. Thus, the worst case revenue scenario is equivalent to that under

transaction costs. At a 35 percent rate, this \$1.9 million increase in Compaq's U.S. taxable income presumably cost it about

exemption – although exemption would not condition the elimination of U.S. tax liability with respect to one’s foreign source income on paying sufficient foreign taxes. In effect, then, the potential harm done by the 100 percent MRR is limited by replacing it, once the credit limit is reached, to a zero percent MRR (ignoring the possible value of foreign tax credit carryovers).

While doing this may well be desirable, given the underlying incentive problem and holding all else equal, it involves arbitrary line-drawing, in the sense that the harms avoided are no different or worse than those that are permitted. To illustrate, suppose a given multinational would owe exactly a million dollars of tax on its U.S. source income. The revenue cost to the U.S. of reducing its overall U.S. tax liability from \$1 million to \$999,999 is really no different than that from reducing the liability from \$1,000,001 to \$1 million. Nor can the two cases’ incentive effects with regard to decisions to incur foreign tax liabilities easily be told apart.

A common line of argument holds that “the foreign tax credit limitation preserves U.S. sovereignty to tax U.S. source income.”²⁹ This is merely a semantic point, however, given that, in the absence of incentive and revenue problems, foreign tax credits could easily be made, not merely allowable against domestic tax liability, but refundable via a cash payment from the U.S. Treasury to the extent in excess thereof. Full refundability, however unwise, would make it clear that the tax on domestic source income was still being imposed, as “sovereignty” ostensibly requires. That tax would merely be getting offset, in the overall balance statement, by the distinct foreign tax credit refund program, while still, dollar for dollar, improving the government’s bottom line position. One is no

²⁹ Stephen E. Shay, J. Clifton Fleming, Jr., and Robert J. Peroni, “*What’s Source Got to Do With It? Source Rules and U.S. International Taxation*. 56 Tax L. Rev. 81, 148 (2002).

less sovereign as a taxing authority merely because one chooses to make payments – as the foreign tax credit effectively does, from the very first dollar – in addition to levying taxes, and through an integrated delivery system.

2) For decades, the U.S. rules have required, albeit with varying rigor over time, that the foreign tax credit limit apply separately to distinct “baskets” of foreign source income, in order to impede cross-crediting (i.e., the use of excess credits from one foreign activity to offset the U.S. tax otherwise due on income from another such activity). At present, the rules only thus separate active income from passive income, but at various times in the past they have been more extensive and ambitious. Proponents of greater worldwide taxation defend the separate baskets as preserving “U.S. sovereignty to impose a residual tax on its residents' low-taxed foreign source income.”³⁰ This, however, is subject to the same objection as the sovereignty defense of foreign tax credit limits. A better way to think of separate baskets is as simply another device, like the overall limitation, to set arbitrary (which is not to say undesirable) limits on the availability of the 100 percent MRR for foreign taxes paid.³¹

3) The credit, by treating foreign income taxes paid³² so much more favorably than other overseas business expenses, creates an incentive for U.S. taxpayers to seek to convert what would otherwise be merely deductible outlays into creditable income tax payments. Unsurprisingly, the U.S. rules combat such planning by providing that payments to a foreign government, even when collected pursuant to its taxing power, are

³⁰ Id.

³¹ Obviously, separate baskets, in addition to causing the MRR for foreign taxes paid to be zero percent rather than 100 percent in more circumstances, also increase the overall U.S. tax burden on foreign source income, if one holds constant the rest of the rules.

³² The fact that only foreign income taxes paid are creditable, as distinct from all foreign taxes, arguably also responds to the over-generosity of the credit's 100 percent MRR, although the exact rationale for thus limiting it is unclear.

not creditable if received in exchange for a “specific economic benefit,” which the regulations define as a 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.”³³

While understandable (and verging on inevitable) as a response to specific tax planning gambits, the “specific benefit” requirement underscores the arbitrariness of treating foreign taxes paid so much more favorably than other overseas business expenses. After all, taxes paid and benefits received may often be generally related to each other. For example, high-tax countries may tend to offer more infrastructure and better-educated workforces than low-tax countries, effectively permitting U.S. companies that invest in high-tax rather than low-tax countries to substitute paying a higher tax rate (rebated through foreign tax credits) for needing to spend more out of pocket or accept lower worker productivity. Only within a given country is paying a dollar more in tax unlikely to affect benefits received (absent the game-playing that the regulation addresses), given the multiplicity of potential beneficiaries.

4) In *Compaq*, the government argued that the transaction lacked requisite economic substance and business purpose, and accordingly that the taxpayer’s foreign tax credit claims should be denied. This view prevailed in the Tax Court, but was controversially³⁴ reversed on appeal. Whatever the proper result in that case, however, it was undisputed that the economic substance and business purpose requirements applied.

³³ Treas. Reg. §1.901-2(a)(2)(ii)(B). Absent a generally imposed income tax in the foreign country, the regulation instead defines a specific economic benefit as one that is “not made available on substantially the same terms to the population of the country in general.” Id.

³⁴ See Shavilo and Weisbach, *supra*, arguing that the Fifth Circuit in *Compaq* misinterpreted both the factual record of the case and the economic substance and business purpose requirements. Note also the IES decision.

Under those requirements, transactions providing tax benefits (such as foreign tax credits) may be disregarded or recharacterized for U.S. federal income tax purposes if they did not sufficiently affect the taxpayer's economic position and serve non-tax business purposes (such as by creating a genuine economic risk of gain or loss with respect to the RDP stock).

This aim of requiring economic substance and business purpose is pervasive in U.S. income tax law (as well as that of other countries with "generalized anti-avoidance rules" or GAAR). Moreover, it can be advanced through rules setting forth precise legal requirements, as well as by general standards, and by statute as well as through judicial doctrine. Indeed, the *Compaq* transaction itself would unambiguously fail to yield allowable foreign tax credits under present law, which was amended in 1997 to require that taxpayers claiming foreign tax credits with respect to withholding taxes on dividends hold the underlying stock, without excessive hedging, for at least fifteen days.³⁵ This parallels expressly requiring economic substance and business purpose, since an unhedged holding period of that length implies both actual risk-bearing and willingness to bear risk.

Though widely accepted, the use of economic substance and business purpose-type requirements (whether imposed through rules or standards, and by legislatures or courts) is arguably paradoxical. Thus, in *Compaq*, if we were to assume that the taxpayer would have purchased the RDP stock in any event, there would be absolutely no reason for the Internal Revenue Service (or anyone else, apart from Compaq's officers and shareholders) to care whether it bore any economic risks of ownership with respect to that stock. No one else would be substantially affected by whether Compaq decided to hold

³⁵ IRC § 901(k).

the stock for fifteen minutes, fifteen days, or fifteen years. Why, then, should the government require a minimum period of ownership as a prerequisite for claiming foreign tax credits, when this would inconvenience Compaq (if it did not want the associated risks) without benefiting anyone else?

The answer is that economic substance and business purpose requirements create friction, raising the cost of acquiring foreign tax credits to taxpayers that prefer not to hold risky positions in foreign stock. Thus, while in some cases the requirements may result in extra deadweight loss, as taxpayers both get to use foreign tax credits *and* otherwise inconvenience themselves to no one's benefit, in other cases the result is to deter the tax shelter transaction altogether.³⁶ Moreover, while this is a general, and in many cases unavoidable, feature of the income tax landscape, the need to apply it to foreign tax credits is a gratuitous consequence of their providing an over-generous MRR for foreign taxes paid.

Economic substance and business purpose requirements more commonly apply to deny taxpayers deductions for claimed losses. With respect to loss deductibility, however, there often is an unavoidable dilemma. True economic losses generally should be deductible, as part of measuring net income accurately and to minimize the undue discouragement of risk-taking that would result from asymmetrically taxing gains but disallowing losses.³⁷ By contrast, artificial tax shelter losses might be disallowed in all

³⁶As I have argued elsewhere, “[f]rom this perspective, economic substance is just a tool for accomplishing aims that have little to do with how one might define it as a matter of internal logic. Leaving aside the institutional reasons why (for courts in particular) economic substance is a particularly suitable tool for deterring undesirable transactions, one might as well condition favorable tax consequences on whether the taxpayer’s chief financial officer (CFO) can execute twenty back-somersaults in the IRS National Office on midnight of April Fool’s Day, if such a requirement turns out to achieve a better ratio of successful deterrence to inducing wasteful effort in meeting requirements that are pointless in themselves.” Shaviro, *Economic Substance, Corporate Tax Shelters, and the Compaq Case*, *supra*, at ____.

³⁷Hence, only good rationale for nonrefundability is concern about noneconomic losses.

cases if one could properly identify them.³⁸ The crux of the problem, however, is that the two may be indistinguishable in practice if comprehensive (and accurate) mark-to-market accounting is unfeasible or, for any other reason, not employed. Burdening taxpayers' loss claims with economic substance and business purpose requirements may make sense as a fallback, given the difficulty of distinguishing between good and bad losses more directly, if we believe that it will act to some degree as a filter.³⁹

Accordingly, using economic substance and business purpose requirements with respect to claimed losses may be optimal given the costliness of simply measuring income more accurately instead. However, no such underlying dilemma arises with respect to foreign tax credits. Suppose one agrees that (a) deductibility is superior to creditability at the overseas tax planning margin and (b) the two approaches' overall U.S. tax burden on foreign source income can be equalized by other means, such as by applying a much lower U.S. tax rate to such income if taxes are deductible than if they are creditable. Then providing credits and burdening their use through economic substance rules and the like seems clearly inferior to getting things right to begin with, via deductibility and a lower outbound than domestic tax rate.

In sum, the various arbitrary limits and burdens that U.S. tax law places on the claiming of foreign tax credits arguably make sense (or at least there is a reasonable case for them), if one takes as given the decision to allow credits. Yet the need for all these bells and whistles, which deductibility would make unnecessary, weighs in favor of the latter approach, so long as the distinct margin of tax burdens on outbound investment is

³⁸ Note exception for intended tax preferences, leading to lots of controversy concerning what intended means. See, e.g., Hariton.

³⁹ [Presumably, only tax shelter losses would generally be deliberate in advance, and since don't want to actually lose money these will tend to be fake losses.]

equalized by other means, such as substantially lowering the U.S. tax rate on foreign source income.

Obviously, this comparison needs a fuller evaluation before one reaches any definite conclusions about it. However, in starting to make the affirmative case for deductibility (plus lower rates) in lieu of creditability, I have not as yet considered the main arguments that often are made in defense of foreign tax credits. I therefore consider those arguments next.

III. WHY IS THE DESIRABILITY OF OFFERING FOREIGN TAX CREDITS SO WIDELY ACCEPTED?

There are two predominant rationales for offering foreign tax credits unilaterally, or at least without expressly requiring reciprocal creditability. The first, which chiefly explains their public political appeal, is that they prevent unfair double taxation. The second, which predominates in defenses of the foreign tax credit by policymakers, academics, and other experts, is that they advance global economic efficiency. Neither rationale is persuasive, however.

A. Aversion to “Double Taxation”

It has been clear for decades, although sometimes forgotten by experts, that foreign tax credits are politically popular because they address what is “perceived as the manifest injustice of double taxation.”⁴⁰ Given foreign source-based taxation of profits earned abroad, which is widely considered both justifiable and a fixed feature of the worldwide political landscape, policymakers (and perhaps even voters) evidently agree

⁴⁰ Graetz and O’Hear, *supra*, at 1047. See also Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 Colum. L. Rev. 815, 818 (1956), noting that multinationals’ argument for exemption, based on competitive disadvantage, was rejected, but that their argument for foreign tax credits, “based on the burden of double taxation, was persuasive”).

that, absent a move to exemption, the U.S. faces a virtual moral compulsion to grant foreign tax credits, in order to avoid double taxation's "essential unfairness."⁴¹

The asserted unfairness of "double taxation" is a common theme in U.S. tax policy debate. For example, President George W. Bush emphasized it in arguing for the adoption of corporate integration via dividend exemption.⁴² Advocates of repealing the estate tax likewise emphasize the claim that it causes unfair double taxation, because "money is taxed once when it is earned and again when it is passed on to the next generation."⁴³ And consumption tax proponents, going all the way back to John Stuart Mill, argue against the income tax that it unfairly double taxes savers, by reaching them duplicatively first when they earn money and then again when they save it.⁴⁴

What really matters, however, is not how many times one is taxed, but relative tax burdens as between the items that are being compared. For example, it surely is better to be taxed twice at 5 percent each than once at 40 percent. Or suppose we are comparing the taxation of people who do A to that of people who do B. If we observe that A is taxed at 30 percent, whereas B is taxed at 40 percent, there is a possible relevant disparity. It should not matter, however, whether, as a formal administrative manner, B was taxed on two occasions or only one. Converting a double tax on B (say, 30 percent

⁴¹ Graetz and O'Hear, *supra*, at 1109.

⁴² For example, in a prominent speech in support of his dividend exemption proposal, President Bush argued that it would result in our "treating investors fairly and equally in our tax laws. As it is now, many investments are taxed not once, but twice. First, the IRS taxes a company on its profit. Then it taxes the investors who receive the profits as dividends.... Double taxation is bad for our economy. Double taxation is wrong... It's fair to tax a company's profits. It's not fair to double-tax by taxing the shareholder on the same profits." See <http://georgewbush-whitehouse.archives.gov/news/releases/2003/01/20030107-5.html> (providing text of presidential speech to the Economic Club of Chicago on January 7, 2003).

⁴³ Michael J. Graetz and Ian Shapiro, DEATH BY A THOUSAND CUTS: THE FIGHT OVER TAXING INHERITED WEALTH 7 (2005).

⁴⁴ For the origin of this argument, see 2 J. S. Mill, PRINCIPLES OF POLITICAL ECONOMY 403-11 (5th ed. New York 1868) (1st ed. Boston 1848).

every January 1 and an additional 10 percent on January 2) into a single, but still 40 percent overall tax, would not significantly change B's overall treatment.

Accordingly, attention is better focused on overall tax neutrality, or more generally the relative tax burdens on the activities that are being compared, than on whether something or other formally faces "double taxation." Thus, the better (if less politically salient) argument for corporate integration is that it addresses disfavoring corporate equity and dividend payouts. The better-framed argument against the estate tax is that it treats bequested wealth less favorably than that spent by the earner, whether or not the tax is formally duplicative of prior income taxation. The case against the income tax is that it disfavors future consumption relative to current consumption – again, whether or not the very same thing is being taxed twice.

In the international realm, obviously double taxation is a potential problem, in that it causes cross-border investment to face a higher overall tax rate than purely domestic investment. Whether or not this is unfair – suppose, for example, that people invested knowing the double tax was in place, but expecting as good an after-tax return as that available from purely domestic investment – it clearly raises efficiency issues, whether from a global welfare perspective or purely that of national self-interest.⁴⁵ The issue, however, is one of relative tax rates, not of how many times a tax is levied. Thus, the important thing, if one disfavors the higher tax rate for cross-border investment, is to reduce it appropriately, whether or not this involves lowering the deemed number of taxes levied from two to one.

⁴⁵ On global versus national efficiency, see Daniel Shaviro, *FIXING THE U.S. INTERNATIONAL TAX RULES*, supra, chapters 3 and 4. I also discuss these issues in section III.B., infra.

To make this more concrete, suppose the U.S. has a worldwide system and generally taxes corporate income at 35 percent, while China has a 20 percent rate for income earned in China. Unmitigated double taxation of U.S. companies' Chinese earnings would result in the application of a 48 percent combined rate.⁴⁶ Suppose one believes this is too high, given the lower one-country rates, and that the U.S. should act unilaterally to mitigate the problem. Offering foreign tax credits is only one possibility. A second, non-mutually exclusive approach is to offer other special tax benefits of some kind for outbound investment, such as deferral under current U.S. law. This, however, may distort other behavioral margins and encourage socially wasteful tax planning to maximize the advantage taken of these benefits.

A third alternative is simply to lower the U.S. tax rate that applies to foreign source income. Exemption, which results from making the outbound rate zero percent, is an example of this approach, but is merely one point along a continuum. Leaving aside administrative issues, a deductibility system with, say, a 1 percent rate, appears quite similar to exemption. It also may place a lower overall U.S. tax burden on outbound investment than does a foreign tax credit system. Accordingly, little about its merits (or demerits) is illuminated by observing that, unlike both a foreign tax credit system and exemption, it involves formal "double taxation."

Whatever the overall domestic tax burden on outbound investment that results from a particular foreign tax credit system (given, for example, domestic versus foreign tax rate relationships and the structure of any foreign tax credit limits), one should always be able to replicate this burden under a deductibility system with a suitably adjusted

⁴⁶ This assumes U.S. deductibility of the Chinese tax, so that U.S. taxpayers retain 80 percent of their pre-tax Chinese earnings after paying the Chinese source-based tax, and 65 percent of that amount (52 percent of the pre-tax whole) after paying the U.S. residence-based tax.

domestic tax rate for foreign source income.⁴⁷ For convenience, I will call this the “burden-neutral” deductibility rate for the particular foreign tax credit system to which it is being compared.

Obviously, the underlying equivalence in U.S. tax burdens on outbound investment is only in the aggregate. As between two burden-neutral alternatives, the deductibility system will impose a higher U.S. tax burden on U.S. investment in high-tax countries, and a lower one on such investment in low-tax countries, reflecting that (unlike creditability) it does not adjust U.S. tax burdens in such a way as to eliminate the incentive to engage in foreign tax minimization. Arguably, this difference is best evaluated on its own terms, without resort to confusing and formalistic labels such as “double taxation.”

Accordingly, if one’s concern, in the earlier U.S.-China hypothetical, was that a 48 percent combined tax rate on cross-border investment seemed excessive in relation to the much lower rates that would apply to purely domestic investment, then double taxation as such offers the wrong focus.⁴⁸ Thus, the relevant choices in addressing the problem are not limited to foreign tax creditability and exemption. Opposing exemption, on the ground that there should be a positive domestic tax burden on outbound investment, falls short of establishing that one should support creditability.

There is, however, a separate line of argument for creditability, resting on efficiency grounds rather than intuitive moral aversion to double taxation as such.

⁴⁷ Absent foreign tax credit limits, the burden-neutral tax rate for foreign source income might, under particular circumstances, be zero or even negative.

⁴⁸ Objections to double taxation on independent moral grounds are potentially harder to allay than those based on efficiency, given that they may assume their own conclusion that it is wrong (thus making refutation impossible). One can, however, question the persuasiveness of allowing formal system characteristics (e.g., is the very same thing being taxed each time, and does one face two distinct taxes or merely bifurcated collection) to drive moral conclusions.

Indeed, this argument was dominant in the international tax policy literature for many decades, though recently challenged,⁴⁹ and it still has numerous adherents. Under it, foreign tax credits (if unlimited), by reason of their eliminating foreign taxes' impact on one's after-tax bottom line, have a virtue, in efficiency terms, that no deductibility system can share. They cause the taxpayer to face the same worldwide net tax rate (i.e., the domestic rate) no matter where it invests, thereby eliminating tax rate differentials as an input to investment choice. I address this efficiency argument for foreign tax credits next.

B. Foreign Tax Credits as a Tool for Advancing Worldwide Efficiency

From the 1960s until recently, just as NN offered the predominant benchmark among international tax policy experts for unilateral national welfare analysis, so the standard of capital export neutrality (CEN) held the high ground in thinking about global welfare, or that in which foreign individuals' welfare counts equally to that of domestic individuals (rather than being disregarded). This equivalent standing reflected that the two standards are effectively identical, except in how they treat foreign taxes. Again, under NN, only domestic taxes are socially a transfer, since the benefit to foreign individuals from their governments' acquiring tax revenues is disregarded. Under CEN, *all* taxes are viewed as transfers rather than costs, and the question of which government collects them is treated as irrelevant.⁵⁰

CEN thus dictates presenting domestic taxpayers with the same tax rate no matter where they invest, so that tax rate differences will not influence (i.e., distort) their investment choices. This is exactly what NN does, except that CEN equates foreign taxes

⁴⁹ See Shaviro, DECODING, *supra*.

⁵⁰ Note Avi-Yonah on why it might matter to global welfare which government gets the revenue – for reasons not part of the CEN model.

with domestic taxes, rather than with other costs of producing income. Thus, it focuses on the net worldwide tax rate, rather than the domestic tax rate.

CEN's worldwide tax neutrality requirement would be satisfied without any need for foreign tax credits if all countries either (1) only levied residence-based taxes that treated foreign and domestic investment the same, or (2) only levied source-based taxes, all of which fortuitously had the same rate. With varying-rate source based taxes being levied around the world, full worldwide taxation plus unlimited foreign tax credits is the only practical device at hand for achieving CEN with respect to one's residents.

For the first four decades after Peggy Richman Musgrave first wrote about CEN in 1963, its only serious rival in the international tax policy literature was capital import neutrality (CIN). Under CIN, all of the parties around the world that might invest in a given location should face the same tax rate, and differences in locations' tax rates are immaterial. CIN is most easily satisfied by exclusively source-based taxation. Thus, it effectively calls for exemption of foreign source income, in contrast to CEN's prescription of worldwide taxation with unlimited foreign tax credits. However, a widespread expert consensus long held that CEN was the more compelling principle, from the standpoint of designing international tax rules to advance global economic welfare.⁵¹ And this in turn, given the peculiar decades-long consensus that one can reasonably discuss international tax policymaking at the national level purely in global

⁵¹ This is a complicated story that I've reviewed in detail elsewhere. See FIXING. In brief, CIN to some extent a "neutrality property in search of a rationale" (Devereux 2008, 13). The favored popular rationale was competitiveness, but note problems with this. The preferred academic rationale pertained to who would save, from Horst. But saving levels often viewed as less tax-responsive than investment location, plus can't unilaterally implement CIN in the face of WW residence-based taxes unless willing to credit them, which appears highly unrealistic.

efficiency terms,⁵² supported a general consensus among experts in favor of offering foreign tax credits, within the setting of a worldwide residence-based system.⁵³

While CEN’s longstanding intellectual acceptance rivaled that of NN – with the difference that CEN was actually considered an appropriate national policy guide – it has recently lost ground for essentially the same reasons. Recall that NN founded empirically on the increasing consensus that outbound investment by resident companies probably does not reduce net domestic investment, reflecting two accepted facts that traditional international tax policy analysis had underappreciated. The first is that a country’s tax rules only determine the overall relative incentives of its own residents, who are interacting in world capital markets with other investors, while the second is that the main actors in cross-border investment are corporations, which are taxed at the entity level.

Suppose that a country’s decision to follow CEN, by taxing residents’ worldwide income with unlimited foreign tax credits, has no effect on net domestic or foreign investment.⁵⁴ Resident multinationals, for example, end up owning less assets in low-tax countries than they would have if they could benefit from the low taxes, but no asset’s location (as distinct from who owns it) changes, relative to the counterfactual in which the country exempted foreign source income. This scenario, in addition to refuting NN, would rebut any claim that the country’s pursuit of CEN has increased global economic efficiency.

⁵² See FIXING, chapter 3, for further discussion of the reasons for this peculiar consensus.

⁵³ Note some acceptance of credit limits as reasonable even though they violate CEN. But the revenue concerns underlying this acceptance were not generalized as relevant to the merits of allowing credits at all.

⁵⁴ Note that, while NN focuses only on domestic investment, no change to one implies no change to the other either if the WW total is the same (a reasonable operating assumption for these purposes).

To make this clear, recall that CEN aims to direct taxpayers' incentives towards pre-tax rather than after-tax profitability, on the view that all countries' taxes are merely transfers from a social standpoint, and with the aim of increasing global economic productivity. In this regard, CEN is effectively a subset of worldwide locational neutrality,⁵⁵ which would exist if *all* investors' locational choices did not affect their net worldwide tax liabilities with respect to a given amount of income. The mechanism by which CEN, in common with broader worldwide locational neutrality, could increase global economic productivity (relative to the world of varying-rate source-based taxes) is by inducing a shift of net investment from low-tax countries to high-tax countries where the pretax profit is higher. If this does not happen when a given country pursues CEN, because the policy only reaches a subset of global investors and thus simply induces ownership shifts, then the global efficiency payoff has failed to materialize.

The implications for CEN of entity-based corporate taxation are no less damaging than those of its reaching only a subset of investors when one country pursues it. Again, corporate residence may verge on being elective, not just for new entities, but even for new equity-financed investment by existing entities. If one wants to pursue a profitable investment opportunity in a low-tax country, the only reason to do it through a multinational that resides in a country practicing worldwide taxation would be to take advantage of that company's unique assets, such as expertise or intellectual property that cannot easily be transferred. This may be important as a transition problem,⁵⁶ but it has no bearing on how to think about optimal tax design going forward. Put bluntly, even without swaps between investors from different countries, one cannot improve worldwide

⁵⁵ On locational neutrality, see Daniel Shaviro, An Economic and Political Look at Federalism in Taxation, 90 Mich. L. Rev. 895 (1992).

⁵⁶ See FIXING, *supra*.

locational neutrality through national-level taxes that, by reason of their reliance on corporate residence, increasingly verge on being elective.

The decline of CEN as a guide to national tax policy – even if one accepts its focus on global rather than national welfare – weakens the case both for imposing worldwide residence-based taxation and for allowing foreign tax credits. Shifting to an exemption system would address both margins, but the case for each change can be made independently of the other. Thus, suppose one favors retaining some U.S. taxation of outbound investment by U.S. multinationals, perhaps to impede their mischaracterizing income as foreign source.⁵⁷ Without the CEN benchmark, this aim does not imply imposing the desired burden via higher tax rates on foreign source income and creditability, rather than via a burden-equivalent shift to lower rates and deductibility.

In sum, the affirmative case for creditability based on CEN, no less than that based on aversion to double taxation, proves unpersuasive when examined closely. Thus, the case against foreign tax credits, founded on the bad incentives (for resident taxpayers and other countries) that they create as viewed from a national welfare standpoint, remains unrebutted. This still leaves the question, however, of whether, in practice, a burden-neutral shift from creditability to deductibility would have any significant disadvantages, potentially offsetting its advantages at this margin. I turn to this question next.

IV. FOREIGN TAX CREDITS VERSUS A BURDEN-NEUTRAL SHIFT TO DEDUCTIBILITY

⁵⁷ Note that Avi-Yonah and Grubert-Altshuler have suggested this. I'm skeptical because corporate residence may be elective in the long run, and hence view this as part of the transition problem.

While a burden-neutral shift to foreign tax deductibility would improve incentives at the overseas tax planning margin without worsening them at the outbound investment margin, it would not be devoid of disadvantages. This section therefore explores the main problems, and then considers the burden-neutral argument's implications for current law if one assumes that the full shift will not be made.

A. Possible Problems With Shifting from Creditability to Deductibility

Shifting from foreign tax creditability to deductibility, with a tax rate cut for foreign source income to ensure that the change is burden-neutral overall, would have three main disadvantages. It would increase the frequency with which source determinations are necessary under current U.S. law, violate existing tax treaties, and raise possible political economy concerns about the long-term stability of the burden-neutral shift.

1. More Frequent Need for Source Determinations

Under a burden-neutral shift to foreign tax deductibility, U.S. taxpayers would need to ascertain, for each dollar of gross income, whether it was U.S. source or foreign source, as this would determine the applicable rate. Likewise, the question of whether deductions reduced U.S. source or foreign source income – recently a topic of much controversy⁵⁸ – would always have U.S. income tax consequences. Under present law, by contrast, source determinations by U.S. taxpayers matter for only one purpose: determining whether they are subject to foreign tax credit limits, which depend on the amount of relevant foreign source income. Accordingly, for U.S. taxpayers that are not potentially excess-credit, source issues under U.S. law are immaterial.

⁵⁸ See Graetz and Hines articles, 2009 Obama Administration proposal (e.g., Tax Notes discussion of it).

Unfortunately, the source of income is not a well-defined economic idea.⁵⁹ Thus, a system that relies on it offers multinational firms the opportunity to minimize their tax liability in high-tax jurisdictions, in ways not available to purely domestic firms, by finding ways to shift the reported source of income.⁶⁰ For example, they may use transfer pricing to shift group income to low-tax affiliates, and arrange borrowing and internal financing patterns so as to take advantage of rate differences. These activities may both directly use real resources, such as the fees paid to lawyers and accountants to arrange complex tax-motivated transactions, and induce what would otherwise be suboptimal patterns of real investment and internal financing.⁶¹

Some argue that the difficulties with source suggest continuing to impose worldwide taxation on U.S. resident corporations.⁶² One problem with this view is the difficulty, transition aside, of assigning positive tax burdens (in the form of an otherwise avoidable worldwide tax) to something as prospectively avoidable as U.S. corporate residence. But even proponents evidently accept that the U.S. tax burden on foreign source income should be much lighter than that on domestic income. Only, they rely on foreign tax credits rather than on using explicit source determinations (other than for purposes of foreign tax credit limits) to achieve this differentiation.

There may be no better testament to foreign tax credits' unmerited canonical status in tax policy thinking than the fact that they are not more widely recognized as simply one way of reducing the domestic tax burden on foreign source income in a

⁵⁹ See Ault-Bradford, FIXING.

⁶⁰ Multinational firms may also end up being disfavored relative to purely domestic firms, if countries' inconsistent source rules cause the same dollar of net income to be taxed more than once without foreign tax credit offsets.

⁶¹ See Harry Grubert and Rosanne Altshuler, Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income, in John W. Diamond and George R. Zodrow, eds., FUNDAMENTAL TAX REFORM: ISSUES, CHOICES, AND CONSEQUENCES (2008), at 339.

⁶² See Grubert and Altshuler, *supra*; Avi-Yonah.

worldwide system. Thus, consider a recent article by Harry Grubert and Rosanne Altshuler,⁶³ proposing burden-neutral repeal of deferral, with the offsetting rate cut (to 28 percent) being extended to U.S. as well as foreign source corporate income, thus avoiding the need for source determinations.⁶⁴ Grubert and Altshuler argue that this proposal “seems to dominate dividend exemption because it eliminates many more distortions in addition to repatriation behavior [which both address]. These include transfer price planning, the shifting of the location of debt, and the need to make expense allocations.”⁶⁵

All of these distortions pertain to determining source. However, in claiming that burden-neutral elimination of deferral “dominates” exemption by making them unnecessary, Grubert and Altshuler appear to have forgotten that only exemption, of the two alternatives they are comparing, eliminates foreign tax credits, along with the need for rules limiting them. This, in turn, matters, not just due to wasteful tax planning aimed at maximizing foreign tax credits, but because paying foreign taxes is a cost like another (say, rent or wages) from the unilateral national welfare standpoint. Grubert and Altshuler thereby miss the point that the choice between dividend exemption and burden-neutral repeal of deferral involves a tradeoff between source-related and foreign tax credit-related distortions, rather than one between more and fewer distortions.⁶⁶

If allowing foreign tax credits were clearly superior, as a device for lowering the U.S. tax burden on outbound investment, to directly lowering the U.S. tax rate on foreign

⁶³ Grubert and Altshuler, *supra*.

⁶⁴ Lowering the domestic rate, simply to make the repeal of deferral burden-neutral while also avoiding the need for source determinations, would be highly suspect, in that it makes the domestic rate hostage to entirely unrelated considerations, if there were not separate reasons, relating to international tax competition, for lowering the domestic rate.

⁶⁵ Grubert and Altshuler, *supra*, at 321.

⁶⁶ The claim that burden-neutral repeal of deferral dominates dividend exemption also overlooks the point that the two may differ in the tax burden they place on outbound investment by U.S. resident companies.

source income, the obvious implication would be that all foreign tax credit limits should be repealed. Once one has conceded the need for credit limits – reflecting the marginal incentive problems that a 100 percent MRR creates throughout its range of potential application, not just once the pre-credit U.S. tax on foreign source income has been fully offset – it is hard to see the basis for assuming that credits are superior to relying on source determinations up to that point.

In considering the tradeoffs presented, it is certainly conceivable that an MRR for foreign taxes in excess of the U.S. marginal tax rate on foreign source income might increase national welfare – despite distorting choices between foreign taxes and other expenses or foregone income – if it permitted reducing the distortions associated with determining source. Even if this is so, however, a 100 percent MRR seems unlikely to be part of the optimal package, given how it entirely jettisons cost-consciousness by U.S. taxpayers. One presumably would not, for example, expect providing a 100 percent U.S. MRR for wages paid to foreign workers to be part of an optimal package from the U.S. standpoint, even if it reduced the need for source determinations. Yet the two are no different from a purely unilateral U.S. perspective.

2. Treaty Issues

If the U.S. repealed the foreign tax credit in a burden-neutral shift to a low-rate deductibility system, it would find itself in violation of dozens of tax treaties. Thus, consider the existing U.S. Model Income Tax Convention.⁶⁷ Tellingly enough, it is entitled a “Convention … for the Avoidance of Double Taxation” (as well as for the prevention of fiscal evasion), reflecting the importance of the double taxation concept to

⁶⁷ United States Model Income Tax Convention of November 15, 2006: Convention Between the Government of the United States of America and the Government of ----- for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income.

how people commonly think about coordination between tax systems. To this end, it expressly commits the United States to relieving double taxation, in the event that the U.S. taxes foreign source income of the treaty partner, by providing foreign tax credits.⁶⁸ It thus envisions exemption (which avoids double taxation altogether) and a foreign tax credit system as being the only permissible choices, and does not countenance shifting from the latter to a burden-neutral, low-rate deductibility system.

In principle, one can always renegotiate treaties. In this case, however, the dauntingness of likely needing to address so many would only be made worse by the continuing intuitive appeal of the anti-double taxation concept. What is more, countries could not entirely be blamed for resisting treaty modifications to permit mere foreign tax deductibility in combination with a sufficiently low rate. One could at least argue that this would disadvantage them in two ways.

First, even in the case of a burden-neutral shift, other countries benefit from having the U.S. credit their taxes, as this means U.S. taxpayers will ignore these taxes in making locational decisions. To be sure, the U.S. could cease to provide credits, consistently with the treaties, by adopting exemption. This might be more beneficial still to low-tax countries, which would find it easier to attract U.S. investment upon elimination of the threat of paying a residual U.S. tax. However, high-tax countries might prefer creditability – especially if they anticipate that U.S. multinationals will find ways to avoid U.S. credit limits – and thus might resist giving the U.S. a more flexible set of options for doing away with it.

Second, suppose a country is concerned about “cheating” by treaty partners, in the form of not sufficiently receding from worldwide taxation of their residents where it

⁶⁸ United States Model Income Tax Convention, Article 23.

overlaps with one’s own source-based taxation. In this scenario, requiring the counterparty to grant either credits or exemption may facilitate monitoring its degree of compliance.⁶⁹ On the other hand, foreign tax credit-granting countries can “cheat” on their commitment, without being easily observed, by defining foreign source income extremely narrowly, so that credits will often effectively be denied. What is more, it is unclear to what extent countries actually need tax treaties to mitigate the burden of overlapping taxation – as distinct from using the treaties to address evasion and coordinate the rules they apply in cases of overlap. The fact that the use of foreign tax credits or exemption for outbound investment by one’s residents is so universal suggests that the temptation thus to “cheat” may not be so great after all.

Even if countries ought not to object, sheer inertia means that a burden-neutral shift to deductibility would likely involve breaching numerous existing treaties. This might set back multilateral cooperation and the U.S.’s reputation as a treaty partner, even absent any actual harm to other countries. This admittedly weighs against adopting the burden-neutral proposal. A further implication is strengthening the case for exemption, if due to treaty problems one cannot otherwise do away with granting foreign tax credits.

3. Political Economy Issues

Suppose that policymakers who wanted to seek enactment of a burden-neutral shift to deductibility were to approach U.S. multinationals, seeking their support or at least non-opposition to the proposal. If the proposal was burden-neutral overall, it presumably would have both winners and losers. Companies that primarily invest in low-tax countries would tend to win, while those in high-tax countries would tend to lose. This alone might make support difficult to obtain, as losers from a proposed change often

⁶⁹ See Shaviro, Why Worldwide Taxation, *supra*.

are more vociferous than the prospective winners. There might also, however, be a strong political economy reason for companies to object to the change even if they anticipated breaking even from it.

Given the clear political salience of using foreign tax credits to address double taxation, companies might well wonder about the relative stability of their taxes under the (initially) burden-neutral replacement. Thus, even if they had no objection to step one, in which foreign tax credits were replaced by deductibility plus a tax rate for outbound investment of (say) 5 percent, they might well wonder whether a likely step two, even if unintended by the current policymakers, might be to raise this rate. After all, a tax rate for outbound investment in the neighborhood of 5 percent might look anomalously and unreasonably low, at least to ill-informed observers who would have accepted the burden-neutral equivalent via foreign tax credits, but who, once the credits were out of sight, kept them also out of mind.

Once again, the implication is that doing away with foreign tax credits might in practice require shifting to an exemption system. This would strengthen the case for exemption even though, in principle, the foreign tax MRR and the overall burden on outbound investment involve distinct margins.

B. Implications for Present Law If One Rules Out Foreign Tax Deductibility

If a burden-neutral shift to foreign tax deductibility is unfeasible, the extra support this lends to the case for replacing worldwide taxation with exemption is only one of the implications. In addition, the problems with creditability have implications for how one thinks about present law, even if one assumes that it can only change relatively marginally. In particular, it suggests two things. The first concerns anti-foreign tax

credit rules, such as those that impede cross-crediting or reduce the measure of foreign source income that is used to apply credit limitations. Given that allowing foreign tax credits is generally a bad policy at the overseas tax planning margin, such proposals are likely to be preferable to alternative means of creating the same increase in the U.S. tax burden on outbound investment, and burden-neutral versions may be affirmatively desirable.

The second implication concerns U.S. tax rules that affirmatively discourage overseas tax planning. Subpart F, for example, imposes deemed dividend treatment, ending deferral, in various circumstances where taxpayers appear to be shifting foreign income from high-tax to low-tax countries. An example includes the foreign base company rules,⁷⁰ creating subpart F income when a corporate group, by establishing a conduit entity in a country where it otherwise does little, appears to be diverting foreign source sales or service income to a tax haven. Or consider subpart F's inclusion of interest income on intra-group debt, on the same terms as that earned on third-party portfolio assets, thus discouraging the use of such internal debt to shift overseas income out of high-tax countries. In such cases, subpart F, by reducing or even eliminating the net benefit from overseas tax planning, "defends" the revenue interest of such countries – oddly, more assiduously than these countries choose to defend it themselves⁷¹ – at the expense of U.S. companies' pre-U.S. tax bottom line. This is bad unilateral policy, even if done on a burden-neutral basis, given the desirability of encouraging U.S. taxpayers to be cost-conscious with respect to foreign taxes.

⁷⁰ See Code section 954(d).

⁷¹ Note that this lack of "self-defense" may be a deliberate device for attracting investment by relatively mobile multinationals, thus implicitly constituting a kind of ring-fencing that thus far has escaped (?) denunciation by the OECD.

The implications for how one should think about deferral are more complicated. Deferral creates its own set of economic distortions, thus motivating the Grubert-Altshuler proposal that it be eliminated on a burden-neutral basis. (This proposal can, of course, be combined with burden-neutral elimination of the foreign tax credit, so long as one abandons its aim of keeping the domestic and foreign source rates the same.) However, while deferral and the foreign tax credit both add unnecessary distortion when considered separately on a burden-neutral basis, each has some tendency to reduce the distortions caused by the other. On the one hand, the prospect of delaying, or perhaps even permanently avoiding, repatriation makes taxpayers more cost-conscious with respect to foreign taxes, which will not be credited if the income remains abroad. On the other hand, taxpayers can repatriate foreign earnings tax-free if their ability to “blend” high-tax and low-tax income enables them to eliminate the residual U.S. tax. Despite this partial offset between the two sets of distortions, it is plausible that both ought to be mitigated as much as possible, whether one prefers higher or lower overall U.S. taxation of foreign source income.

Beyond these general points, understanding the problems with foreign tax creditability may aid one in evaluating international tax policy reform proposals, which may differ in desirability even when they would similarly affect the overall U.S. tax burden on outbound investment. Thus, consider the proposals that the Obama Administration introduced early in 2009 regarding the tax treatment of American multinationals that own controlled foreign corporations (CFCs). In general, these proposals would increase U.S. taxation of the companies’ foreign source income. If one believes (as I do) that corporate residence-based worldwide taxation is becoming

increasingly unfeasible and unwise, one may regard this as movement in the wrong direction. However, one can also distinguish between the proposals on how they would affect taxpayer incentives other than those pertaining to the level of outbound investment by U.S. companies.

In particular, consider the following three proposals, all of which directly implicate overseas tax planning by U.S. companies:

1) Prevent claiming of “supercharged” foreign tax credits – In most circumstances, U.S. taxpayers claiming foreign tax credits must also simultaneously include the associated income that generated the foreign tax liability. This reduces the net benefit from claiming the credits to merely the excess of the foreign tax over the U.S. tax on that income.⁷² Given that U.S. corporate statutory tax rates generally are higher than those in most other countries, often there may be no net benefit at all.

In recent years, however, U.S. taxpayers have developed a new planning technique, permitting them to claim foreign tax credits without the associated income. The resulting “supercharged” or “hypercharged” credits (as they are known) can thus be used in full to reduce U.S. tax liability on other foreign source income.

As background for how the technique works, in 1996, the U.S. Treasury Department issued what are known as the “check-the-box” regulations,⁷³ under which U.S. taxpayers can elect whether or not certain legal entities in which they own equity will be treated as separate corporations for U.S. tax purposes. The check-the-box rule replaced prior law’s cumbersome “corporate resemblance” test, thereby providing

⁷² Thus, suppose a CFC, owned by a U.S. taxpayer, earns \$100 abroad, on which it pays \$40 of tax. Upon repatriating the after-foreign tax profit of \$60, the U.S. taxpayer is treated as having \$100 included of foreign source income, on which \$35 of U.S. tax is due. After offsetting this entire tax with the associated foreign tax credit, only \$5 of credits are left to offset the U.S. tax on other foreign source income.

⁷³ U.S. Treasury Regulations sections 301.7701-1 through 301.7701-3.

simplification and greater certainty. The rule turned out, however, to have unanticipated tax planning applications for U.S. multinationals, for whom they facilitated the creation abroad of “hybrid entities,” or those that U.S. tax law regards as merely undifferentiated branches of their sole owners (and thus, in tax lingo, as invisible or transparent), but that under foreign tax law are separate entities.

To generate supercharged foreign tax credits, one establishes a wholly owned transparent entity in a foreign country, and makes it the parent of any CFCs in the country that actually generate income and consequent tax liability. The foreign government agrees, however, that all of the local group’s tax liability formally belongs to, and is paid by, the invisible (to the U.S. tax system’s eyes) top-tier entity. Accordingly, for U.S. tax purposes, the U.S. parent has paid these foreign taxes itself directly, via a mere branch, and can claim immediate foreign tax credits even though the associated income, which was earned by the CFCs, continues to benefit from deferral.⁷⁴

The Obama Administration proposal would bar U.S. taxpayers from claiming foreign tax credits with respect to income that has not yet been recognized for U.S. tax purposes. Obviously, one effect would be to increase the U.S. tax burden on foreign source income in cases where alternative tax planning techniques are unavailable. A second would be to discourage repatriation of foreign source income that is benefiting from deferral, where the technique could have been used to make the repatriation tax-free. Both of these effects may be considered undesirable. However, a third and clearly desirable effect is increasing U.S. taxpayers’ cost consciousness with regard to foreign

⁷⁴ The IRS unsuccessfully challenged the claimed tax treatment of such a transaction in *Guardian Industries Corp. v. U.S.*, 477 F.3d 1368 (C.A.F.C. 2007).

tax liabilities, which under the proposal would no longer be as generously and swiftly reimbursed by the U.S. Treasury.

2) Require foreign tax credit pooling – A second Administration proposal would cause the foreign tax credits made available by repatriating CFC income to depend, not on the foreign taxes paid with respect to the particular income that was repatriated, but on the overall ratio of foreign taxes to earnings and profits (E & P) for all of the taxpayer's CFCs. In other words, high-tax income and low-tax income would be pooled in order to determine the allowable credit, even if only the former was repatriated.

In illustration, suppose Acme Corporation, a U.S. multinational, has two CFCs, each with \$10 million of E & P, plus its own foreign source income that would otherwise bear a residual U.S. tax. However, CFC-A operates in a country with a 50 percent rate⁷⁵ and thus has paid \$5 million of foreign taxes, while CFC-B operates in a country with a 20 percent rate, and thus has paid only \$2 million. On average, the two CFCs pay exactly the U.S. rate (i.e., \$7 million of tax on \$20 million of E & P, or 35 percent).

Under current law, if Acme repatriated \$1 million in cash from CFC-A, this would trigger a foreign tax credit of \$1 million on a deemed repatriation of \$2 million.⁷⁶ Given the 35 percent U.S. rate, this would leave Acme with \$300,000 in extra credits that it could use to offset the U.S. tax otherwise due on its other foreign source income.⁷⁷ Acme thus would be generating extra credits, through careful orchestration of which income it repatriated, even though on average its CFCs were not paying tax at more than

⁷⁵ While the 50 percent rate may be unrealistic, I use it for arithmetic simplicity.

⁷⁶ For U.S. tax purposes, the dividend is grossed up by the foreign taxes deemed attributable thereto, which thus increase taxable income in addition to generating a foreign tax credit.

⁷⁷ By contrast, repatriating the same amount of cash from CFC-B would trigger foreign tax credits of only \$250,000 on a deemed repatriation of \$1.25 million, thus actually increasing Acme's U.S. tax liability by \$187,500 (the excess of \$437,500, the amount due on the grossed-up income at a 35 percent rate, over the credits of \$250,000).

the U.S. rate. The Administration proposal would prevent this from happening, by applying the average foreign tax rate for all E & P of Acme's CFCs, no matter which particular dollars were repatriated.

From a tax planning standpoint, the consequences of enacting this proposal would include (a) potentially increasing Acme's tax burden on foreign source income, (b) discouraging it from repatriating such income, and (c) making Acme more reluctant to pay high taxes abroad, given the greater difficulty of using the 100 percent U.S. MRR to maximum advantage. As with the anti-supercharging proposal, this third consequence is clearly desirable from a unilateral U.S. standpoint, even if the first two are not.

3) Address use of transparent entities to avoid subpart F income on intra-group debt – A third Administration proposal relates to further unintended international tax planning consequences of the check-the-box rule. In illustration, suppose that a U.S. company's German CFC establishes a wholly owned Cayman entity, providing cash (in exchange for the entity's stock) that the CFC then borrows back at a market interest rate.⁷⁸ This generates interest deductions that Germany may allow, without significant (or any) offsetting inclusion in the Caymans.

Without the ability to create hybrid entities, the German tax benefit would be offset by required treatment of the Cayman entity's interest income as taxable to the U.S. parent as a deemed dividend under subpart F. Under the check-the-box rules, however, one simply makes the Caymans entity invisible for U.S. tax purposes, and thus a mere branch of the German CFC, with the consequence that the U.S. observes no interest payment and charges no tax. (One cannot receive a taxable interest payment from

⁷⁸ Alternatively, the U.S. parent could give cash to a Caymans entity that was above the German CFC in the ownership chain, and then have the same money on-lent by the entity to the CFC.

oneself). Thus, the German tax benefit from intra-group debt is now newly worth exploiting.

The Administration proposal would eliminate such use of the check-the-box rules to avoid the creation of subpart F income. By so doing, however, it not only potentially increases the tax burden on outbound investment by U.S. companies, but may do so to the revenue benefit of foreign governments, rather than the U.S. Impeding U.S. companies' efforts to save foreign taxes seems likely to be against unilateral U.S. self-interest, and thus to be worse national policy than increasing the companies' worldwide tax burdens via reduced foreign tax creditability.

V. CONCLUSION

Among means of reducing the domestic tax burden on foreign source income that would otherwise result from worldwide taxation of resident taxpayers, foreign tax credits are decidedly problematic. They provide a 100 percent marginal reimbursement rate (MRR) for foreign taxes paid, notwithstanding that the optimal such rate, from a unilateral national welfare standpoint, equals the otherwise applicable marginal tax rate for foreign source income.

Exemption systems, under which foreign source income is not taxed, are implicitly deductibility systems for foreign taxes paid. If foreign tax credits, as a practical matter, are inevitable under a worldwide system that does not grossly overburden outbound investment by combining mere deductibility with application of the full domestic rate to foreign source income, then the problems with creditability create an additional ground for favoring exemption. However, if creditability is not inevitable in this setting, a country, such as the U.S., that imposes worldwide taxation with credits,

could improve its system by switching to deductibility on a burden-neutral basis, such as by greatly reducing the tax rate applicable to foreign source income. Better still, this could be combined with burden-neutral elimination of deferral, like that recently proposed by Harry Grubert and Rosanne Altshuler (albeit without a matching reduction in the domestic tax rate, given the magnitude of the rate cut that would be made necessary by burden-neutral repeal of creditability).

Is the advocacy herein of burden-neutral repeal of foreign tax creditability an actual proposal, or merely a suggestive thought experiment? I am honestly unsure. The big problems that I see relate to U.S. tax treaty obligations and to concern about the political stability of the low rate on foreign source income that would result from a burden-neutral shift to deductibility. In addition, the fact that the shift would eliminate one of the principal defects of the current U.S. international tax regime does not mean that it is preferable to an exemption system, which it merely matches at the overseas tax planning margin. However, it clearly merits further consideration if an exemption system is not adopted. And the defects of foreign tax creditability should be kept firmly in mind when comparing the existing regime to potential alternatives.