

THE CASE AGAINST FOREIGN TAX CREDITS

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ABSTRACT

In international tax policy debate, it is usually assumed that, if one chooses not to exempt residents' foreign source income, the preferred system would offer foreign tax credits. This assumption is mistaken, given the bad incentives created by the credits' marginal reimbursement rate (MRR) of 100 percent and the unpersuasiveness of common rationales for granting them, such as those based on aversion to "double taxation" or support for capital export neutrality. While taxing foreign source income at the full domestic rate with only deductions for foreign taxes would over-tax outbound investment, at least in principal creditability is dominated by a burden-neutral shift to deductions plus a reduced tax rate for such income. And even if such a shift is unfeasible or unwise, the incentive problems resulting from a 100 percent MRR for foreign taxes paid may illuminate various more practical tax issues, such as the merits of (1) shifting to an exemption system, which features implicit deductibility, and (2) various proposed reforms, such as removing disincentives in subpart F for foreign tax planning by U.S. multinationals.

1. INTRODUCTION

The English writer Saki (2008, 2) once observed: "When one's friends and enemies agree on any particular point they are usually wrong."² So it is with U.S. international taxation. Both friends and foes of imposing U.S. tax on domestic companies' foreign source income—the issue raising greatest controversy in the field—generally agree that the fundamental policy choice lies between two rival systems.

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2 I admit to having used this line once previously. See Daniel Shaviro (2007a, 5).

2 The first alternative, so the consensus holds, is a territorial system, in which the United States treats domestic companies' foreign source income as exempt. The second is a worldwide system, in which the United States taxes all of its residents' income, no matter where it arose, but allows foreign tax credits, 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. Some commentators favor a worldwide system with credits (*e.g.*, Fleming, Peroni, & Shay (2001); Office of Tax Policy (2000)), while others, gaining intellectual sway in recent years (Shaviro 2009a, 127), favor exemption (*e.g.*, Desai & Hines (2003, 2004); Hines (2009)). Nearly all, however, seem to agree that this is where the choice lies.³ In so assuming, however, both sides are wrong—at least intellectually, even if, as a practical political matter, the view that this is the basic choice operates as a self-fulfilling prophecy.

3 To see why and in what sense both sides are wrong, consider another ongoing tax policy debate: that between proponents of income and consumption as the domestic tax base. These two systems, while similar in many respects, differ (in their abstract forms) in just one dimension. A pure income tax reaches, while a pure consumption tax exempts, the normal return to saving (Shaviro 2004). Hence, assuming acceptance of income and consumption taxation's shared features, it is indeed accurate to say that the domestic tax base debate involves a single choice at a single margin, which proponents of the two pure systems would resolve differently.

4 The international tax debate, by contrast, involves two distinct choices at two distinct margins. The first is what tax burden the United States should place on "outbound" investment (defined as that made by a U.S. company, wherever its owners actually reside). A worldwide system typically imposes a positive tax burden on outbound investment, the level of which depends on the details of the applicable tax rate and base. By contrast, a properly designed exemption system imposes an outbound tax rate of zero.

5 The second choice concerns the marginal reimbursement rate (MRR) offered by the U.S. system to its taxpayers with respect to foreign taxes paid. An exemption system has an MRR of zero—although, since this matches the positive tax rate on foreign source income, exemption is a

3 An important recent exception is Michael Graetz & Itai Grinberg (2003).

deduction-equivalent or implicit deductibility system, in which the MRR equals the marginal tax rate (MTR) that the taxpayer faces upon adding or subtracting a dollar of foreign source income. (Thus, 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.) By contrast, a worldwide system, if it offers foreign tax credits that are unlimited and become available immediately, has an MRR of 100 percent. Each creditable dollar of additional foreign taxes paid reduces domestic tax liability by exactly a dollar.

All else equal, the choice between foreign tax deductions and credits affects the tax burden on outside investment, since a credit is much more favorable. Nonetheless, the two distinct margins at which the two leading approaches to international taxation differ can in principle be addressed entirely separately. Thus, suppose one wanted a 100 percent MRR for all foreign taxes paid (as under the prototype worldwide system), but no net U.S. tax revenue from outbound investment (as under an exemption system). Revenue estimators with sufficiently good information could presumably determine the tax rate on foreign source income that, when combined with unlimited foreign tax credits, would yield net U.S. tax revenue of zero over the long run. (The point, of course, is not that there is any discernible reason for wanting to do this, but rather that it is technically feasible because the margins are distinct.)

Alternatively, suppose one preferred deductibility to creditability with respect to foreign taxes paid, but wanted to hold constant existing U.S. tax revenues from outbound investment. Now all the revenue estimators would have to do—again a simple exercise in theory, whether or not in practice—is determine the reduced tax rate for foreign source income that, when combined with making foreign taxes merely deductible, would keep net revenue the same. This exercise, moreover, is far easier to motivate than the one described above. It offers a potential improvement over present law if one (a) believes that the optimal MRR for foreign taxes paid equals the MTR for foreign source income, rather than being 100 percent, and yet (b) either is agnostic about the optimal U.S. tax burden on outbound investment, or else regards it as raising issues that are best considered separately.

The idea of making a revenue-neutral change to current U.S. income tax law, in which foreign tax credits are downgraded to mere deductions but the net tax increase from this is precisely offset by a rate cut for foreign source income, may initially seem strange or arbitrary. One could equally say,

however, that current law's use of foreign tax credits to reduce the tax burden that otherwise would result from having a worldwide system is arbitrary.

9 By analogy, consider the other key feature of the U.S. international tax rules that reduces outbound tax burdens relative to those under a pure worldwide system: deferral for the unrepatriated earnings of U.S. companies' foreign subsidiaries. Deferral is widely recognized as having no good rationale for treating foreign subsidiaries differently from foreign branches (whose income is immediately includable, as they are not legally separate from the U.S. companies that operate them). It also has been rightly criticized for creating costly and inefficient tax planning incentives, such as to avoid repatriating one's foreign subsidiaries' earnings other than by circuitous means that permit continued avoidance of U.S. tax. In apparent recognition, however, that deferral's defects are conceptually distinct from the question of whether one ought to raise taxes on U.S. companies' outbound investment, Harry Grubert and Rosanne Altshuler (2008) have proposed a "burden-neutral" repeal of deferral, in which the resulting tax detriment to U.S. multinationals would be offset by reducing the applicable tax rate from 35 percent to 28 percent.⁴

10 Few commentators appear to recognize, however, that foreign tax credits are no less perverse and ill-designed than deferral as a means of reducing outbound tax burdens. As we will see, foreign taxes are not relevantly different, in the appropriate tax policy calculus, from any other expense of doing business abroad. After all, unlike domestic taxes, they are socially a cost, rather than a transfer, if one only counts benefit to people in one's own country. Thus, even if one believes that a pure worldwide system with mere deductibility for foreign taxes would risk overburdening outbound investment, this can be addressed instead through rate reduction or any other pro-taxpayer change to the tax base. Given the relevant equivalence between foreign taxes and other business outlays, it is hard to see why raising the former's MRR—rather than that, say, for foreign wages paid or energy costs—should be viewed with special favor.

11 To be sure, the rationales commonly offered for the foreign tax credit are not limited to its being one means among many of reducing the U.S. tax burden on outbound investment in an otherwise worldwide system. In particular, popular support for the credit reflects its addressing what many

4 The Grubert-Altshuler proposal, unlike the thought experiment I describe above, would involve lowering the U.S. corporate tax rate for domestic as well as foreign source income.

would otherwise consider unfair “double taxation” of the income from cross-border investment. In a welfare economics framework, however, one cannot easily defend this focus on the supposed evils of double taxation, as distinct from the more general issue of not overly discouraging cross-border investment.

Worldwide taxation with unlimited foreign tax credits also has traditionally been defended as serving the worldwide efficiency norm of capital export neutrality (CEN), which seeks to maximize the value of global economic production by inducing taxpayers to invest on a (worldwide) pretax basis. However, the case for treating CEN as an international tax policy guidepost has greatly weakened over the last decade, for reasons I discuss in section 3 of this paper.

The 100 percent MRR that foreign tax credits typically provide in a pure worldwide system is not only above the optimal rate (the domestically imposed MTR for the related income) but is potentially extremely pernicious. So high an MRR eliminates any incentive for resident multinationals to be at all cost-conscious with regard to the foreign taxes they pay. With a 100 percent MRR, not only is there no incentive to prefer investing in low-tax rather than high-tax countries that offer the same pretax returns, or to engage in any overseas tax planning, but one would theoretically have an incentive to assume foreign taxpayers’ liabilities abroad, no matter how great, in exchange for even nominal compensation. Thus, suppose a foreign taxpayer offered me \$1 in exchange for my paying its billion-dollar tax liability to a foreign government. If the United States made this payment creditable to me without limitation, thus giving me my billion dollars back, the deal would be worth accepting. Yet it would leave U.S. individuals, as a group, a billion dollars (minus the dollar I received) poorer.

In actual practice, U.S. taxpayers often do not face a 100 percent MRR, despite the foreign tax credit. In particular, deferral makes U.S. companies foreign-tax-conscious with respect to foreign earnings that remain unrepatriated. Moreover, the foreign tax credit limit, which denies current-year foreign tax credits to the extent that they exceed the U.S. tax liability otherwise due on foreign source income, can reduce the MRR to zero. Even with these countervailing features, however—which do nothing to weaken the case against a 100 percent MRR in principle—the foreign tax credit’s over-generosity, when it applies in full, is potentially so dire that the U.S. income tax law must deploy a warehouse full of tools to combat its “abuse.” These tools may well be worth having on hand given the underlying

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incentive problem, even though they impose their own distortions and wasteful tax planning costs, but they would be unnecessary if the foreign tax credit were not so overgenerous to begin with.

- 15 The rest of this article proceeds as follows. Section 2 expands on the argument for setting the foreign tax MRR at the domestically imposed MTR for the related income, and thus against allowing foreign tax credits. Section 3 explores why credits receive such strong support, in both real-world tax politics and the academic literature, notwithstanding their excessive generosity at the foreign tax planning margin. Section 4 considers the issues that would be raised by a revenue-neutral shift from foreign tax creditability to deductibility, and examines how the paper's analysis should affect our view of present law if one assumes that such a shift will not be made. Section 5 offers a brief conclusion.

2. THE CASE FOR FOREIGN TAX DEDUCTIBILITY, RATHER THAN CREDITABILITY

2.1. A Puzzling Consensus

- 16 Perhaps no feature of modern income tax systems has gained such consistent—and unmerited—approval from commentators as the foreign tax credit. By offering a 100 percent MRR, it treats paying a dollar of tax to a foreign government as equivalent to paying it to the home government. Creditors are not usually so selfless as to say: “You can either pay me, or give the money to someone else who is entirely unrelated to me. So long as you pay someone, I don’t care who it is.” Yet this is what the foreign tax credit effectively does.
- 17 Because the credit is so “extraordinarily generous,” T. S. Adams, its inventor at the U.S. Treasury Department in 1918, was skeptical that Congress would even consider it, and then was shocked when it passed easily (Graetz & O’Hear 1997, 1046). Adams might have been even more surprised had he gotten to witness the provision’s almost unchallenged intellectual and political entrenchment during the more than ninety years since its enactment.
- 18 Consider, for example, the consistent support that creditability receives even from strong proponents of taxing U.S. companies’ foreign source income. From Stanley Surrey (1956, 1958) early on, to the U.S. Treasury in 1962 and thereafter right through to the present, to the writings of leading contemporary proponents of increased worldwide taxation of U.S. firms (Fleming, Peroni, & Shay 2001), one repeatedly sees creditability

being accepted in principle—even if “abuses” are criticized—whereas the other major pro-taxpayer feature in U.S. international tax law, the allowance of deferral for foreign subsidiaries’ unrepatriated overseas earnings, receives constant criticism.

For a close analogy to the view people seem to take of creditability, consider general acceptance of the view that, under an income tax, allowing deductions is a necessary correlate to taxing gross income. Rules addressing abuse may be necessary, such as in cases where the taxpayer bore no true cost or is excluding the associated gross income, but deductibility remains in principle sacrosanct—as indeed it should, given the lack of any good rationale for taxing gross, rather than net, income.

Evidently, there is comparable acceptance of the view that allowing foreign tax credits is a necessary correlate to taxing foreign source income. Yet there should not be, given two fundamental differences between the seemingly analogous claims. First, allowing deductions for business expenses does not make taxpayers entirely indifferent to how much they spend unless the applicable MTR, which determines their MRR, is 100 percent. Second, the case for making residents’ worldwide tax burdens foreign tax-invariant is not nearly so compelling as that for taxing net rather than gross income. To examine this second point, however, one must look more closely at why foreign taxes might matter from a domestic policy standpoint, which in turn depends on one’s underlying normative perspective.

2.2. Global Welfare, Unilateral National Welfare, and Cooperative National Welfare

A standard first step in the international tax policy literature is to ask whether one should focus on national economic welfare or, as is surprisingly common in the literature, global welfare. One’s underlying normative perspective is always 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 favoring tax neutrality is that tax liabilities, while a cost to those bearing them, are socially a transfer, as the Treasury gets the money and can spend it on another domestic resident’s behalf. This analysis does not apply to foreign taxes, however, unless one similarly 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 selfishness from both ourselves and others.

23 If self-interested behavior is acceptable in practice for individuals, then surely it is permissible as well for countries. What is more, in the national setting, efforts to impose policies that reflect global altruism in excess of that favored by voters would raise principal-agent issues. As Michael Graetz (2000, 279) 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 well-being, rather than that of the entire world.

24 In any event, the conventional divide in international tax policy debate between global and national welfare analyses is overstated. Proponents of the global standard typically do not take the next step and urge that the United States 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 United States over the long run. Thus, the U.S. Treasury has argued against "establish[ing] policies that promote national short-term 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" (Office of Tax Policy 2000, 25–26).

25 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.⁵

26 With the question of reciprocity's potential thus in mind, suppose we now consider foreign tax credits, but looking purely at the foreign

5 Thus, for example, Michael Graetz & Itai Grinberg (2003) argue from the unilateral standpoint for mere foreign tax deductibility with respect to portfolio assets, and then assess whether the prospect of retaliation by other countries should change the result.

tax planning margin, without regard to the 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 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.⁶

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 United States 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.⁷ 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 United States has a foreign tax credit system, Germany has an exemption system,⁸ and Bermuda is a tax haven into

6 Based on a model somewhat like this, Mihir Desai and Dhammika Dharmapala (2009) conclude that foreign tax credits for outbound portfolio investment can be nationally optimal.

7 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.

8 For purposes of this example, to make the United States and Germany equal in the overall tax burdens they impose on foreign source income, differing only in the method used, suppose that the United States 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.

which residents of either country can shift foreign taxable income.⁹ Foreign tax credits potentially cost the United States 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 United States might be offset by Germany's eliminating the incentive for German companies to do the same as between the United States 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.

- 31 In principle, the U.S. foreign tax credit rules could be revised to limit the benefit to reciprocally credit-granting countries. 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.¹⁰ A second is that, for purposes of the foreign tax credit limit in reciprocating countries, one would have to determine the specific source country for much or all overseas income, thus multiplying the problems in determining source under current law. Thus, foreign tax credits probably cannot be entirely (or even significantly) reciprocal in practice, and one must consider the unilateral perspective when evaluating their desirability from a national welfare standpoint.

2.3. Evaluating the Optimal MRR for Foreign Taxes from a Unilateral National Welfare Perspective

- 32 From a unilateral national welfare perspective, the question of the optimal MRR for foreign taxes almost settles itself. Again, the reason taxes are classified in the domestic setting as socially a transfer, rather than a cost, is that the payment of a tax merely causes money to change hands, as between

9 The choice of Bermuda for this example may suggest that no real economic cross-border activity shifts out of the United States 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.

10 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 Shaviro (2007b). 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 Shaviro (2009b).

domestic residents. However, if one disregards the benefit to people in other countries from having tax payments made to their governments, foreign tax payments are no longer any different from any other business expenses, as judged from a domestic perspective. Hence, foreign taxes should simply be deductible in computing foreign source income for purposes of a domestic tax on such income.¹¹ This causes the MRR for such taxes to equal the otherwise applicable MTR, and makes U.S. taxpayers indifferent between (a) paying \$1 of foreign taxes, (b) incurring any other \$1 business expense, and (c) forgoing \$1 of gross income.

Absent reciprocity, in the sense of foreign countries raising their MRRs for U.S. taxes in response to our increasing the MRR we apply to their taxes, it is difficult to see what could change this result from a unilateral national welfare standpoint. Suppose, for example, that, as Julie Roin (2001) has posited, the corporate tax is aptly viewed as a benefit tax, reimbursing the home government for the extra cost of providing services by reason of the taxpayer's economic activity in the jurisdiction. In that scenario, the government might actually prefer (all else equal) that its companies invest abroad rather than at home, so as to spare it any costs associated with their domestic activities' use of government-provided domestic infrastructure (588). However, while (as Roin notes) this might affect the optimal domestic tax treatment of outbound investment, it would not undermine the case for deductibility unless foreign taxes paid actually served as a measure of the costs saved domestically,¹² which seems quite unlikely.

My conclusion that, in a unilateral national welfare analysis, the optimal MRR for foreign taxes paid equals the domestically imposed MTR for foreign source income, should not be considered either surprising or novel. It has been known at least since Peggy Richman (1963) set forth the unilateral national welfare standard of national neutrality (NN), according to which,

11 For simplicity, I disregard the possibility that proper income tax accounting would require that particular foreign taxes be capitalized, such as on the ground that they created durable assets or expectations of future income. This might indicate that even unconditional foreign tax deductibility was too generous.

12 Roin (2001, 588) argues that "[t]he problem with allowing taxpayers only a deduction for foreign taxes is that it suggests that the U.S. government is entitled to apply its normal tax rates to the income that remains after the deduction has been taken." My analysis, however, expressly separates the issues of outbound tax rate and MRR. Roin sees the benefit tax view as supporting exemption, which I describe as an implicit deductibility system.

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. 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.

35 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 (Desai & Hines 2003, 2004). Lying behind this empirical issue are two important points that traditional international 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.¹³ Second, the main actors in cross-border investment are corporations, which are taxed at the entity level. Corporate residence, unlike that of individuals, may increasingly verge 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 forgoing its use to invest at home. But well-established corporations can finance all demonstrably meritorious projects by issuing equity. This causes their prospective domestic and foreign projects, which are surely substitutes for each other in some cases (e.g., in deciding where to locate

13 Congestion may exist, for example, as to desirable production sites, qualified workers, and local consumer demand for particular products.

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.¹⁴

While NN's claim about taxing residents' worldwide income has thus been (at a minimum) seriously undermined, it remains uncontroverted with regard to the unilateral national welfare implications of a resident's paying a dollar of foreign taxes. 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. Only a lack of clear thinking about the distinction between the outbound investment and MRR margins has prevented this point from being so widely recognized as to need no elaboration here.

2.4. Problems with a 100 Percent MRR for Foreign Taxes

2.4.1. Actual MRRs for U.S. Taxpayers

In principle, the MRR for foreign taxes, no less than the domestic tax rate for foreign source income, can vary continuously. In a pure foreign tax credit system, however, it is 100 percent. Likewise, in a pure deductibility system, it equals the MTR for the associated foreign source income.

MRRs that are below 100 percent but greater than the associated MTR can arise in either of two ways. First, one can offer them explicitly, such as via partial credits for foreign taxes paid. (A 50 percent credit, for example, would make the MRR 50 percent.) Second, even with a full credit, other rules in a country's international tax system can result in modifying the effective bottom line. Thus, consider the effect of deferral in the U.S. system. It generally provides that foreign tax credits are not allowed until the associated income is repatriated.

Deferral, whenever it may apply to particular foreign source income of a U.S. taxpayer, creates an incentive to be cost-conscious with respect to the foreign taxes paid. After all, even if repatriation (and consequent U.S.

14 See, e.g., Mihir Desai (2009, 68) ("[I]t is hard to find systematic evidence of significant negative effects of the overseas activities of firms on domestic investment or employment....[and] "the emerging consensus is that the average effect is positive, although it may mask some underlying heterogeneity.").

reimbursement via the nominally 100 percent credit) occurs after just one year, the foreign tax payment in effect earns zero interest for the taxpayer during the twelve-month delay. If the U.S. taxpayer expects the income to remain permanently reinvested abroad—a status often claimed for foreign earnings by U.S. companies in their published earnings reports—then effectively, so far as foreign tax cost-consciousness is concerned, the actual system is one of exemption, with an MRR (matching the MTR for permanently deferred income) of zero.

40 The foreign tax credit limit has similar effects on the MRRs that actually apply to U.S. taxpayers in practice. Where the limit results in permanent denial of a given foreign tax credit claim, the taxpayer's MRR is zero—presumably matching its MTR for the associated foreign source income, given that the limit only applies once credits have eliminated the residual U.S. tax. Once again, therefore, the end result is exemption-equivalent. Where disallowed excess credits, having been carried forward by the taxpayer, can be claimed in a future year, the result is nominally full reimbursement that falls short of being such in present value-equivalent terms, due to the lack of any interest adjustment for the lag period between foreign tax payment and effective U.S. government reimbursement.

41 In sum, therefore, while foreign tax credits, where fully operative, create a 100 percent MRR for foreign taxes paid, other features of U.S. international taxation often prevent actual effective MRRs from being so high. Indeed, where either deferral or foreign tax credit disallowance is expected to be permanent, foreign tax creditability does not affect the taxpayer's marginal incentives at all. However, if the allowance of foreign tax credits is merely postponed for a finite period (and not for longer than the delay in subjecting the associated foreign source income to U.S. tax), then the true MRR presumably exceeds the otherwise applicable MTR for that income. Accordingly, while deferral and foreign tax credit limits may make U.S. taxpayers at least somewhat cost-conscious with respect to their foreign tax liabilities, these rules do not eliminate the distortion (from a U.S. standpoint) of inducing them to be unwilling to incur as much as a dollar in order to avoid a dollar of foreign taxes.

42 What is more, even though U.S. taxpayers' actual effective MRRs often are below 100 percent, it is worth asking what happens when the credit applies immediately and in full. This not only happens under present law in some cases, but is evidently appropriate from the standpoint of anyone

who supports foreign tax creditability. Thus, I next examine what can be expected to happen when foreign tax credits are fully applicable.

2.4.2. Lack of Cost-Consciousness When the MRR Is 100 Percent

When U.S. taxpayers actually face a 100 percent MRR, they have no incentive whatsoever to be cost-conscious with respect to foreign tax liabilities. They therefore would be expected to make no effort whatsoever to economize at this margin. Even losing a dollar of pre-tax profits to save a billion dollars of foreign taxes does not pay off in the complete absence of relevant cost-consciousness.

To be sure, even at 100 percent, taxpayers do not affirmatively profit from incurring such liabilities—as they would, say, from cost-plus reimbursement, or that exceeding 100 percent. 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 trivial compensation from foreigners, consider the notorious case of *Compaq v. Commissioner*,¹⁵ in which the taxpayer effectively paid out of pocket for the right to be 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 unable 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).¹⁶ At the prompting of an investment bank’s solicitation letter, it therefore did the

15 113 T.C. 214 (1999), rev’d, 253 F.3d 350 (8th Cir. 2001). I discuss the *Compaq* case at length in Shaviro (2000) and Shaviro & Weisbach (2002).

16 Internal Revenue Code section 1211.

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.¹⁷

47 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. Even deferral would no longer matter in this scenario, as taxpayers would have no reason to postpone repatriations that would generate a negative tax liability.

48 Given how, even with deferral, the foreign tax credit's 100 percent MRR could in principle eliminate all U.S. tax revenues, it is worth asking how these dangers are avoided. As we will see, the price of operating a tax system that is so overgenerous at this margin is the need for a host of limiting rules that impose otherwise needless inefficiency and complexity in other respects. Such rules transmute and reduce, but do not eliminate, the harm done by being so overgenerous in the first instance.

17 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 transaction costs. At a 35 percent rate, this \$1.9 million increase in Compaq's U.S. taxable income presumably cost it about \$665,000.

2.4.3. *Proposed and Actual U.S. Tax Rules Responding to the Incentive Problems Created by a 100 Percent MRR*

The U.S. international tax rules apply a number of different mechanisms to limit the adverse revenue effects of offering a 100 percent MRR for foreign tax payments. Leading examples, in current U.S. law and prominent recent reform proposals, include the following:

Foreign tax credit limits. 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 exemption, although exemption would not condition eliminating U.S. taxation of foreign source income on paying high foreign taxes.

The resulting shift in MRR from 100 percent to 0 percent when the limit is reached, though likely preferable from a national welfare standpoint to keeping the MRR at 100 percent all the way, seems unlikely to be optimal even if one believes, contrary to the analysis in this article, that mere deductibility for foreign taxes would set the MRR too low. While the 100 percent MRR eliminates all cost-consciousness, the 0 percent MRR erroneously treats foreign taxes as if they were irrelevant to net income. Moreover, the sudden jump is unrelated to any accompanying change in the marginal impact on unilateral national self-interest.

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 United States 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.¹⁸

18 A common line of argument holds that "the foreign tax credit limitation preserves U.S. sovereignty to tax U.S. source income" (Shay, Fleming, & Peroni 2002, 148). 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 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.

53 One consequence of imposing foreign tax credit limits is that U.S. firms are divided into those that are “excess credit” and thus have an MRR of zero, and those that are “excess limit” (i.e., have foreign source income that is unsheltered by foreign tax credits), and thus have an MRR of 100 percent. This can distort foreign asset ownership patterns as between U.S. firms, such as by inducing excess-credit firms to invest in low-tax countries while excess-limit firms invest in high-tax countries even if, absent the U.S. tax difference, they would have preferred to swap these assets. As Desai and Hines (2003, 2004) have noted, cross-border business investment is largely driven by productivity differences between firms with respect to specific assets, and efficiency is promoted when tax differences do not cause the “wrong” firm, as determined on a pre-tax basis, to own a particular asset.

54 At the individual firm level, foreign tax credit limits induce cross-crediting, or seeking to use credits from high-tax countries against income from low-tax countries, so that one can avoid being either excess-credit or excess-limit. This distorts underlying investment patterns, as in the case where a given firm would otherwise invest only in one of the two types of country. It also induces costly tax planning with respect to the timing of taxable repatriations from countries in the two groups (Kleinbard 2007).

55 In response to cross-crediting, the U.S. rules respond by adding another layer of complexity. For many decades, they have required, albeit with varying rigor over time, that the foreign tax credit limit apply separately to distinct “baskets” of foreign source income, thus reducing the set of circumstances in which a 100 percent MRR is actually available.¹⁹ 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, even, at one time, applying per-country limitations in which credits for taxes from one country could not be used to offset the U.S. tax on income from another country. Multiple baskets can add significantly to tax planning complexity—for example, in the case of separate per-country limits,

19 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” (Shay, Fleming, & Peroni, 2004, 148). This, however, is subject to the same objection as the sovereignty defense of overall foreign tax credit limits.

by requiring that the taxpayer determine the source by country for each dollar of its overseas income.

Defining creditable taxes. The credit, by treating foreign taxes paid 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 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.”²⁰

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).

Another apparent policy response to the foreign tax credit’s extreme generosity is its being expressly limited to foreign income taxes, or those whose “predominant character ... is that of an income tax in the U.S. sense.”²¹ As a result of this rule, when Bolivia in 1994 considered enacting a business cash flow tax—effectively, a consumption tax that had much in common with a corporate-level income tax except that capital outlays would be expensed, rather than being capitalized and amortized—it had to back off due to concern that the tax would not be creditable in the United States (McLure 1997, 181–182). This feature of the existing U.S.

20 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.*

21 Treas. Reg. §1.901-2(a)(1)(ii).

foreign tax credit rules serves no discernible purpose, and surely could be loosened without inducing rampant tax planning in response, but presumably reflects underlying concern about the extreme generosity of a 100 percent MRR.

59 *Use of economic substance and business purpose requirements.* 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 controversially (see Shaviro & Weisbach 2002) reversed on appeal. Whatever the proper result in that case, however, it was undisputed that the economic substance and business purpose requirements applied. 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).

60 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 current 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.²² 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.

61 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 U.S. government (or anyone else, apart from Compaq's officers and shareholders) to care whether the taxpayer bore any economic risks of ownership with respect to that stock. No one else would be substantially affected by

22 IRC § 901(k).

whether Compaq decided to hold 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.²³ 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 overgenerous 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. By contrast, artificial tax shelter losses might be disallowed in all cases if one could properly identify them.²⁴ 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.

23 As I have argued elsewhere (Shaviro 2000, 223), "[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."

24 Noneconomic losses that Congress intended taxpayers to claim as tax preferences may complicate the analysis.

64 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, since offering a 100 percent MRR is far less well motivated than taxing net rather than gross income.

65 *Use of other “anti-abuse” rules.* Inevitably, the foreign tax credit “abuses” that a 100 percent MRR invites are not limited to situations where economic substance requirements can be counted on to apply. Thus, the U.S. government periodically identifies new transactions that have caught on in tax practice to the extent that it deems a targeted response necessary. One recent example is foreign tax credit arbitrage transactions, in which taxpayers exploit inconsistencies between countries’ rules to permit the claiming of duplicative benefits with respect to foreign tax payments (*see* Sheppard 2008). The U.S. Treasury responded by issuing new proposed regulations that seek to prevent this from happening (*see* Peaslee, Duncan & Berman 2008). Likewise, consider the recent development of a new planning technique permitting U.S. taxpayers to claim foreign tax credits without having to include the associated income, which U.S. law attributes to a foreign taxpayer. The resulting “supercharged” credits (as they were known) could thus be used in full to reduce U.S. tax liability on other foreign source income. In August 2010, Congress enacted new Code section 909 to prevent this from happening prospectively.

66 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 offer a 100 percent MRR. Yet the need for all these bells and whistles helps to demonstrate the problems that result from providing so high an MRR, thereby reinforcing the case against foreign tax creditability.

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

67 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.

3.1. Aversion to “Double Taxation”

Foreign tax credits are politically popular because they address what is “perceived as the manifest injustice of double taxation” (Graetz & O’Hear 1997, 1047). Given foreign countries’ 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 that, absent a move to exemption, the U.S. is thought to face a virtual moral compulsion to grant foreign tax credits, in order to avoid double taxation’s “essential unfairness” (Ibid., 1109).

The asserted unfairness of “double taxation” is a common theme in U.S. tax policy debate. For example, President George W. Bush (2003) emphasized it in arguing for the adoption of corporate integration via dividend exemption. 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” (Graetz & Shapiro 2005, 7). And consumption tax proponents, going all the way back to John Stuart Mill (1868, 403–411), 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.

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 twenty times at one percent each time, 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, that affects incentives and possibly distribution. 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 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 on 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 bequeathed 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.

72 In the international realm, overlapping residence-based and source-based taxation clearly is a potential problem, in that it may cause 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. 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.

73 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.²⁵ Suppose one believes this is too high, given the lower one-country rates, and that the United States 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.

74 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

25 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.

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 domestic tax rate for foreign source income.²⁶ Likewise, if one focuses on revenue raised rather than overall tax burdens, there inevitably is a revenue-neutral deductibility rate for any particular foreign tax credit system.

Obviously, the underlying equivalence in U.S. tax burdens on outbound investment is only in the aggregate. For example, as between two revenue-neutral alternatives, the deductibility system will impose higher U.S. taxes on U.S. investment in high-tax countries, and lower taxes on such investment in low-tax countries, reflecting that (unlike creditability) it does not adjust tax liability 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.”

There is, however, a separate line of argument for creditability, resting on efficiency grounds rather than intuitive moral aversion to double taxation as such. Indeed, this argument was dominant in the international tax policy literature for many decades, though recently challenged, 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 a domestic 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 its investment choices. I address this efficiency argument for foreign tax credits next.

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

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

78 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.

79 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 with domestic taxes, rather than with other costs of producing income. Thus, CEN focuses on the overall worldwide tax rate, rather than the domestic tax rate.

80 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.

81 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. 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 efficiency terms,

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

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 the same reasons.
Recall that NN foundered 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 invest-
ment are corporations, which are taxed at the entity level (Desai & Hines
2003, 2004).

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. 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.

To make this clear, recall that CEN aims to direct taxpayers' incentives
toward pre-tax rather than after-tax profitability, on the view that all coun-
tries' taxes are merely transfers from a social standpoint, and with the aim
of increasing global economic productivity. In this regard, CEN is effec-
tively a subset of worldwide locational neutrality, which would exist if
all investors' locational choices did not affect their net worldwide tax lia-
bilities with respect to a given amount of income (Shaviro 1992). 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.

85 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 creating a 100 percent MRR via 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. 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.

86 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 un rebutted. This raises the question of whether, in practice, a revenue-neutral shift from creditability to deductibility would have any significant disadvantages, potentially offsetting its advantages at this margin. I turn to this question next.

4. FOREIGN TAX CREDITS VERSUS A REVENUE-NEUTRAL SHIFT TO DEDUCTIBILITY

87 While a revenue-neutral shift to foreign tax deductibility would improve incentives at the overseas tax planning margin without significantly changing them, in the aggregate, at the outbound investment margin, it would not be free of disadvantages. This section therefore explores the main problems, and then considers the implications for current law if one assumes that the full shift should not or will not be made.

4.1. Possible Problems with Shifting from Creditability to Deductibility

88 Shifting from foreign tax creditability to deductibility, with a tax rate cut for foreign source income to ensure that the change is revenue-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 revenue-neutral shift.

4.1.1. *More Frequent Need for Source Determinations*

Under a revenue-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 controversy—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.

Unfortunately, the source of income is not a well-defined economic idea (Ault & Bradford 1990). 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.²⁷ 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 (Grubert & Altshuler 2008, 339).

Some argue that the difficulties with source suggest continuing to impose worldwide taxation on U.S. resident corporations. 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.

27 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.

92 This view is conceivably defensible if one posits that the only available choices are present law on the one hand, and a revenue-neutral shift to foreign tax deductibility on the other. One cannot, however, easily defend the proposition that source problems would make granting foreign tax credits a logical policy move if further alternatives are available. After all, as we saw in section 2, foreign tax payments are akin to other overseas business expenses, from a unilateral national welfare standpoint, given that foreign countries' tax collections do not generally redound to the benefit of domestic individuals. Thus, it is unclear why one would optimally reduce the need for source determinations by offering foreign tax credits, rather than by otherwise offering favorable treatment to particular foreign receipts or outlays.

4.1.2. *Treaty Issues*

93 If the United States repealed the foreign tax credit in a revenue-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.²⁸ 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 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 United States taxes foreign source income of the treaty partner, by providing foreign tax credits.²⁹ It thus envisions exemption and a foreign tax credit system as being the only permissible choices, and does not countenance shifting from the latter to a revenue-neutral, low-rate deductibility system.

94 In principle, one can always renegotiate treaties. In this case, however, the dauntingness of 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

28 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.

29 United States Model Income Tax Convention, Article 23.

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 revenue-neutral shift, other countries benefit from having the United States credit their taxes, as this means U.S. taxpayers will ignore these taxes in making locational decisions. To be sure, the United States 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 United States 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 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.³⁰

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

4.1.3. *Political Economy Issues*

Suppose that policymakers who wanted to seek enactment of a revenue-neutral shift to deductibility were to approach U.S. multinationals, seeking their support or at least non-opposition to the proposal. If the proposal

30 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.

was revenue-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 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 seemingly should expect to gain from it.

99 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) revenue-neutral replacement. Thus, even if they had reason to favor 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 revenue-neutral equivalent via foreign tax credits, but who, once the credits were out of sight, kept them also out of mind.

100 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.

4.2. Implications for Present Law If One Rules out Foreign Tax Deductibility

101 If a revenue-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 revenue-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,³¹ 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 intragroup 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 themselves³²—at the expense of U.S. companies' pre-U.S. tax bottom line. This is bad unilateral policy, even if done on a revenue-neutral basis, given the desirability of encouraging U.S. taxpayers to be cost-conscious with respect to foreign taxes.

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 revenue-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 revenue-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

31 See Code section 954(d).

32 This lack of "self-defense" may be a deliberate device for attracting investment by relatively mobile multinationals, without more overtly and explicitly tax-favoring them.

possible, whether one prefers higher or lower overall U.S. taxation of foreign source income.

5. CONCLUSION

104 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 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. In practice, exemption systems, since they are implicit deductibility systems for foreign taxes paid, get this right, whereas worldwide/foreign tax credit systems do not.

105 Might it nonetheless be reasonable, as a matter of unilateral self-interest, for a country to offer foreign tax credits? Assuming a decision not to enact exemption—the assessment of which would require analyzing the outbound investment margin, as distinct from just the foreign tax minimization margin—this depends on the pluses and minuses of realistically available alternatives. No definite conclusions will emerge immediately in a world of politically and administratively constrained choices that only an extreme optimist would view as anywhere close to *second-best*. However, even if one rejects the realism or desirability of converting our existing foreign tax credit system into, say, a revenue-neutral deductibility system, the defects of foreign tax creditability should be kept firmly in mind. These defects may importantly influence both big-picture choices, such as that between the worldwide and exemption systems, and more interstitial reform debates within the context of a continuing worldwide system.

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