

Comments on “The Future of the Foreign Tax Credit”

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Presentation for 64th University of Chicago Tax Conference, November 11, 2011

A badly flawed debate

International tax policy debate is fundamentally flawed, reflecting the intellectual weight of the dead past.

This critique applies across the spectrum, from the most pro-WW to the most pro-territorial commentators who are active today.

With all due respect, it 's time to move past T.S. Adams from 1918 (framing “double taxation” as the core problem) & Peggy Musgrave’s work from 1962 (inventing the “alphabet soup” of CEN, CIN et al).

I’ll illustrate by re-using (with commentary) two of Phil’s slides.

I mean no criticism whatsoever of Phil’s excellent presentation – which correctly applies frameworks that are generally accepted.

But I see my job on this panel as different – to show that prevailing frameworks are wrong &/or irrelevant.

Evaluating Policy Options

Policy	Neutrality/ Economic Efficiency	Simplicity/Administrability	Alleviation of Double Taxation	Revenue
Exemption of foreign income	Would promote capital import neutrality	Simpler than current regime? But increase pressure on transfer pricing, sourcing, and allocation of deduction rules; likely need credit for passive income	Yes, but potential for but double non-taxation depending on system design	Would depend on design of exemption system
Unlimited foreign tax credit	Would promote capital import neutrality	Would appear to be simpler than current regime	Yes	Potential for erosion of the U.S. tax base
Overall limit	Would promote capital export neutrality	Would appear to be simpler than current regime because would not require taxpayers to assign foreign income and deductions to separate categories (but would still require sourcing rules and allocation and apportionment of deductions)	Potentially not entirely	Would likely reduce revenue

The problem: neither “Neutrality/Economic Efficiency” as defined here, nor “Alleviation of Double Taxation,” are normatively relevant.

What's wrong with prevailing frameworks?

Yes, neutrality & economic efficiency matter – but CEN & CIN (not to mention CON) do not.

Their 3 primary flaws: (a) Fetishizing one margin when there are many to consider. What ever happened to tradeoffs?

(b) Inexplicably relying on global rather than national welfare, with absolutely no attempt to demonstrate that countries' strategic interactions will turn this into a Pareto deal.

Not a matter of one's framework – no-one seriously purports to base national policy on global altruism – it's really all about reciprocal / cooperative versus unilateral strategies to promote national welfare.

But what's the point to, say, cooperating via CEN if others are doing so via CIN?

(c) Ignoring this is what I call the “global convention fallacy.” 4

What are the actual efficiency issues in U.S. international taxation?

Very simple: here as elsewhere, the ratio between (a) deadweight loss borne by U.S. individuals and (b) revenue raised.

Note also the distributional goal of backstopping WW taxation of U.S. individuals (and imposing tax burdens, if possible, on foreign ind'ls).

To see the efficiency motivation for taxing FSI, say we could tax ALL the WW income of ALL companies, no matter where resident.

This would address a fundamental incentive problem: source-based U.S. taxes are a cost to the TP but not to us collectively. The U.S. tax would now be unavoidable via location choice.

More on the actual efficiency issues

Of course, we **can't** tax all companies' WW income. Can only do this for the companies that we colorably define as U.S. residents.

Hence, e.g., may discourage U.S. incorporation or the use of U.S. entities, create clientele effects re. who invests in low-tax countries abroad, etc.

The resulting problems of electivity or tax-elasticity may lower significantly the optimal tax rate for FSI relative to that for U.S.-source income – but probably not all the way to zero.

Plus, note the extreme inefficiency of actual U.S. international taxation (extremely high tax planning & compliance costs relative to revenue raised) – definitive of a bad system.

More on the reasons for this shortly.

A word on “double taxation”

If only we could revise the First Amendment to the U.S. Constitution so as to ban all discussions of “double taxation.”

Not just here – but also, e.g., in debating income vs. consumption taxation, corporate taxation, estate or inheritance taxation, etc.

The problem: it’s a purely formalistic exercise – how many separate taxes, are they the same, etcetera.

And who cares? I would rather be taxed twenty times at 1% each than once at 35%.

What **is** of genuine normative interest: heavy vs. light taxation at a given margin, equal vs. unequal taxation at 2 margins.

Plus, foreign taxes are different than domestic ones – we don’t get the money! Need *reciprocity* for treating the 2 as equivalent to make any sense.

Where Should We Be on This Spectrum?

Exemption No
Limitation
on Credit Overall
Limitation Baskets Per
Country
Limitation Per Item
Limitation Deduction

Where should we be?

Is this spectrum in the right order?

This offers a useful left-to-right spectrum re. overall U.S. tax burden imposed on FSI (leaving aside the possibility that unlimited credits could lose revenue).

But there are 2 relevant margins: (a) that shown, which depends on the *rate* & the *base* (affected by deferral & treatment of foreign taxes), (b) the marginal reimbursement rate (MRR) for foreign taxes paid.

Where Should We Be on This Spectrum?

Exemption No Limitation on Credit Overall Limitation Baskets Per Country Limitation Per Item Limitation Deduction

U.S. tax burden on FSI matters for the reasons discussed earlier.

But with multiple inputs, one can get to the same place by multiple means.

See, e.g., Grubert-Altshuler (2008): burden-neutral repeal of deferral, due to lower rate). The same is possibly, at least conceptually, for the FTC.

The MRR also & separately matters because it affects domestic TPs' aversion to paying foreign taxes.

Again, we don't get the money – so foreign taxes are purely a cost from a unilateral domestic standpoint (but with *no* implication re. optimal U.S. tax burden on FSI).

Where Should We Be on This Spectrum?

Exemption No Limitation on Credit Overall Limitation Baskets Per Country Limitation Per Item Limitation Deduction (NN)

The order is wrong if we are considering just the MRR.

FTC: 100% MRR (and hence zero TP cost-consciousness) if FTC is fully allowed & no deferral.

Deferral lowers the PV of the reimbursement provided by FTCs, since not time-adjusted (e.g., say you pay \$1 foreign tax today, & get \$1 FTC in ten years).

Deductibility means that the MRR equals the MTR. (E.g., deducting \$1 of foreign taxes saves you 35 cents if the tax rate is 35%.)

But exemption is an implicit deductibility system – hence the far left & far right above are in a sense the same re. MRR.

Exemption is an implicit deductibility system

Exemption is an implicit deductibility system, since the MRR for foreign taxes (0%) equals the MTR (0%).

This may initially sound like a cute semantic point – but in fact it's an important substantive point.

In a deductibility system (be it exemption or NN), TPs try to maximize after-foreign-tax income, & treat \$1 of foreign tax liability as equivalent to any other \$1 outlay or foregone receipt.

By contrast, in a pure credit system (w/o deferral or FTC limits), TPs try to maximize pre-foreign tax income & are wholly indifferent to foreign tax liabilities. (E.g., if creditable, I should be willing to pay someone's \$1M foreign tax bill in exchange for a \$1 side payment. Cf. *Compaq* & *IES*.)

Note how similar exemption is to an explicit deductibility system in which the tax rate for FSI is, say, 0.0001%.

Deductibility vs. creditability

From a unilateral domestic standpoint, deductibility is the correct treatment of foreign taxes.

Since we don't get the revenue, foreign taxes are no different to us than other foreign expenses or foregone gross income.

Hence (all else equal), we should want companies owned by U.S. individuals to maximize *after*-foreign tax income.

We benefit if such companies invest in low-tax rather than high-tax countries (w/ outbound investment constant – but why rely on foreign taxes to keep the money home, absent FTC reciprocity?)

Key implications: (1) Exemption is better than a WW / FTC system at the MRR margin – but so is NN. No implications from this for the desired U.S. tax rate on FSI (which could also in principle be *between* 0% and 35%).

(2) Reciprocity does **not** support our granting FTCs – other countries can & do reciprocate with exemption (i.e., mere foreign tax deductibility).

FTCs plus deferral: the worst of all worlds?

Relative to an NN system, we use **2** sets of bad rules to lower the U.S. tax burden on FSI: FTCs and deferral.

FTCs reduce foreign tax cost-consciousness (where to invest, trying to save foreign taxes).

Again, but for deferral & FTC limits such cost-consciousness would be zero.

Hence the need for an ever-expanding Rube Goldberg panoply of anti-FTC “abuse” rules.

And the horrible incentive / tax planning & compliance effects of deferral are well-known.

Note the \$1.2 trillion in unrepatriated foreign earnings that U.S. companies are currently stashing abroad.

More on FTCs plus deferral

The one good thing about FTCs plus deferral: each somewhat mitigates the other's ill effects.

With deferral (potentially forever, at least if you believe what companies tell their accountants), U.S. TPs often ARE highly foreign tax cost-conscious.

And FTCs can reduce or eliminate the tax bite from repatriation.

Hence, the Obama Admin's foreign tax credit pooling proposal is (a) better than present law re. FTCs, (b) worse than present law re. the lock-out from deferral, and (c) either better or worse re. the overall U.S. tax burden on FSI.

While deferral & FTCs reduce each other's distortions, any system with both is guaranteed to have a horrendous ratio of tax planning & compliance costs to revenue raised.

What to do?

In principle, 2 steps: (a) [placeholder]-neutral repeal of FTC & deferral in exchange for a lower tax rate on FSI, then (b) suitably adjust that tax rate.

Unclear where (b) would end up, but I would surmise well above zero, well below 35%, & possibly higher than the tax rate derived from step (a).

All this might, however, be problematic in various dimensions (e.g., treaty compliance, political feasibility, political sustainability).

Hence, I would countenance a shift to exemption (or better still, a low positive rate, as in Chairman Camp's recent proposal, albeit w/o FTCs), plus:

(a) Transition tax on the \$1.2 trillion of foreign earnings that arose under present law (e.g., via timely deemed repatriation), plus

(b) Significant improvement to the source rules (e.g., WW unitary business in lieu of separate-company accounting for *all* multinational groups).