Foreign Tax Credit Reform: A Response to Peroni, et al

by John P. Steines, Jr.

Robert Peroni, Clifton Fleming, and Stephen Shay have written an informative paper cataloging problems with the U.S. foreign tax credit system and renewing several technical and policy suggestions for reform.1 Their major proposal is to return to a per-country limitation, with a separate per-country passive income limitation and proportionate overall allocation and recapture of foreign losses. They recognize that such a change would not enhance simplification as much as merely reducing the number of baskets in the existing system, but believe that the change is necessary nevertheless in order to enhance fairness and efficiency by reducing cross-crediting opportunities that threaten the U.S. tax base. In this commentary I will summarize and respond to their proposal and conclude that reinstatement of a per-country limitation would add complexity without meaningfully curtailing cross-crediting potential.

I. Backdrop

In their paper and elsewhere2 the authors have expressed a preference for ending deferral of U.S. tax on foreign income. However, their recommendations on the foreign tax credit system proceed on the assumption that deferral will remain intact, with a separate per-country passive income limitation and proportionate overall allocation and recapture of foreign losses. They recognize that such a change would not enhance simplification as much as merely reducing the number of baskets in the existing system, but believe that the change is necessary nevertheless in order to enhance fairness and efficiency by reducing cross-crediting opportunities that threaten the U.S. tax base. In this commentary I will summarize and respond to their proposal and conclude that reinstatement of a per-country limitation would add complexity without meaningfully curtailing cross-crediting potential.


F and the passive foreign investment company (PFIC) rules. Other proposals explore the possibility of an exemption (territorial) system, in which foreign income (other than passive or certain types of tax-haven income) would not be taxed in the United States when earned or repatriated, thus generally eliminating the need for a foreign tax credit. This possibility is also excluded in analyzing foreign tax credit reform.

Whether these assumptions prove accurate will be resolved shortly, as the U.S. Congress digests bills to exempt foreign income, contract subpart F, police inversion transactions, and adopt other reforms. In all likelihood, however, deferral will not be ended; accrual of foreign income is too complicated, too controversial, too uncertain in its economic effects, and too disharmonious with the tax systems of other countries to warrant the experiment. Enactment of an exemption system has a greater chance of success, especially in light of the need to respond to the World Trade Organization’s invalidation of U.S. export assistance provisions (the foreign sales corporation (FSC) regime and its replacement, the Extraterritorial Income Exclusion Act (ETI) regime) as illegal trade subsidies, but here too the odds of success are not good in the current political and economic environment.

Thus, foreign tax credit reform against a backdrop of general deferral is a timely and important subject. Indeed, a bill currently before Congress would contract the number of separate income categories, or baskets, to two (active and passive) and relax interest allocation rules to simplify the system and reduce instances of double taxation.3

II. Summary of the Paper

This part summarizes the paper. Readers familiar with the paper may wish to skip ahead to part III.

A. Purpose, Policy, and Undesirable Reform Measures

Setting the stage for its principal recommendations, the paper recounts the purpose of the foreign tax credit

to ameliorate double taxation of foreign income while, through the limitation mechanism, preserving full U.S. tax on U.S. income and residual U.S. tax on foreign income taxed abroad at less than the U.S. rate. The paper asserts the importance of deciding which, or which combination, of the familiar economic models of optimal capital movement the system should aspire to: capital export neutrality (neutrality as to location of investment by a given investor); capital import neutrality, which is typically associated with competitive equality of multinationals from different home countries (equality of tax burden on a given geographic investment regardless of the investor's home country); and national neutrality (heavier tax burden on foreign income than on domestic income, typically in the form of only a deduction for foreign tax), a piñata typically served up in the literature before debating the relative merits of export and import neutrality.

All told, the point here, not surprisingly, is that complexity is due to absence of a single unifying theme that explains all of the intricacies of the foreign tax credit system.

The paper assigns a high priority to simplification and attributes the complexity of the current system to the following sources: pressure imposed to deviate rules from their predominantly export-neutral purpose; failure to adhere to a single economic model; balancing simplification with sometimes competing goals of fairness, precision and efficiency; the perceived necessity of complicated rules to respond to highly complex cross-border transactions; and conceptual inconsistency, such as recognizing the separateness of foreign subsidiaries by deferring taxation of their foreign income yet granting an indirect credit upon repatriation for tax paid by the subsidiary as though it were unified with its U.S. parent. All told, the point here, not surprisingly, is that complexity is due to absence of a single unifying theme that explains all of the intricacies of the foreign tax credit system.

Hugely simplifying measures, such as replacing the foreign tax credit with a deduction for foreign tax, a' la national neutrality, or removing the limitation on foreign tax credits altogether, a' la export neutrality, are dismissed because they would profoundly violate other goals and impede international investment. Exemption systems are disfavored because they stray too far from export neutrality and, because they would require a passive income exception and attributes the complexity of the current system to the following sources: pressure imposed to deviate rules from their predominantly export-neutral purpose; failure to adhere to a single economic model; balancing simplification with sometimes competing goals of fairness, precision and efficiency; the perceived necessity of complicated rules to respond to highly complex cross-border transactions; and conceptual inconsistency, such as recognizing the separateness of foreign subsidiaries by deferring taxation of their foreign income yet granting an indirect credit upon repatriation for tax paid by the subsidiary as though it were unified with its U.S. parent. All told, the point here, not surprisingly, is that complexity is due to absence of a single unifying theme that explains all of the intricacies of the foreign tax credit system.

B. Alternatives to a Basket Limitation System

The paper rejects an overall limitation because, although it would add some simplification, it would create too much potential to average high and low foreign tax and, consequently, too great an incentive to seek low-taxed foreign income, particularly passive income. The resulting loss in equity and efficient allocation of capital is not worth the simplification gain. This was the main reason cited by Congress for rejecting an overall limitation and enacting the basket system in the Tax Reform Act of 1986.
the same as that used in subpart F and the PFIC rules, which is not entirely true under current law.

The authors would place all royalties in the passive basket, regardless of whether received from a controlled foreign corporation (CFC) or from an unrelated party, and regardless of whether the licensor or CFC uses the intangible in an active business. The reason is that royalties typically bear little foreign tax and therefore should not be integrated with general limitation income under the existing exceptions from passive income for active royalties received from an unrelated licensee and for royalties received from a CFC that uses the intangible in an active business. The high-tax kick-out for passive income bearing effective foreign tax at least equal to the U.S. rate would be repealed on complexity grounds (the same as those described above in part B in connection with a high/low tax limitation system) and because there is no cogent basis for penalizing those few taxpayers who actually incur high foreign tax on passive income.

**High Withholding Tax.** The high withholding tax basket would be repealed for taxpayers other than financial institutions, at whom the provision was primarily aimed. The suspicion in 1986, when the basket was created, was that financial institutions generally pass the burden of withholding tax to foreign borrowers through higher interest rates and should not be permitted to average the resulting high effective tax against other low-taxed business income, even though competing banks from other countries might be able to underbid U.S. banks by reason of double tax relief in their home countries.

**Financial Services Income.** The separate basket for financial services income for companies predominantly engaged in financing activity would be retained, essentially for the same reasons put forth in 1986 — to prevent taxpayers engaged in other businesses from acquiring banking arms and averaging foreign taxes on the two activities. The high withholding tax basket would continue to apply separately from the financial services basket, even though taxpayers may generally cross-credit high and low taxes from the same business, because, as mentioned above, financial institutions might not economically bear high withholding tax.

**Export Financing Interest.** The exception from the three foregoing baskets for export financing interest would be repealed as a narrow and unwarranted subsidy.

**Shipping Income.** The separate basket for shipping income, which typically bears little foreign tax, would be retained, although consideration could be given to folding it into the passive basket.

**10/50 Company Dividends.** The proposal here is to apply the look-through rule of IRC section 904(d)(4) to all dividends paid by 10/50 companies, regardless of whether the dividend is funded by pre- or post-2003 earnings and profits. However, consistent with current law, look-through treatment would not extend to interest, rents, and royalties received from a 10/50 company, on the ground that such payments bear little foreign tax. For the same reason, the authors would repeal look-through treatment of such payments from a CFC.

**Foreign Trade Income.** The three existing baskets covering foreign trade income, which have little ongoing significance, would be eliminated and foreign trade income would be integrated into the passive basket.

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**General Limitation Income.** Income from inventory sales where title passes abroad would be placed in a separate basket or treated as U.S.-source income unless attributable to a foreign office and subject to a minimum rate of foreign tax. Similarly, business income not subject to foreign tax by reason of absence of a permanent establishment in the host country would be subject to the same treatment. The reason for these rather stark encroachments on what is clearly general business income is to preclude averaging such lightly taxed income with other high-taxed foreign income. The paper goes on to embrace an earlier proposal to divide general limitation income into two subcategories, one for income earned in treaty partners imposing rates comparable to U.S. rates and another for all other general limitation income, and claims that such an approach avoids the complexity associated with a high/low tax limitation system of having to calculate effective foreign tax rates.

**Oil and Gas Income.** IRC section 907, apart from the section 904 limitation, limits creditable tax on income from extraction of natural resources to the U.S. tax rate. Section 907 would be retained on the ground that the dual-capacity taxpayer regulations under section 901 do not always adequately separate taxes from disguised oil royalties paid to the host country and, even when they do, do not prevent averaging high and low foreign tax.

**Treatment of Separate Losses.** Losses in a particular foreign basket would proportionately offset both U.S. and foreign income in other baskets, as opposed to the present-law approach of offsetting other foreign income first and only then offsetting U.S. income. Also, U.S. income would be recharacterized as foreign income to the extent U.S. losses previously offset foreign income.

### D. Per-Country Limitation

As the foregoing discussion reveals, the authors’ primary concern is with cross-crediting. To weed out cross-crediting to the greatest extent possible and most
closely approximate a transactional limitation, the main proposal is to resurrect a per-country limitation, which was last in effect in 1976. The authors acknowledge the difficulty of dealing with taxes paid to multiple countries on income earned by a resident of a single country. This would occur, for example, when a subsidiary resident in country A pays tax to countries A and B on income partially sourced in each country.

Two additional refinements are suggested. First, to minimize cross-crediting within a country, each country would have a separate passive income limitation. Second, losses within a foreign country would proportionately offset income in the United States and other countries. Presumably, such losses would be recaptured in the same proportions and, as proposed in connection with refinement of the basket system, mirror treatment would be accorded U.S. losses.

E. Other Issues

Creditable Taxes. The authors would extend creditability of foreign tax to any type of foreign tax, such as various consumption taxes, as opposed to only those that qualify as an income tax under U.S. principles or that are entirely in substitution of an income tax under IRC section 903. Limiting the amount of credit to the effective U.S. rate, determined under U.S. income tax principles, obviates confining credits to income taxes.

The paper also criticizes the “technical taxpayer” rule,\(^6\) which assigns the credit to the party on whom foreign law imposes the tax, regardless of whether the economic burden of the tax is shifted to other persons. This criticism is aimed particularly at reverse hybrid structures, which have the effect of temporarily separating, for U.S. income tax purposes, the foreign tax from the underlying income on which it is imposed. Notice 98-5\(^7\) threatened regulations that would either defer credits or accelerate the underlying income in reverse hybrid structures, thus marrying timing of the tax and underlying income and ending temporarily supercharged credits, but the government has not followed up with these regulations. In symmetry with their criticism of reverse hybrids, the authors criticize a regulation that permanently denies indirect credits to shareholders who economically bear the burden of corporate tax.\(^8\)

Indirect Credits. Several technical suggestions, mostly geared toward simplification and coherence, are made regarding indirect credits under IRC sections 902 and 960. Constructive stock ownership, which counts toward entitlement to credits under section 960 but not section 902, would be extended to section 902 as well. Contrary to current law, indirect credits would be available with respect to all lower-tier subsidiaries, regardless of how far down the chain and of whether the subsidiary is a CFC, provided the requisite stock ownership requirements are met. Guarded support is voiced for basing indirect credits on the subsidiary’s taxable income or financial earnings, as opposed to earnings and profits. Finally, the cumulative pooling approach, adopted in the Tax Reform Act of 1986 in place of the prior-law “peelback” method in order to eliminate rhythmic maximization of credits, would be retained notwithstanding associated recordkeeping burdens.

Carryovers. The carryback period under IRC section 904(c) would be shortened to one year and the carryforward period left unchanged at five years.

Interest Allocation. The “water’s edge” approach of current law for apportioning a U.S. group’s interest expense\(^9\) would be replaced by an approach that generally limits the amount chargeable against foreign income to the proportion of such expense that foreign assets (including assets of foreign subsidiaries) bear to worldwide assets.

III. Critique

A. Balancing Theory and Pragmatism

Accepting the undeniable premise that a foreign tax credit is necessary to ameliorate double taxation, and regardless of whether one regards the essential purpose of a limitation thereon as necessary to protect the U.S. tax base or to inject as much tax neutrality as possible into decisions of where to locate investment, it is hard to argue with the theoretical norm embraced by the authors. That is, each investment decision should stand on its own. Translated, the closest administratively reasonable proxy of a transactional limitation is the ideal. But the analysis should not end there.

Is the theoretical ideal really ideal? Of course the rules must protect against unacceptable encroachment of the U.S. tax base. On the domestic front, for example, the dividends-received deduction or an equivalent is an essential theoretical strut in the architecture of a classical system, but it was necessary to deny the deduction in certain cases to prevent unacceptable tax-avoidance opportunities. So constraints were enacted;\(^a\) theory had to yield. Given the virtual intellectual stalemate between the cases for export versus

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\(^6\)Treas. reg. section 1.901-2(f).

\(^7\)1998-1 C.B. 334.

\(^8\)Treas. reg. section 1.902-1(a)(9)(iv), (10)(ii). These regulations overturn the result in Vulcan Materials Co. v. Comm’r, 96 T.C. 410 (1991), aff’d, 959 F.2d 973 (11th Cir. 1992).

\(^9\)Treas. reg. section 1.861-9T et.seq.

\(^a\)See IRC sections 246(c), 1059.
import neutrality, as witnessed by probably every major tax system having landed somewhere between the two poles, and (my apologies to economists) the inability of anyone to say convincingly which model makes the world or a particular country a better place, more consideration should be given to other factors, especially when a respectable school of thought holds that averaging within integrated business operations is a tolerable incursion into the residual U.S. tax base so long as it does not get out of hand.

**Another reason to go slowly before changing the limitation system is the tremendous complexity cost of transition rules.**

So I would want answers to certain questions before making any changes. How serious is the magnitude of cross-crediting? What are the causes? Can the causes be rooted out without systemic change of the limitation system and attendant accumulation of what could easily turn out to be extremely complicated transition rules? Finally, would a per-country limitation necessarily prevent much cross-crediting?

**B. Magnitude and Causes of Cross-Crediting**

Cross-crediting requires effective foreign tax rates that straddle the U.S. corporate tax rate of 35 percent. International tax planning for U.S. multinationals consists in large part of minimizing foreign tax through a combination of financing structures that erode the base in high-tax jurisdictions and location of intangibles and distribution networks that assign income to low-tax jurisdictions. These arrangements produce pools of low-taxed income. But without other pools bearing effective foreign tax in excess of 35 percent, cross-crediting cannot occur, no matter how much low-taxed income is repatriated. And the smaller the excess of foreign rates over 35 percent, the smaller the magnitude of the problem. In light of the worldwide trend — tax havens and developing low-tax countries aside — of corporate tax rates converging in a band close to 35 percent and low withholding taxes imposed by treaty partners, it would not seem that nominal rates near or below 35 percent is, undoubtedly, sophisticated tax planning to achieve precisely that effect by stripping away the foreign income recognized for U.S. tax purposes from the associated foreign tax that is credited. For example, the reverse hybrid structures illustrated by the authors in part VII.B of the paper convert a nominal 30 percent foreign tax into effective taxes of 75 percent and 300 percent, respectively. And there are other techniques that separate high- and low-taxed income in separate jurisdictions, paving the way for rhythmic repatriation patterns, assisted by the ability to jump over low-taxed intermediaries through IRC section 956 investments. But these are discrete problems that may be addressed, where appropriate, through remedies more surgical than revamping the entire foreign tax credit limitation system. Why, if more tailored remedies exist, should all taxpayers and the government incur the expense of determining and auditing separate limitations for each country of operation?

**C. Transition Issues**

Another reason to go slowly before changing the limitation system is the tremendous complexity cost of transition rules. The most recent case in point is the 10/50 basket, enacted in 1986 for dubious reasons and repealed in 1997, effective in 2003 but with lingering life for distributions funded by pre-2003 earnings. One need only read the recent guidance on the lingering effects,9 which reaches ridiculous levels of complexity in the context of cross-border reorganizations,10 to be reminded that, once limitation categories are enacted, they hang around indefinitely and spread complexity like weeds. Adoption of a per-country system and later purposes but not for purposes of determining foreign tax liability, artificially suppress foreign income and often have the effect of rendering interest expense incurred by the U.S. members of a multinational group effectively deductible nowhere. Virtually no one defends this condition (except as hostage to stricter anti-deferral rules or the end of deferral altogether), and there have been repeated calls to adopt the type of modified worldwide apportionment method favored by the authors. It may be that reversing the effect of indefensible allocation rules through cross-crediting is an inappropriate substitute for changing the allocation rules themselves, but it is equally hard to pounce on otherwise indefensible cross-crediting within a business unit just because it negates the unduly harsh effects of the allocation rules.

The other source of high effective foreign tax rates in the face of nominal rates near or below 35 percent is, undoubtedly, sophisticated tax planning to achieve precisely that effect by stripping away the foreign income recognized for U.S. tax purposes from the associated foreign tax that is credited. For example, the reverse hybrid structures illustrated by the authors in part VII.B of the paper convert a nominal 30 percent foreign tax into effective taxes of 75 percent and 300 percent, respectively. And there are other techniques that separate high- and low-taxed income in separate jurisdictions, paving the way for rhythmic repatriation patterns, assisted by the ability to jump over low-taxed intermediaries through IRC section 956 investments. But these are discrete problems that may be addressed, where appropriate, through remedies more surgical than revamping the entire foreign tax credit limitation system. Why, if more tailored remedies exist, should all taxpayers and the government incur the expense of determining and auditing separate limitations for each country of operation?

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discovery that the change was ineffectual, prompting a shift back to a basket system or some other type of limitation, would create a much more pervasive version of the 10/50 experience. And even if a per-country system survived, the complexity associated with change could be avoided by adopting surgical reforms that work directly on the root causes of cross-crediting.

D. Would a Per-Country System More Effectively Curtail Cross-Crediting?

As mentioned above, the major causes of cross-crediting in a world of generally converging tax rates are disharmonious interest allocation rules and tax planning to separate foreign tax from the underlying income. If the interest allocation rules are changed to adopt a modified worldwide approach, the United States will have moved toward allowing, without need for cross-crediting, foreign tax credits previously available only through cross-crediting.

Even so, there will be a continuing incentive to minimize foreign tax in general and to engineer high effective foreign tax rates through separation techniques accompanied by rhythmic repatriation. For financial accounting purposes, the benefit to earnings of a low foreign tax can be claimed if the associated assets are permanently reinvested in the foreign location. Repatriation sheltered from U.S. tax through cross-crediting with engineered high-taxed income preserves the benefit. And even if some of the benefit is foregone through financial accounting reserves to account for the possibility of challenge by the Internal Revenue Service, there is relatively little downside risk. If the statute of limitations period expires and the cross-crediting has not been challenged, the financial accounting reserve can be released or kept in place for a newer version of the rhythmic pattern. Thus, financial accounting benefits are likely to provide a strong continuing incremental incentive to attempt cross-crediting, on top of the monetary savings of reduced worldwide taxation.

It is far from clear that a per-country system would foreclose such tax planning. In a basket system, cross-crediting requires separating foreign tax from income in the same basket as the low-taxed earnings. In a per-country system, cross-crediting would require separating foreign tax from income in the same country as the low-taxed earnings. Accordingly, if the underlying separation technique works, a per-country system may serve only to proliferate entities and strategies necessary to achieve separation.

Moreover, the need to duplicate structures necessary to achieve separation in every country that generates low-taxed earnings would depend on the existence of a rule preserving the source of income, notwithstanding that the income is earned by a resident of another country or distributed to a holding company resident in another country. Rules preserving the source of income in these circumstances would be very complicated. In essence, they would represent the geographic equivalent of rules necessary to group income, expenses, and taxes in the appropriate basket under the current system. And, as suggested, even if such rules worked, the likely result would be proliferation of separation structures in several countries.

IV. Conclusion

In a world of converging corporate tax rates and tax planning to reduce foreign tax liability through base-eroding financing structures and location of intangibles and distribution networks in low-tax jurisdictions, the most likely cause of significant cross-crediting of high- and low-taxed foreign earnings is the ability to generate foreign earnings bearing a high effective foreign tax through a variety of techniques that separate foreign tax from the underlying income. It is not clear that an administratively feasible per-country system would stop such activity. Indeed, a per-country system would likely proliferate use of such techniques in several countries, thus adding complexity to the foreign tax credit limitation system and to the transactions it governs without meaningfully curtailing cross-crediting.

A better reform would be to adopt a modified worldwide method of allocating interest expense and reduce the number of baskets in the existing system, as has been proposed in Congress, and to begin the process of identifying and, where appropriate, prohibiting separation techniques that create artificially high-taxed pools of foreign earnings. Until the latter reform is achieved, no limitation system other than a high/low tax system, which would be very complicated, would meaningfully curtail cross-crediting.

Addressing separation techniques on the merits is the foreign-subsidiary counterpart to identifying inappropriate tax shelter activity on the domestic front. The issues are quite similar and, absent a high/low limitation, there is no substitute for addressing them. Also, eradicating aggressive techniques instead of the very concept of averaging within integrated business operations would be less disruptive of the delicate balance of import- and export-neutral features inherent in most if not all modern tax systems.