Rethinking
Foreign Tax Creditability

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Background

Ambition: “obviously wrong” → “obvious.”

Hard to exaggerate FTC’s universal acceptance, exemption aside. (Cf. deductibility & taxing net, not gross, income.)

BUT: (1) Its intuitive roots (responding to “double taxation”) can’t be defended in a welfare economics framework.

(2) Its normative underpinning (CEN) is collapsing.

(3) Shouldn’t conflate (a) overall tax burden on outbound w/ (b) marginal reimbursement rate for foreign taxes (MRR).

In principle, could have 100% MRR w/ no net tax on outbound (like exemption), OR burden-neutral shift to deductibility. (Given other variables – e.g., rate on foreign source income, credit limits.)

Whose welfare counts?

Choice between WW & national welfare is foundational to thinking about foreign taxes.

Should we view them as mere transfers (like domestic taxes) or as costs (like other business outlays)?

WW view is morally compelling but not really expected for individuals OR countries. (Agency cost issue if adopted by policymakers.)

Ostensible proponents of WW welfare don't really mean it – e.g, not advocating massive wealth transfers from rich to poor countries.

Rather, they have in mind *cooperative*, rather than *unilateral*, pursuit of national welfare.

Reciprocity and foreign tax credits

With cooperation, anything that increases WW welfare CAN create Pareto improvement.

FTCs treat it as irrelevant whether taxes are paid to oneself or another country (clearly contrary to unilateral national welfare).

Where sufficiently reciprocal, crediting others' taxes in exchange for having them credited could be a wash.

But this requires unrealistic reciprocity – same tax rates, credits not exemption, don't "cheat" on credit limits, reciprocal flows (formally defined), etc.

Crediting only some taxes may be unrealistic (e.g., for credit limits), in addition to being contrary to current U.S. law.

What is the nationally optimal MRR for foreign taxes?

Absent reciprocity, foreign taxes are no different from any other outlay.

Hence, we want TPs to be indifferent between a $1 foreign tax liability, and any other $1 reduction to net foreign income.

Thus, the MRR should equal the MTR for such income.

This, of course, results automatically from foreign tax deductibility.

Deductibility is therefore optimal in a unilateral framework, holding constant the overall U.S. tax burden on foreign source income (given possibility of other adjustments).

Making things worse …

100% MRR for foreign taxes is not merely excessive, but eliminates all TP cost-consciousness.

Suppose the MRR > 100%. Easy to see how this would be a problem.

Now consider Case 1: foreigner pays me $1 to pay its $1B foreign tax bill (if permitted by the rules).

Or Case 2: I pay $100K to be treated as the payer of a $1B foreign tax bill (a la *Compaq* et al).

These are not much better.

More on the incentive problem

Even if we can block or burden these transactions, the incentive problem is fundamental. NOT an “abuse” issue!!!

Case 3: TP invests in high-tax rather than low-tax country.

E.g., say US MNE, owned by US individuals, could earn (a) $100 pre-foreign tax in a country charging 35%, or (b) $90 in a country with no income tax.

Since foreign but not U.S. taxes are a social cost from the U.S. social standpoint, option (a) leaves Americans $25 poorer, but will be chosen in an FTC regime.

You’d need an awfully good lawyer to argue that choosing (a) is “FTC abuse.”

Is deductibility a surprising result?

Not at all - in fact it’s quite a familiar result.

Cf. not only national neutrality (NN), but also exemption.

Exemption is an implicit deductibility system: (a) TP is indifferent between foreign taxes and other reductions in net income, (b) it’s almost the same as an express deduction system w/ 0.0001% rate.

NN and exemption are identical at the foreign tax cost consciousness margin (my interest in this paper), although they differ at the U.S. tax burden on “outbound” investment margin.

(Scare quotes because “outbound” is defined formalistically in terms of corporate residence.)

How bad is the FTC?

Not an empirical paper - but note that every dollar of FTC claimed involved inappropriate incentives from a U.S. national welfare standpoint.

US TPs may over-invest in high-tax relative to low-tax countries, & do too little foreign tax planning.

Effects are mitigated by (a) our not actually having a pure WW, unlimited FTC system (e.g., deferral), (b) lots of bells & whistles burdening efforts to use FTCs.

But all this is no defense of FTCs in principle, & creates its own set of further distortions.

Rules needed to combat FTC problems

FTC is powerful enough to wipe out all tax revenues unless hemmed in (e.g., by credit limits & frictions).

To be sure, the same is true of deductions under a realization income tax (given tax arbitrage).

But deductibility is unavoidable if one is taxing net income.

Since the FTC isn't unavoidable, costs of hemming it in affect the assessment of whether we should have it to begin with.

FTC limits, separate baskets, "specific economic benefit" rule, economic substance & business purpose requirements, etc.

Debunking the case for FTCs

1) AVERSION TO DOUBLE TAXATION

A powerful trope in domestic U.S. politics – but the # of times one is taxed is normatively meaningless.

E.g., better ten 1% taxes than one 35% tax.

And the assessment turns on formalistic inquiries – e.g.: Is the same thing being taxed twice? Are the taxes truly separate?

What actually IS of normative interest is relative tax burdens (potentially affecting incentives & distribution).

So the problem with duplicative residence & source-based taxes isn't "double taxation" but relative burden on cross-border activity.

Debunking the case for FTCs, cont.

2) Needed for capital export neutrality (CEN) – albeit that an FTC system with credit limits violates CEN.

The decline of CEN as a dominant benchmark is a topic unto itself; herein just the highlights.

Even granting the WW welfare benchmark without regard to reciprocity, 2 reasons why a country may not advance global pretax profitability by making residents foreign tax-indifferent:

(a) Entity-level corporate tax makes residence close to elective (transition aside).

(b) With nonresident investors still sensitive to source taxes, relative asset valuations differ, & may just get clientele effects.

Implications of FTC problems if one rules out burden-neutral FTC repeal

1) Strengthens the case for exemption (an implicit deductibility system that is treaty-compliant & potentially stable).

2) Viewing foreign taxes as pure costs from a domestic standpoint suggests favoring burden-neutral changes that:

(a) Reduce discouragement of overseas tax planning (e.g., U.S. subpart F and intra-group debt, foreign base companies).

(b) Restrict allowability of foreign tax credits.

But note tradeoff between foreign tax credits & deferral (since each eases distortions associated with the other).