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A Hitchhiker's Guide to Reform of the Foreign Tax Credit Limitation

Robert J. Peroni

A HITCHHIKER'S GUIDE TO REFORM OF THE FOREIGN TAX CREDIT LIMITATION*

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THE purpose of this short article is to provide a few comments on what should be done in the nature of reform of the foreign tax credit limitation in U.S. international tax law.[1] This article is intended to lay the groundwork for a later, more detailed article on foreign tax credit limitation reform.[2]

I. THE PURPOSE OF THE FOREIGN TAX CREDIT IS TO MITIGATE INTERNATIONAL DOUBLE TAXATION AND THE DESIGN OF THE LIMITATION SHOULD BE CONSISTENT WITH THAT PURPOSE

Let's start with the basics. The purpose of the foreign tax credit is to mitigate international double taxation and prevent such double taxation from discouraging efficiency enhancing cross-border transactions from taking place. Its function is not, and should not be, to provide a subsidy for foreign investment by U.S. persons, to favor foreign investment over domestic investment or vice versa, or to favor any particular type of foreign investment over any other type of foreign investment.

Arguments by some multinational corporations and their tax advisers that the foreign tax credit provisions should be designed to promote the "competitiveness" of U.S. multinationals in the global economy are essentially claims that the U.S. tax system should subsidize foreign-source income by taxing it more lightly than domestic-source income. Those arguments have little to do with the fundamental purpose of the foreign tax credit provisions, which is to provide unilateral double taxation relief by the residence country. Moreover, these arguments in favor of skewing the foreign tax credit provisions in favor of "competitiveness" are often

** Robert Kramer Research Professor of Law, George Washington University; J. Landis Martin Visiting Professor of Law and Business, Northwestern University. The author would like to thank J. Clifton Fleming, Jr. and Christopher Hanna for their comments on an earlier draft of this commentary.

1. *See* I.R.C. § 904 (2002). For a detailed discussion of the foreign tax credit limitation provisions in § 904, see JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION ¶ B4.16 (1992).

2. The later article will be co-authored with my frequent co-authors, J. Clifton Fleming, Jr. and Stephen Shay, and will be presented at an upcoming Annual Tax Seminar for the Government, co-sponsored by New York University School of Law and Tax Analysts.

made with rather unconvincing empirical support for the claim that the foreign tax credit provisions of current law in fact are causing competitive harm to U.S. multinationals.[3] Those who argue in favor of using the foreign tax credit provisions as a subsidy for foreign investment by U.S. multinationals bear the heavy burden of demonstrating (1) the need for such a subsidy; (2) why finite U.S. government budgetary resources should be devoted to subsidizing U.S. multinationals instead of providing additional support to health care, education, environmental protection, anti-terrorism measures, national defense, or other government expenditures; and (3) that the foreign tax credit provisions are the appropriate vehicle for implementing a subsidy to U.S. multinationals.

The foreign tax credit performs its job properly when it allows a U.S. taxpayer a dollar-for-dollar credit for foreign income taxes imposed on a particular item of foreign-source income up to the pre-credit U.S. tax on that income item.[4] If a foreign country imposes a tax at a rate below the U.S. tax rate, the United States, as the residence country, has the right to collect a residual tax on the foreign-source income in accordance with international tax norms. Indeed, to the extent that the U.S. tax exceeds the foreign tax, there is no double taxation (only taxation by the United States, the residence country) and, hence, no need for double taxation relief. If a foreign country imposes tax at a rate above the U.S. rate, no credit should be allowed for the foreign tax in excess of the U.S. rate because, again, to that extent there is no double taxation (only taxation by the source country). Moreover, the only way to provide a foreign tax credit for foreign taxes in excess of the U.S. rate is to allow an offset of the excess foreign tax against either U.S. residual tax on low-taxed foreign income or U.S. tax on U.S.-source income. This approach would erode the U.S. tax base because the United States would be forgoing either its tax on U.S.-source income or its residual tax on foreign-source income in order to subsidize investment in foreign countries with tax rates above the U.S. rate.[5] Thus, if the foreign tax credit were designed to accomplish its purpose of providing double taxation relief and do noth-

3. *See, e.g.*, THE NFTC, FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY: PART TWO: RELIEF OF INTERNATIONAL DOUBLE TAXATION 301-09 (2001) (making a valiant, but ultimately unpersuasive, attempt to demonstrate the negative effect of the U.S. international tax rules on the competitiveness of U.S. multinational corporations).

4. Foreign taxes imposed on income that the United States treats as U.S.-source income in accordance with the principles of international tax law should not be eligible for the foreign tax credit. Such taxes should be treated by the U.S. tax system the same as any other cost of generating income—namely, as a deductible expense under § 162 (or § 212 if the activity giving rise to the income is an income-producing activity that is not a trade or business for federal income tax purposes). Disputes between the United States and a foreign country concerning the proper source rule for a particular type of income are best handled through the treaty negotiation process.

5. *See also* STAFF OF J. COMM. ON TAX'N, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, JCS-3-01, 2 RECOMMENDATIONS OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION TO SIMPLIFY THE FEDERAL TAX SYSTEM 389 (Comm. Print 2001) [hereinafter RECOMMENDA-

ing more, the foreign tax credit limitation would be applied on an item-by-item basis and no cross-crediting of excess foreign tax against U.S. residual tax would be allowed.

Because it is thought that an item-by-item application of the foreign tax credit limitation is not administratively feasible,[6] the foreign tax credit limitation has historically been applied among categories of foreign-source income. The least refined limitation under this approach is one based on overall foreign-source income and such a limitation allows a great deal of cross-crediting of high and low taxes on different types of foreign-source income. The limitation in current U.S. law is one based on categories of income (often called "baskets") in § 904(d), but despite the seeming rigor of these basket limitations, liberal cross-crediting is still allowed for foreign taxes imposed on most types of foreign business income in the residual or general limitation basket.[7] A loose limitation which allows liberal cross-crediting creates a strong incentive for taxpayers to shift both active and passive income to low-tax foreign jurisdictions. Any serious reform of the foreign tax credit limitation should reduce the opportunities for cross-crediting, or averaging, of high and low foreign taxes with respect to all types of foreign-source income, including foreign business income.

II. REFORM WILL NOT PRODUCE A SIMPLE FOREIGN TAX CREDIT LIMITATION

Simplification is an important objective of tax reform efforts. Sensible simplification of the foreign tax credit rules should include an expansion of the de minimis rule in current § 904(j), which makes the foreign tax credit limitation inapplicable to U.S. individual taxpayers with relatively small dollar amounts of foreign tax credits. These individuals should not be forced to deal with the complications of the foreign tax credit limitation, not even the comparatively simple overall limitation. The potential for abuse in such cases is small and the costs in terms of administrative expense for the IRS and compliance cost for the taxpayer exceed the benefits of applying the limitation in such cases. Accordingly, the de minimis rule in § 904(j) is a sensible rule but should be broadened a bit. The ceiling on the creditable foreign taxes that an individual taxpayer may have and still qualify for the de minimis rule should be raised from $300 ($600 in the case of a joint return)[8] to some higher amount, such as $1,000

TIONS] (describing this phenomenon as having "the effect of using U.S. tax collected from domestic income to subsidize the revenue requirements of a foreign jurisdiction").

6. *See, e.g.*, AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 319-20 (1987).

7. *See* I.R.C. § 904(d)(1)(I) (2002).

8. The de minimis rule should continue to be limited to individual taxpayers in order to preserve its simplification potential and avoid abuse of the rule by a single individual conducting her foreign activities through multiple corporate entities. If corporations were given access to the de minimis rule, an aggregation rule for corporate groups would be necessary to prevent the preceding abuse and such a rule would be contrary to the simplification objective of § 904(j).

($2,000 in the case of a joint return). Moreover, consideration should be given to eliminating the requirement that the individual's foreign-source income consist only of "qualified passive income" and instead allow creditable foreign taxes on any type of foreign-source income to qualify for the de minimis rule. This would mean that a U.S. individual who is within the de minimis ceiling would qualify for the de minimis rule by disclosing on his or her return the amount of creditable taxes for which the de minimis rule is claimed, the country to which the taxes were paid, and the nature of the income on which the foreign taxes were imposed.

On the other hand, for taxpayers with large amounts of foreign tax credits who engage in complicated cross-border transactions, the credit limitation is probably not going to be simple. Complicated transactions create the need for complicated tax rules and complicated abuse transactions are likely to lead to complicated anti-abuse rules.[9] Moreover, international transactions involve the application and interplay of the tax rules of multiple foreign countries, itself a significant contributing factor to the complexity of the U.S. international tax system. Then, at the end of the day, all one can reasonably expect in terms of simplification of the foreign tax credit limitation for taxpayers other than individuals qualifying for the de minimis rule is that the limitation not be unnecessarily complicated given its objectives: (1) to mitigate international double taxation; but (2) not to subsidize countries who impose taxes in excess of the U.S. tax rate; and (3) to reduce the incentive for taxpayers to make tax-motivated decisions concerning the location of business and investment activities. Accordingly, as in other areas of the tax law, the goal of simplification of the foreign tax credit limitation has to be balanced with the goals of making the foreign tax credit rules more equitable and economically efficient. Stated differently, the simplest foreign tax credit limitation is not necessarily the optimal foreign tax credit limitation from a tax policy point of view since the simplest limitation may result in erosion of the U.S. tax base and lead to tax-motivated cross-border investments that take advantage of cross-crediting opportunities.

III. ADOPT A PER-COUNTRY LIMITATION

The most significant issue concerning foreign tax credit limitation design relates to how the limitation is to be broken down and applied. The current limitation in § 904(d) breaks down a taxpayer's foreign-source taxable income into various categories but then applies on an overall basis within each category. It is complex and still permits too much cross-crediting or averaging in the general or residual basket. A better approach would be a foreign tax credit limitation that sorts out a taxpayer's foreign-source taxable income on a country-by-country basis, with two

9. Stated differently, the extensive and sophisticated tax planning efforts in the international tax arena are themselves a considerable source of complexity in the U.S. international tax rules.

categories per country: a passive basket and a residual basket.[10] However, the passive basket of current law, when applied on a per-country basis, could be considerably simplified by eliminating the special rules for export financing interest[11] and eliminating any need for having a high-tax kickout.[12] Moreover, no special categories for high withholding tax interest,[13] shipping income,[14] or financial services income[15] would be necessary in a limitation applied on a per-country basis, thus eliminating the definitional and coordination issues that those three basket limitations generate under current law.

Applying the foreign tax credit limitation on a country-by-country basis prevents a U.S. taxpayer from cross-crediting high foreign taxes on foreign business income in one foreign country with low foreign taxes on foreign business income in another foreign country, thereby removing the tax incentive for a U.S. taxpayer with operations in a high tax foreign country from shifting other operations from the United States or other foreign countries to a low-tax foreign country. Stated differently, the per-country limitation does a better job of ensuring that the foreign tax credit limit performs its principal function of providing double taxation relief without distorting economic behavior. The reason for the passive basket in the per-country limitation is to remove any tax incentive for taxpayers to shift easily mobile passive investments to foreign countries that tax business income at rates above the U.S. rate and passive income at low or zero rates.

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10. In 1984 and 1985, the Reagan Administration proposed the enactment of a per-country foreign tax credit limitation as part of its major tax reform effort. *See* 2 U.S. TREAS. DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 360-63 (1984); U.S. TREAS. DEP'T, THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 385-96 (1985). Congress, however, did not enact this proposal as part of the Tax Reform Act of 1986 in part because it viewed the per-country limitation as adding complexity to the federal income tax system. *See, e.g.*, ALI FEDERAL INCOME TAX PROJECT, *supra* note 6, at 323-26, 328. Instead, in 1986, Congress enacted the expanded basket limitation system in § 904(d). One could well argue that the per-country limitation is not significantly more complicated than the basket limitations in § 904(d), particularly as applied in conjunction with the look-through rules in § 904(d)(3) (enacted in 1986) and § 904(d)(4) (enacted in 1997).

11. *See* I.R.C. § 904(d)(2)(A)(iii)(II), (d)(2)(G) (2002); *see also* I.R.C. § 904(d)(2)(C)(iii)(III) (2002). There is scant empirical evidence that these special rules for export financing interest have any significant effect on stimulating U.S. exports; accordingly, they provide nothing more than a windfall (i.e., a wasteful subsidy) to those taxpayers to whom they apply. Moreover, they arguably are export subsidies that violate the spirit of the United States's obligations under the WTO agreements. Accordingly, even if the basket limitation system of current law is retained (instead of being replaced by a per-country limitation), the tax policy objectives of simplification and efficiency would be promoted by repealing these provisions.

12. *See* I.R.C. § 904(d)(2)(A)(iii)(III), (d)(2)(F) (2002). The high-tax kickout in the passive basket greatly complicates the application of § 904(d) under current law.

13. I.R.C. § 904(d)(1)(B), (d)(2)(B) (2002).

14. I.R.C. § 904(d)(1)(D), (d)(2)(D) (2002).

15. I.R.C. § 904(d)(1)(C), (d)(2)(C) (2002).

IV. SOURCE RULES

In the context of the foreign tax credit limitation, the source rules of current law need to be revised to reflect the purpose for which they are being applied. The current rules all too often allow income that is not taxed (and is not likely to be taxed) by a foreign country to be treated as foreign-source income, thereby inflating the taxpayer's foreign tax credit limitation. Instead, as Steve Shay, Cliff Fleming, and I have argued elsewhere, income should be treated as foreign-source income for purposes of the foreign tax credit limitation only if it is subject to a substantial tax by a foreign country that is consistent with international norms for asserting source-based taxing jurisdiction.[16] This means, for example, that to the extent that income is exempt from foreign taxation by reason of a U.S. income tax treaty it should not be treated as foreign-source income for purposes of the foreign tax credit limitation.[17] This also means that the inventory export source rule in § 861(a)(6) and § 862(a)(6) should be replaced with a rule that treats a U.S. person's inventory sales income as U.S.-source income, unless the taxpayer maintains a foreign office to which the inventory sale is attributable and pays an income tax of a specified percentage.[18]

V. FOREIGN TAX CREDIT REFORM AND DEFERRAL

In order to reform the foreign tax credit limitation, it is also necessary to do something about the deferral privilege. Under the deferral privilege, a U.S. person who conducts business abroad through a foreign corporation defers U.S. income tax on the corporation's foreign-source earnings until those earnings are repatriated to the United States through distributions to the U.S. shareholder.[19] This deferral privilege is subject to a number of weak anti-deferral regimes that eliminate deferral only in limited circumstances.[20] By contrast, a U.S. person who conducts business abroad through an unincorporated branch or through a pass-through entity (e.g., partnership or limited liability) pays current U.S. tax on the

16. *See* Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *The David R. Tillinghast Lecture: "What's Source Got to Do With It?"—Source and U.S. International Taxation*, 56 TAX L. REV. 81 (2002).

17. *See* Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 VA. L. REV. 1753, 1775 (1995) (suggesting that treaty-protected income of U.S. persons that would be treated as foreign-source income under the U.S. tax law source rules should be placed in its own foreign tax credit limitation category so that it cannot be blended with other high-taxed foreign-source income).

18. *See* I.R.C. § 865(e)(1) (2002) (providing an example of such a source rule, although the 10% threshold is probably too low).

19. *See, e.g.*, CHARLES H. GUSTAFSON, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS 20-21, 399-400 (2d ed. 2001). At the time that the foreign corporation distributes the dividend to the U.S. shareholder, the U.S. shareholder may be entitled to an indirect credit under § 902 for foreign income taxes paid by the foreign corporation if the shareholder is a U.S. corporation owning at least 10% of the voting stock of the foreign corporation.

20. *Id.*

foreign-source income, subject to a foreign tax credit for qualifying foreign income taxes imposed on such income.

The deferral privilege should be thought of as a subsidy for foreign investment in low-tax foreign countries, which encourages taxpayers to shift their business and investment activities to low-tax foreign countries. The combination of the benefits of deferral and the still rather liberal cross-crediting permitted under § 904(d) may well result in a negative U.S. tax rate on a U.S. taxpayer's foreign-source income earned through a foreign subsidiary. In other words, the U.S. taxpayer is often provided with a lower effective rate of U.S. tax than the zero rate of tax on foreign-source income imposed by an explicit exemption system.[21] Numerous attempts to tinker with the anti-deferral regimes of current law have failed to do much to eliminate this deferral privilege and yet have added great complexity to the tax system.

As my co-authors and I have vigorously argued elsewhere, it is time to seriously consider eliminating deferral altogether by imposing a pass-through regime on U.S. shareholders' ownership interests in foreign corporations, at least with respect to U.S. shareholders owning 10% or more of the stock of the foreign corporation.[22] If this proposal were adopted, the subpart F provisions of current law could be repealed, as well as the indirect credit provisions of § 902 and § 960. No indirect credit would be needed since 10-percent-or-more U.S. shareholders would pay current tax on their pro rata share of the foreign corporation's taxable income and would obtain a direct credit under § 901 for any foreign income taxes imposed on the foreign corporation's foreign-source income.[23]

VI. ALTERNATIVE MINIMUM TAX

One complicating feature of our income tax system generally, and the foreign tax credit provisions in particular, is the alternative minimum tax provisions. They create a second, complicated income tax system containing its own rules and rates, which stands side-by-side with the regular tax provisions. The existence of this alternative minimum tax system is an admission by Congress of its inability to design a regular tax system that accurately measures a taxpayer's net income. As persuasively argued by others, a strong case can be made for repeal of the alternative minimum tax provisions, particularly as they apply to individual taxpayers.[24]

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21. *See* HARRY GRUBERT & JOHN MUTTI, TAXING INTERNATIONAL BUSINESS INCOME: DIVIDEND EXEMPTION VERSUS THE CURRENT SYSTEM 12-13 (2001).

22. *See* Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 989-90 (1997); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, *An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral*, 20 TAX NOTES INT'L 547 (2000); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

23. *See, e.g.*, Peroni, *supra* note 22, at 990.

24. *See, e.g.*, Daniel Shaviro, *Tax Simplification and the Alternative Minimum Tax*, 91 TAX NOTES 1455 (2001); RECOMMENDATIONS, *supra* note 5, at 13-16 (recommending the repeal of both the individual and corporate alternative minimum tax provisions on the

The special provisions in the alternative minimum tax dealing with the foreign tax credit add complexity to the U.S. international tax system and are inconsistent with the policy underlying the foreign tax credit of mitigating international double taxation. The 90-percent limit on the foreign tax credit in § 59(a)(2) is arbitrary and results in the double taxation of a U.S. taxpayer's foreign-source income in contravention of the policy underlying the foreign tax credit provisions. It undercuts, rather than effectuates, the accurate measurement of a U.S. taxpayer's appropriate income tax liability. Accordingly, even if Congress decides not to repeal the individual and corporate alternative minimum tax provisions, § 59(a)(2) and the other special provisions in the alternative minimum tax provisions relating to a U.S. taxpayer's foreign tax credits[25] should be eliminated.[26]

VII. CONCLUSION

This brief article presents two main points. First, in the context of the foreign tax credit limitation provisions, as in other areas of the tax law, simplification cannot be undertaken without considering other tax policy objectives such as fairness and efficiency. Stated differently, international tax reform and international tax simplification are not synonymous. Thus, for example, the overall limitation may be the simplest type of foreign tax credit limitation (other than none at all); however, it is objectionable from an efficiency point of view because (as explained above) it distorts economic behavior by providing an incentive for taxpayers to make tax-motivated decisions concerning the geographical location of their business and investment activities. Repealing the basket limitations in § 904(d) and replacing them with an overall limitation might well achieve some element of tax simplification but only at the price of significant efficiency losses. Second, achieving reform and sensible simplification of the foreign tax credit provision requires work on the other defects in the U.S. international tax rules, such as the complex and largely ineffective anti-deferral rules of current law.

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grounds that they are complex and do not necessarily accurately measure a taxpayer's net income).

25. *See* I.R.C. § 59(a) (2002).

26. *See* Peroni, *supra* note 22, at 1001-02.