

Chapter **6****Tax Policy Evaluation****I. Overview**

This chapter assesses the extent to which the current U.S. foreign tax credit and related corporate income tax rules achieve five key objectives traditionally used by the Treasury Department to evaluate tax policy. These objectives, listed below, were elaborated when Treasury announced that it would undertake a comprehensive review of U.S. tax policy relating to the deferral of income earned by foreign subsidiaries (the “deferral study”), and were subsequently incorporated in the report released in December 2000 (the “Policy Study”):¹

- **Fairness.** Meet the revenue needs determined by Congress in a fair manner;
- **System costs.** Minimize compliance and administrative burdens;
- **Neutrality.** Minimize distortion by, and maintain neutrality of, tax considerations in the making of investment decisions;
- **Competitiveness.** Take due account of the competitiveness needs of U.S. multinational business; and

¹ See, DONALD C. LUBICK, TREASURY ASSISTANT SECRETARY OF TAX POLICY DONALD C. LUBICK REMARKS BEFORE THE GWU/IRS ANNUAL INSTITUTE ON CURRENT ISSUES IN INTERNATIONAL TAXATION, DEPARTMENT OF THE TREASURY, OFFICE OF PUBLIC AFFAIRS (Dec. 11, 1998) [hereinafter “Lubick”]; and U.S. DEPARTMENT OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY (December 2000) [hereinafter “Policy Study”]. The Policy Study does not view competitiveness as a “fundamental goal” of international tax policy, but instead states that “one should consider whether any policy option would place undue burdens on the competitive position of U.S. companies.” *Id.*, 82.

- **International norms.** Conform with international norms, to the extent possible.

A Treasury policy initiative, Notice 98-5,² is considered in VII., below, in light of these policy objectives.

In summary, we find the rationale for adding additional separate foreign tax credit limitation baskets in the 1986 Tax Reform Act has been eroded by the worldwide tax rate reductions that have subsequently occurred. Moreover, experience has shown that the complexity of the 1986 rules was vastly underestimated. Judged by the principles that Treasury has set forth for evaluating international tax systems, we conclude that the current foreign tax credit regime leaves much to be desired.

II. Fairness

The first policy goal set forth in Treasury's announcement of the deferral study was that the tax system should raise revenue fairly. This goal was identified as being of primary importance. Two tests for evaluating the fairness of the international tax rules were set forth:

- Is the tax burden divided fairly between domestic and foreign-source income?
- Is the tax burden divided fairly between business and wage income?

While no benchmarks were provided for establishing whether the U.S. international tax system meets these tests, Treasury emphasized that the credibility of the tax system rests on the perception of fairness, and that this must be judged by the "significant popular satisfaction of some significant majority."³

While one could poll the public about their satisfaction with U.S. rules for taxing foreign-source income, we instead choose to review the empirical evidence regarding Mr. Lubick's two fairness tests.

²1998-3 I.R.B. 49.

³ Lubick, *supra* note 1.

A. Division of Tax Burden between Domestic and Foreign Sources

A common perception is that the primary reason that U.S. companies operate abroad is to take advantage of low tax rates. Accordingly, it is widely believed, even by tax policymakers, that multinational corporations pay lower taxes than companies that do not operate globally.⁴

The perceived tax advantage of U.S. multinationals can be tested by measuring the effective tax rates paid by U.S. companies that have foreign operations with those paid by U.S. companies that do not have foreign operations (“domestics”). Comparisons of this type can be made using the information reported in U.S. companies’ audited financial statements. Financial statement information has two advantages over tax return information for this purpose: (1) the income of domestic and foreign operations is measured using a common set of accounting rules; and (2) it is publicly available.⁵

Douglas Shackelford and Julie Collins, accounting professors at the University of North Carolina, have compared tax payments of U.S. multinationals and U.S. domestics.⁶ In two separate studies covering the 1982–1991 and 1992–1997 periods, Collins and Shackelford use financial statement information to estimate average tax rates for multinationals and domestics. Over both the 1982–1991 and 1992–1997 periods, the authors find that U.S. multinational companies have faced a greater tax burden than U.S. domestics, controlling for industry and other factors.⁷ This is particularly true in the years following the Tax Reform Act of 1986. Over the 1992–1997 period, the authors estimate that U.S. multinationals paid 7.4 percent more net income in taxes than U.S. domestics, controlling for industry and other factors, up from a 4.4 percent additional tax burden during the 1982–1991 period.

⁴ See, for example, Stuart LeBlang, *International Double Taxation*, TAX NOTES 255-256 (July 13, 1998). LeBlang asserts that the data support the conclusion that “foreign investments of U.S. corporations, generally face lower taxes than purely domestic investments.” *Id.*, 256.

⁵ For U.S. tax purposes, companies measure foreign income using “earnings and profits” accounting rules that generally result in more taxable income than the accounting rules used to measure domestic taxable income.

⁶ Julie H. Collins and Douglas A. Shackelford, *Corporate Domicile and Average Effective Tax Rates: The Cases of Canada, Japan, the United Kingdom, and the United States*, INTERNATIONAL TAX AND PUBLIC FINANCE, Vol. 2, No. 1, 55-84 (1995); and JULIE H. COLLINS AND DOUGLAS A. SHACKELFORD, DID THE TAX COST OF CORPORATE DOMICILE CHANGE IN THE 1990s? A MULTINATIONAL ANALYSIS (mimeo, April 2000) [hereinafter “Collins & Shackelford”].

⁷ The authors regress a company’s average tax rate based on: (1) its country of incorporation; (2) an indicator of multinational operations; (3) industry; (4) a categorical variable indicating whether the company’s income statement is unconsolidated; and (5) a categorical variable indicating whether the company’s financial statement is restated in accordance with Generally Accepted Accounting Principles (GAAP).

These findings imply that, on average, U.S. multinationals paid 37 percent more of their pre-tax net income in taxes than domestic-only U.S. corporations during the 1992–1997 period.⁸ The multinational tax “penalty” is particularly high for the mining, construction, finance, insurance and real estate industries, where multinationals’ tax rates on average exceeded those of U.S. domestic-only companies by more than 12 percentage points.

Shackelford and Collins have also reviewed the economics literature to determine whether empirical analysis supports the view that foreign investments of U.S. corporations face lower income tax burdens than purely domestic investments.⁹ While there is empirical evidence that multinational corporations engage in tax planning activities designed to reduce their overall tax burden, Shackelford and Collins find insufficient empirical evidence to support the view that cross-border investment is taxed advantageously compared with domestic-only activity.

In December 2000, Treasury released its Policy Study on the deferral of income earned through controlled foreign corporations.¹⁰ The Policy Study suggests that the foreign income of U.S. multinationals is taxed at a lower rate than income earned in the United States.¹¹

In 1996, the average foreign tax rate on such U.S. overseas operations was 10 percentage points below the average U.S. tax rate on similar domestic investment (21 percent versus 31 percent).

The Policy Study conclusion is based on a comparison of items 2 and 4 in the following table:

⁸ Collins & Shackelford, *supra* note 6, 11.

⁹ Julie H. Collins and Douglas A. Shackelford, *Taxes and Cross-Border Investments: The Empirical Evidence*, AMERICAN ENTERPRISE INSTITUTE, SEMINAR SERIES IN TAX POLICY (February 19, 1999).

¹⁰ See Policy Study, *supra* note 1.

¹¹ *Id.*, 57.

Tax Rate Calculations in Policy Study	
Item	Tax rate (percent)
1. Foreign income taxes paid or accrued as a percentage of foreign earnings and profits for foreign manufacturing subsidiaries (1994 tax return information for foreign subsidiaries with 10 percent or greater U.S. ownership)	21
2. Foreign income taxes paid or accrued as a percentage of foreign earnings and profits for foreign manufacturing subsidiaries with positive earnings (1996 tax return information for foreign subsidiaries with 10 percent or greater U.S. ownership)	21
3. Total tax on foreign-source income of U.S. manufacturing companies, including foreign income and withholding taxes and U.S. federal income tax, but excluding state income tax (1994 tax return information)	26.4
4. U.S. federal and state income tax rate on domestic income of U.S. manufacturing companies (1996 financial statement information)	31
5. U.S. federal income tax rate on domestic income of U.S. manufacturing companies (1996 financial statement information)	27
<small>Source: OFFICE OF TAX POLICY, U.S. DEPT. OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY (December 2000).</small>	

While this analysis makes it appear that the foreign income of U.S. companies is more lightly taxed than domestic income, the comparison is misleading for two reasons.

First, the tax rate on foreign operations does not include all taxes paid by U.S. multinationals with respect to this income; foreign withholding taxes and U.S. income taxes are excluded. When foreign withholding and U.S. federal income taxes are included, Treasury calculates that the total tax rate on foreign-source income of U.S. manufacturing companies is 26.4 percent (item 3 in table).

Second, the tax rate on the domestic income of U.S. manufacturers includes both federal and state income taxes, while the tax rate on foreign-source income excludes state income taxes. For comparability, the relevant figure is the federal income tax rate on domestic income, which is 27 percent according to Treasury calculations (item 5 in table).

Thus, Treasury's own calculations show that the average rate of tax on the foreign-source income of U.S. manufacturing companies (26.4 percent) is almost identical to the average rate of tax on the U.S.-source income of U.S. manufacturing companies (27 percent), where both tax rates are computed net of state income taxes.

Thus, if fairness is determined according to whether the foreign income of U.S. companies bears the same tax burden as their domestic income, then multinationals must be judged to pay their fair share (based on the Policy Study) or more than their fair share (based on the Collins-Shackelford study).

B. Division of Tax Burden between Business and Wage Income

Some tax policy analysts, both in the United States and abroad, have expressed concern that the corporate income tax base is eroding over time, with the potential result that labor income will ultimately bear an unfair share of the income tax burden.¹²

One threshold observation is that corporate income in the United States is subject to double taxation—both at the corporate level and at the shareholder level on the receipt of dividends.¹³ By contrast, labor income is taxed once (indeed, some employer-provided fringe benefits are tax-free).¹⁴ For a shareholder in the top income tax bracket, the total tax on corporate dividends is 60.74 percent, equal to the 35 percent corporate tax, plus the 39.6 percent top individual income tax rate applied to the 65 percent of corporate income available to distribute after corporate income tax.¹⁵ Thus, for a shareholder in the top income tax bracket, the total tax on corporate dividends is more than 50 percent higher than the tax on labor

¹² While corporate income taxes reduce profits available for distribution to shareholders, there is considerable uncertainty regarding how much of the corporate tax burden is borne by shareholders as compared to workers, consumers and owners of capital generally.

¹³ Unlike dividends paid by subchapter C corporations, dividends paid by subchapter S corporations generally are not subject to double taxation. Because of the various restrictions imposed on subchapter S corporations, the overwhelming majority of U.S. corporate assets and revenues are derived from C corporations.

¹⁴ It should be noted that the U.S. tax system also includes payroll and excise taxes, estate and gift taxes, and customs duties. The fairness standard articulated by Treasury Assistant Secretary Lubick appears to be limited to *income* taxes.

¹⁵ For the sake of simplicity, this calculation is based on a taxpayer that is not subject to the alternative minimum tax or to the various income-based phase-outs in the Code (e.g., the phase-out of personal exemptions and itemized deductions) that have the effect of increasing the marginal income tax rate. For purposes of this analysis, taxable income is assumed to be equal to "economic" income. In practice, taxable income may be higher or lower than economic income for a variety of reasons. For example, accelerated depreciation lowers taxable income relative to economic income, but this may be offset by the failure to index depreciation for inflation.

income (60.74 percent versus 39.6 percent). The over-taxation of corporate income, compared to labor income, is relatively greater for shareholders in lower income tax brackets (see Table 6.1).

Similarly, corporate income that is retained, rather than distributed, is subject to a second tax when shares are sold or exchanged. Lower capital gains rates apply to disposals of shares held for more than one year. For a shareholder in the top income tax bracket, the total tax on corporate income realized through the sale of shares is 48 percent, equal to the sum of the 35 percent corporate income tax rate plus the 20 percent rate on long-term capital gains applied to the 65 percent of corporate income remaining after corporate income tax. Thus, for a shareholder in the top income tax bracket, the total tax on retained corporate income is more than 20 percent higher than the rate on labor income (48 percent versus 39.6 percent).¹⁶ Again, the over-taxation of corporate income, compared to labor income, is relatively greater for shareholders in lower income tax brackets (see Table 6.1).

Thus, if fairness is determined according to whether corporate income bears the same tax burden as labor income, then current law must be judged unfair to corporate income, because income earned through corporations is subject to double taxation. As of 1996, the United States was the only G-7 country, and the only OECD country other than Switzerland and the Netherlands, that did not provide some form of relief from the double taxation of corporate dividends (see Table 6.2).

At a more fundamental level, judging the fairness of the tax system by the distribution of the burden between labor and capital income has no well-articulated rationale. Advocates of consumption-based taxation argue that a fair tax system is one that taxes income used for consumption and exempts income used for investment purposes. This principle was articulated by Hobbes who argued that taxation should be based on what is removed from the economy, not what is productively invested in the economy.¹⁷

By contrast, advocates of income-based taxation argue that the best measure of ability to pay tax is an individual's income from all sources. Under this standard, fairness can be achieved only if ultimate income tax liability is determined at the shareholder level. Thus, under the pure

¹⁶ The effective tax rate on retained earnings may be higher because the basis for measuring capital gains is not indexed for inflation, and may be lower because the tax on capital gains is deferred until shares are sold (or constructively sold). Shares that are held to death are not subject to capital gains tax but may be subject to the estate and gift tax at rates of up to 55 percent.

¹⁷ See, HOBBS, *LEVIATHAN*, Ch. xxx, "what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idly, getteth little and spendeth all he gets."

application of *either standard* of taxation—consumption or income—there is no fairness rationale for a separate tax on corporate income that is not integrated with the individual income tax system.

C. Summary

This section evaluates current law using the two objective standards of fairness set forth in Treasury's announcement of the deferral study: (1) is the tax burden divided fairly between domestic and foreign-source income? and (2) is the tax burden divided fairly between business and wage income? We conclude that the corporate income tax system fails the second fairness test because income earned through corporations is subject to double taxation. The treatment of foreign-source corporate income scores poorly on the first fairness test because U.S. multinationals pay a higher share of their income in taxes than do U.S. companies without international operations.

III. System Costs

The burden of the corporate income tax consists not only of the taxes paid, but also of the costs that taxpayers incur in complying with the income tax and that government incurs in administering the tax. For a corporation, these costs typically include both the internal costs associated with operating its tax department (employee compensation, data processing, overhead, etc.) and payments to external tax advisors. Costs are incurred in complying with federal, state and local, and foreign countries' income taxes, as well as various other types of taxes such as payroll, sales and excise, and property taxes. In aggregate, the costs of tax compliance represent a substantial hidden tax burden on taxpayers.

A complex tax system also is expensive for tax authorities to administer. These costs of administration are financed by government revenues, with the result that high costs of tax administration ultimately require higher taxes (or lower government services). In this sense, the costs of government tax administration represent another hidden tax burden. Tax simplification is an important public policy objective because simpler taxes reduce the economic resources that must be devoted to tax compliance and administration, leaving more resources available to produce goods and services that are valued by consumers.

A. Blumenthal-Slemrod Study

Judged by the standard of low compliance costs, the U.S. rules for taxing foreign-source income do not fare very well according to a study by Profs. Marsha Blumenthal and Joel Slemrod.¹⁸ In 1989, the University

of Michigan Office of Tax Policy Research surveyed 365 firms in the IRS Coordinated Examination Program (CEP). Based on the survey, Blumenthal and Slemrod analyzed the costs to corporations of complying with U.S. tax rules, and separated these costs between domestic and foreign-source income.

Limiting the sample to Fortune 500 firms, the authors found that 43.7 percent of federal income tax compliance costs are attributable to foreign-source income, while foreign operations represent only 27.8 percent of assets, 30.1 percent of sales and 26.2 percent of employment. For the Fortune 500 sample, the federal corporate income tax compliance costs are between 57 percent and 67 percent higher for foreign than domestic-source income.

For the entire CEP sample, the authors found that 39.2 percent of federal income tax compliance costs are attributable to foreign-source income, while foreign operations represent only 21.1 percent of assets, 24.1 percent of sales and 17.7 percent of employment. Compared with domestic income, these statistics indicate that the cost of complying with federal income taxes on foreign income are grossly disproportionate—ranging from 86 percent to 121 percent more expense per dollar of assets, per dollar of sales or per employee.¹⁹ These statistics suggest that the costs of calculating U.S. tax on foreign-source income are especially daunting for small firms.

The information collected in the CEP survey did not allow the authors to calculate compliance costs as a percentage of federal tax revenues from foreign-source income. However, based on a 1993 survey of 17 very large multinational corporations, the authors found that compliance costs associated with foreign-source income amounted to 8.5 percent of the federal income tax collected from this source. We would expect that compliance costs would be an even larger share of U.S. tax revenues from foreign sources in the case of smaller companies. Moreover, these statistics do not take into account the additional government resources for tax administration necessitated by the complexity of U.S. rules relating to foreign-source income.

¹⁸ Marsha Blumenthal and Joel Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications*, INTERNATIONAL TAX AND PUBLIC FINANCE, Vol. 2, No. 1, 37-54 (1995).

¹⁹ The authors used multiple regression analysis to isolate the effect of foreign operations on compliance costs, holding worldwide size constant. Measuring foreign presence as the fraction of assets, sales or employment abroad, the estimated coefficient on the foreign presence fraction is positive, indicating that the U.S. tax compliance costs of foreign operations are higher than those of domestic operations. For example, for a firm of a given worldwide size as measured by employment, an increase in the proportion of employees abroad of 10 percentage points is associated with a 6.5 percent increase in compliance costs.

The high costs of complying with the rules regarding the taxation of foreign-source income represent a drag on the economy, but also point to an opportunity to achieve significant cost reductions. To explore promising directions for policy reform, Blumenthal and Slemrod asked survey respondents to indicate suggestions for reducing compliance costs. Of those answers related to foreign-source income, simplification of the foreign tax credit and of the reporting of controlled foreign corporation activity dominated. In the smaller survey of 17 very large multinationals, the most frequently cited simplification measure was to use financial statement income (measured under generally accepted accounting principles) to determine earnings and profits of foreign affiliates.

B. American Law Institute Study²⁰

The 1987 American Law Institute Study on U.S. international tax reform (the “ALI Study—see Chapter 4, above) comments that “[a]chieving all of the policy objectives that might be pursued in formulating the foreign tax credit limitation rules would push the system to a degree of complexity the taxpayer would find it difficult or impossible to comply with and that the Internal Revenue Service would be incapable of administering.”²¹ The ALI Study recommends that foreign tax credit limitation rules be adopted one-by-one, beginning with the most important from a policy perspective. “This process should continue until it reaches the point at which additional complexity would overwhelm the system, and there the elaboration of rules should stop.”²²

Many international tax practitioners believe that the foreign tax credit limitation regime adopted in 1986 is far too complex and is an appropriate area on which to focus international tax reform efforts. For example, David Tillinghast, the reporter for the ALI Study, has observed that “[c]ertainly the place to start in simplifying the foreign tax credit is at the point of its greatest complexity—the multiple limitation baskets.”²³ Similarly, in an article on tax reform, former IRS Associate Chief Counsel (International) Kevin Dolan stated that “[o]ne of the areas singled out as illustrative of this untenable complexity is the foreign tax credit area, particularly the for-

²⁰ American Law Institute, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION (1987) [hereinafter “ALI Study”]

²¹ *Id.*, 332.

²² *Id.*

²³ D. Tillinghast, *International Tax Simplification*, 8 AMERICAN J. TAX POLICY 187, 215 (1990) [hereinafter “Tillinghast”].

eign tax credit limitation under §904(d) as revised by the Tax Reform Act of 1986.”²⁴

It would have been difficult for the 1986 Act’s drafters to anticipate the full system costs of the Act’s foreign tax credit limitation regime. Fifteen years of experience applying the 1986 Act rules, however, enables taxpayers and government policymakers today to identify those rules that cause the greatest system cost for the least tax policy payoff. Tillinghast has applied the approach of the ALI Study described above, *i.e.*, balancing the complexity of a particular foreign tax credit limitation rule against the policy benefits thereof—to the current foreign tax credit limitation regime and suggested the following simplifications:

- **Passive basket high-tax kick-out.** Tillinghast suggests the high-tax kick-out in section 904(d)(2)(F) of the Code be repealed. In his view, the kick-out “creates enormous complexity.” Its premise—that taxpayers have high-taxed passive income with which they can shelter low-taxed passive income from U.S. tax—seems flawed because taxpayers have little incentive to generate high-taxed passive income. Further, Tillinghast suggests that the back-to-back loan strategy,²⁵ which the legislative history cites as the sole rationale for the high-tax kick-out’s enactment, cannot be widespread, and can be handled instead with a general anti-abuse rule.²⁶ Such an anti-abuse rule is already in the Code (at section 904(d)(6)(B)), having been adopted by the Senate in 1986 as an alternative to the high-tax kick-out and then retained in conference. Dolan, who supervised the drafting of the IRS regulations interpreting the high-tax kick-out, calls the kick-out “[p]erhaps the single greatest source of complexity in section 904(d)”²⁷ and suggests several possible alternatives to address Congress’s concerns.²⁸
- **Separate limitation for high withholding tax interest.** Tillinghast recommends repeal of this separate limitation for several reasons. First, for portfolio investors (as opposed to financial institutions) the 5 percent and higher withholding rates triggering the limitation’s application do not appear to produce excess credits, because portfolio investors typically are not leveraged to the same extent as financial institutions. Second, it is not clear why the averaging of high and low tax rates by

²⁴ K. Dolan and C. DuPuy, *The Future of the Foreign Tax Credit—Some Preliminary Observations for Reform*, 8 TAX MGT INT’L J. 487 (December 8, 1989) [hereinafter “Dolan & DuPuy”].

²⁵ STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 99TH CONG., 2D SESS. 879-880 (1987) [hereinafter “1986 Bluebook”].

²⁶ Tillinghast, *supra* note 23, 220-221.

²⁷ Dolan & DuPuy, *supra* note 24, 492.

²⁸ *Id.*, 494-495.

financial institutions is uniquely inappropriate since such averaging is permitted in other industries. Third, withholding taxes of 5 percent or higher are routinely imposed on other types of income that have not been singled out for a separate limitation.²⁹

- **Separate limitations for passive, Domestic International Sales Corporation (DISC), Foreign Sales Corporation (FSC), and shipping income.** Tillinghast suggests collapsing into a single separate limitation some or all of the separate limitations applicable to what is generally low-taxed income (*i.e.*, passive income, shipping income, and distributions from DISCs and FSCs). Provided none of these separate limitations contains significant high-taxed income, little incentive to place marginal investments overseas should result from such a simplification. Tillinghast says that “it seem highly unlikely that a taxpayer would go out of his way to create highly taxed income in these categories—voluntarily to subject a FSC, for example, to substantial foreign taxes (which would completely destroy the purpose of the special purpose corporation).”³⁰ Tillinghast, however, reserves judgment on consolidating the separate limitation for shipping income with the other separate limitations affecting low-taxed income.
- **Section 907.** Like the ALI Study,³¹ Tillinghast questions the continuing need for the section 907 limitation on the creditability of foreign taxes imposed on oil and gas extraction income. Section 907 essentially was enacted to distinguish royalty payments from income taxes so that a foreign tax credit would be allowed only for the latter. However, Tillinghast notes that the 1983 foreign tax credit regulations (Reg. § 1.901-2A) now in place distinguish royalty payments from income taxes independently from section 907, making it “at least highly questionable whether the additional complexity of section 907(a) segregation is necessary.”³² If the general income tax rate in a foreign country on all activities, oil and gas activities included, is high, and all other requirements are met, the 1983 regulations treat the full amount of the levy as a tax rather than a royalty, though the

²⁹ Tillinghast, *supra* note 23, 222-223 and 229-230. The “abuse” that apparently motivated adoption of the high-withholding tax interest basket involved sovereign debt, where the borrower is indifferent to the rate of withholding tax (because the borrower is also the recipient of the tax revenue). This particular concern could have been addressed through a much more narrowly crafted anti-abuse rule.

³⁰ *Id.*, 230-231.

³¹ ALI Study, *supra* note 20, 340.

³² Tillinghast, *supra* note 23, 227-228.

foreign tax rate exceeds the highest U.S. tax rate.³³ Section 907(a), by contrast, disallows as credits any foreign taxes paid by an extraction company that are in excess of the highest U.S. rate. It seems inappropriate to disallow credits claimed by extraction companies in excess of the U.S. rate in such situations because companies in other industries paying the same high foreign tax rate face no such disallowance.

IV. Neutrality

A. Background

A neutral tax system is one in which investment decisions are made in the same way that they would be made in the absence of taxes. In an international context, this principle is referred to as “capital export neutrality”. Under a capital export neutral tax system, investments made outside the investor’s home country would bear tax at the home country rate. By contrast, the principle of competitiveness requires that all investments made in the same country be subject to the same amount of tax, regardless of where the investor is resident. When countries impose different tax rates, cross-border investment cannot simultaneously be subject to neutral taxation (taxed at the home country rate) and competitive taxation (taxed at the host country rate).³⁴

Because the principles of neutrality and competitiveness conflict in a world where countries have unequal tax rates, policymakers must strike a balance between these principles. If the neutrality principle is adopted, foreign investment must bear the same rate of tax as home country investment. As a practical matter, this would require current taxation of foreign-source income (whether or not remitted) and an *unlimited* credit for foreign taxes.³⁵ By contrast, if the competitiveness principle is adopted, foreign investment must bear the same rate of tax as host country investment. As a practical matter, this would require the home country to

³³ This reflects the sound judgment that, to the extent all taxpayers, including those in industries not receiving a specific economic benefit from the levying country, pay a high tax, no portion of that tax is a royalty.

³⁴ See, JOINT COMMITTEE ON TAXATION, FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES, JCS-6-91, 245 (May 30, 1991).

³⁵ As noted in THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY; PART ONE: A RECONSIDERATION OF SUBPART F (March 25, 1999) [hereinafter “NFTC Subpart F Report”], neutral treatment also would require imposition of a U.S. corporate level tax, on an accrual basis, on income earned by U.S. individual and institutional investors from portfolio investments in foreign corporations. This has become a far more important, though frequently overlooked, aspect of capital export neutrality because foreign portfolio investment flowing out of the United States is about twice as large as foreign direct investment.

exempt foreign-source income. As of 1999, about half of the 29 OECD member countries taxed income on a worldwide basis, while the other countries generally exempted active foreign business income from home country taxation, either by statute, by treaty, or in the case of listed countries (see Table 6.3).

B. Foreign Tax Credit Limitation

The Treasury Department has a long history of favoring neutrality over competitiveness in the formation of international tax policy, although the current system is a hybrid. This policy direction is clear from: (1) the Kennedy Administration's 1962 proposal to tax undistributed foreign income of U.S.-controlled foreign corporations, which was the genesis of the Subpart F anti-deferral rules; (2) the rejection of territorial income tax systems in major tax reform studies published in the Carter and Reagan Administrations;³⁶ and (3) the Policy Study released by the Clinton Administration in December 2000.

In view of the deference accorded to the capital export neutrality principle, it is perhaps surprising that the United States allowed an unlimited foreign tax credit only during the first three years of the foreign tax credit's existence (1918-21). Since 1921, the United States has experimented with various systems for limiting the foreign tax credit including: the overall limitation; the per-country limitation; the lesser of the overall and per-country limitations; election by the taxpayer of either the overall or per-country limitation; and the current system of per-category limitations.

The current foreign tax credit limitation is inconsistent with both the principles of neutrality and competitiveness, so it must be justified on other grounds. According to the Treasury Department in 1985, the reason for having any limitation at all is twofold: (1) to protect the domestic tax base (*i.e.*, revenues from the taxation of U.S.-source income); and (2) to discourage foreign governments from raising taxes on U.S. investors to exploit the U.S. Treasury.³⁷

While there is some appeal to the notion that the credit for foreign taxes should not exceed U.S. tax on foreign-source income (thereby protecting the domestic tax base), not all tax credits are "basketed" in this manner. For example, the research tax credit is not limited to U.S. tax on

³⁶ See U.S. TREASURY DEPARTMENT, BLUEPRINTS FOR BASIC TAX REFORM (January 17, 1977) and U.S. TREASURY DEPARTMENT, TAX REFORM PROPOSALS FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH (November 1984).

³⁷ See THE WHITE HOUSE, THE PRESIDENT'S PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY 387 (May 1985) [hereinafter "White House"].

income attributable to qualifying research expenditures. Of course, an exemption system for foreign-source income could also achieve this goal with less complexity.

The second rationale offered by the Treasury Department in 1985 for the foreign tax credit limitation (*i.e.*, to prevent foreign governments from “raiding” the U.S. Treasury by raising income taxes on U.S. investors) can be questioned because the United States specifically does not permit a foreign tax credit for “soak-up” taxes.³⁸ A “soak-up” tax is an income tax that is targeted at U.S. investors and is excessive in comparison to the generally applicable income tax rate. As a result of this rule, a foreign government must impose high income tax rates on all investors for U.S. investors to be able to credit the tax. Because many countries have foreign dividend exemption systems (that do not provide a credit for foreign income taxes), a host country that maintains high income tax rates will risk losing investment from investors resident in such countries. (Of course, it will also risk the wrath of locally-owned companies.)

Moreover, even with an unlimited foreign tax credit, many U.S. investors would prefer to invest in countries with low corporate income tax rates to maximize the amount of income available for reinvestment abroad.³⁹ Further, the importance of the United States as a source of foreign direct investment has declined very substantially during the last three decades, from over 50 percent in 1967 to 25 percent in 1996.⁴⁰ Consequently, the risk that an unlimited U.S. foreign tax credit would lead host countries to increase their generally applicable corporate income tax rates is likely overstated.

1. What Type of Foreign Tax Credit Limitation Is Most Consistent with Neutrality?

Although the principal of capital export neutrality is consistent with an unlimited foreign tax credit, U.S. tax law has contained some type of foreign tax credit limitation system since 1921. Because policymakers are unlikely to repeal the foreign tax credit limitation system, this section addresses what type of limitation system is *least inefficient*. The credit for foreign taxes can be limited to U.S. tax on foreign-source income determined on a per-category,

³⁸ Treas. Reg. § 1.901-2(c).

³⁹ Under current law, active foreign income that is reinvested abroad in an active business generally is not subject to U.S. tax until remitted to the United States. See NFTC Subpart F Report, *supra* note 35.

⁴⁰ Measured as a percentage of the worldwide stock of outward foreign direct investment. See NFTC Subpart F Report, *supra* note 35, Chapter 5.

a per-country or an overall basis, and each of these alternatives has different implications for the allocation of investment.

Immediately prior to the Tax Reform Act of 1986, the overall limitation method generally was followed, with separate categories for certain tax-favored export promotion entities, oil and gas extraction income, and certain passive interest income. Before that, various permutations and combinations of the per-country and overall limitation were utilized.

In 1985, President Reagan proposed restoration of a per-country limitation for foreign income not subject to one of the existing special limitation categories. The main rationale for the President's per-country limitation proposal was economic efficiency:

“... the averaging permitted by an overall limitation gives taxpayers with operations in a high tax country an incentive to invest in low tax countries. For a taxpayer with excess foreign tax credits, low tax country investments may be more attractive than investments in the United States that generate a higher pre-tax economic return simply because of the possibility of using the excess credits to offset a portion of the U.S. tax otherwise due.”⁴¹

In adopting several new foreign tax credit limitation categories in the 1986 Act, Congress was similarly concerned about efficiency. Congress believed that the Act's reduced income tax rates would increase excess foreign tax credits substantially, which would encourage taxpayers to make marginal investments in low-tax foreign jurisdictions.

In theory, the potential for the overall foreign tax credit limitation to distort investment decisions could have been addressed simply by repealing the foreign tax credit limitation. It is the imposition of *any* foreign tax credit limitation that violates the principle of capital export neutrality. However, because some type of foreign tax credit limitation is likely to be retained as long as the United States continues to tax worldwide income, a key economic question is whether the imposition of *multiple* foreign tax credit limitations actually increases the efficiency of capital allocation (as suggested by the Reagan Administration's Treasury Department).

⁴¹ White House, *supra* note 37, 387.

2. Lyon-Haag Model

In a recent paper, Prof. Andrew Lyon and Matthew Haag seek to determine whether a system of multiple foreign tax credit limitations is less inefficient than an overall limitation.⁴² The authors develop a simplified model to answer this question. In their model, a perfectly competitive firm allocates a fixed amount of equity capital between two foreign countries to maximize its after-tax return. These are the standard assumptions that economists traditionally have used to demonstrate the economic efficiency of capital export neutral tax systems.⁴³ The home country taxes worldwide income and allows a foreign tax credit.⁴⁴ As a further simplification, the home and host country definitions of foreign-source income are taken to be identical, income within each country is taxed uniformly at the same rate, and there are no withholding taxes.

Initially, the authors consider a one-period model where all foreign income is taxed at the end of the period. Using the model, the authors compare the allocation of capital between the two foreign countries by an investor subject to an overall foreign tax credit limitation versus a per country limitation. The model's methodology and conclusions apply generally to any multiple limitation system, not just the per-country limitation, provided that income in each limitation category is taxed uniformly. The objective of this analysis is to determine which limitation method results in the highest level of production (*i.e.*, is relatively most efficient). The results of the model are as follows:⁴⁵

⁴² Andrew B. Lyon and Mathew Haag, *Optimality of the Foreign Tax Credit System: Separate vs. Overall Limitations*, INTERNATIONAL TAX POLICY FORUM, Mimeo (UNIVERSITY OF MARYLAND AT COLLEGE PARK) [[HTTP://WWW.BSOS.UMD.EDU/ECON/LYON](http://www.bsos.umd.edu/econ/lyon)] AND ANDREW B. LYON AND MATHEW HAAG, CAPITAL EXPORT NEUTRALITY AND THE OPTIMAL FOREIGN TAX CREDIT SYSTEM, NATIONAL TAX ASSOCIATION, PROCEEDINGS OF THE NINETY-THIRD ANNUAL CONFERENCE (2000).

⁴³ For a critique of these assumptions, see Michael P. Devereux and Glenn Hubbard, *Taxing Multinationals*, AMERICAN ENTERPRISE INSTITUTE, SEMINAR SERIES IN TAX POLICY (1999) (also published as National Bureau of Economic Research Working Paper No. 7920, September 2000).

⁴⁴ In this model, the foreign tax credit cannot be carried forward or back to other years.

⁴⁵ The model can also be applied to cases where the investor has pre-existing foreign investments. In cases where the domestic tax rate lies between the foreign tax rates, historic investment in high-tax countries increases the investor's likelihood of being in an excess credit position under the overall limitation, so the per-country limitation will tend to be more efficient. Conversely, the overall limitation tends to be most efficient for investors with historic investments in low-tax countries.

- If both of the foreign countries' tax rates are less than the home country rate, or both of the foreign countries' tax rates are greater than the home country rate, then the per-country and overall limitations are *equally* efficient.⁴⁶
- Otherwise, the *overall* limitation is preferable if the taxpayer would have relatively few or no excess credits, at the efficient allocation of investment among countries; if not, the *per-country* limitation is preferable.

These results are summarized in the following table:

Case	Foreign tax credit limitation system		More efficient limitation system
	Overall	Per-country	
1. Both foreign tax rates less than U.S. rate	Capital export neutral	Capital export neutral	Equivalent
2. Both foreign tax rates above U.S. rate	Inefficient	Inefficient	Equivalent
3. U.S. rate between foreign tax rates and:			
a. No excess credits at efficient investment allocation under overall limitation	Capital export neutral	Inefficient	Overall
b. Few excess credits at efficient investment allocation under overall limitation	Inefficient	Inefficient	Overall
c. Deep excess credits at efficient investment allocation under overall limitation	Inefficient	Inefficient	Per country

⁴⁶ In generalizing the model to a per-item or per-category of income limitation, the relevant foreign tax rates are those applicable to the respective items or categories of income.

The first result can be explained as follows. When all foreign income is taxed at or above the U.S. rate, the marginal tax rate on foreign investment is the foreign countries' rate under both the overall and per-country limitations. By contrast, where all foreign income is taxed below the U.S. rate, the marginal tax rate on foreign investment is the U.S. rate under both the overall and per-country limitations. In both cases, the overall and per-country limitations are equally efficient because the tax incentives for investment are the same.⁴⁷

The second result can be understood as follows. If, under the overall limitation, the investor would not have excess credits when foreign investment is allocated efficiently (*i.e.*, without regard to tax considerations), then the overall limitation achieves capital export neutrality—foreign and domestic investments both are taxed at the home country rate. By contrast, the *per-country* limitation is *not* capital export neutral in this case because it creates a tax incentive to shift investment from the high-tax to the low-tax country. That is, by *creating* excess credit categories of income where none would otherwise exist (under an overall limitation method), multiple limitation systems discourage investment that would otherwise occur in high-tax foreign activities and promote excess investment in low-tax foreign activities.

In the opposite case, where the investor would have excess credits under an overall limitation, *both* the overall and per-country limitations are *inefficient* because there is a tax incentive to shift investment from the high-tax to the low-tax jurisdiction. Which limitation system is *least* inefficient depends on how deeply in excess credits the investor would be, at the efficient allocation.⁴⁸ If the investor would have relatively few excess credits under the overall limitation, then only a small re-allocation of investment from the high-tax to the low-tax country would occur under the overall limitation, because excess credits are quickly eliminated (and once eliminated, the investor has no further incentive to allocate investment to the low-tax country). In this case, the overall limitation dominates, because it is less inefficient than the per-country limitation. However, if there are deep excess credits under the overall limitation, the investor will re-allocate more investment from the high-tax to the low-tax

⁴⁷ If the tax rate in both foreign countries is identical and greater than the home country tax rate, the per-country and overall limitation methods are both capital export neutral because the model only allows substitution of investment between *foreign* countries (and *not* between foreign countries and the home country)

⁴⁸ The higher the weighted average foreign tax rate is compared to the home country rate, the greater the excess credit position.

country under the overall limitation than would be the case under the per-country limitation, so the latter system is less inefficient.⁴⁹

The authors also present a more complicated two-period model in which the taxpayer optimally reallocates investment after the end of the first period and taxation of undistributed income is deferred to the end of the second period. The conclusions from the two-period model are very similar to those from the one-period model. However, the ability to defer home country taxation of foreign income from the first to the second period generally means that the overall limitation will no longer achieve perfect capital export neutrality even where the taxpayer would not have excess credits.

3. Policy Implications

The preceding analysis shows that the claim made in the President's 1985 Tax Reform Proposal that a per-country foreign tax limitation is more efficient than an overall limitation is not necessarily correct. The overall limitation may be *more or less* efficient than the per-country limitation for a given taxpayer depending on that taxpayer's pattern of foreign investment. The more the average foreign rate of tax exceeds the U.S. tax rate (with some foreign countries having tax rates below the U.S. rate and other with rates in excess of the U.S. rate), the greater the likelihood the per-country limitation will be more efficient than the overall limitation. This generally was the situation when Congress added multiple new limitations in 1986. Conversely, as the average foreign tax rate falls below the U.S. rate, the greater the likelihood the overall limitation will be more efficient than multiple limitation systems.

While the U.S. corporate income tax rate was low compared to the rates of other countries immediately after the Tax Reform Act of 1986, this is no longer the case as a result of substantial corporate tax reductions abroad. The unweighted average of corporate income tax rates in the OECD countries was 32 percent in 1995—less than the 35 percent U.S. corporate income tax rate (see Table 6.4). Subsequent tax rate cuts in Canada, Germany and the United Kingdom, among other countries, have likely lowered the average OECD statutory corporate tax rate relative to the U.S. rate.

⁴⁹ This can be explained as follows: under the per-country limitation, the effective tax rate on investment in the low-tax country (*i.e.*, tax rate below the home country's rate) is the home country's tax rate. Under the overall limitation, when the investor has deep excess credits, at the efficient allocation, the effective tax rate on investment in the low-tax country is the (lower) foreign country's tax rate (because home country tax on income from the low-tax country is shielded by excess foreign tax credits from the high-tax country). Thus, the marginal incentive to invest in the low-tax country is greater under the overall limitation system as long as excess credits are not "used up" as a result of the investment reallocation.

Consistent with this decline in foreign tax rates, the proportion of income reported for purposes of the U.S. foreign tax credit (Form 1118) that is in limitation categories for which the taxpayer had excess foreign tax credits dropped from 57.3 percent in 1990 to 39.9 percent in 1996 (see Table 6.9). Disregarding foreign tax credit carryovers (which reflect foreign taxes paid with respect to prior year distributions), only 14.1 percent of income reported for foreign tax credit purposes was in excess credit “baskets” in 1996.

According to 1994 IRS data, for large U.S.-controlled foreign corporations, the weighted average foreign income tax rate (including income taxes imposed by subnational governments), for companies reporting positive foreign earnings and profits, was 19.8 percent of earnings and profits (see Table 6.5).⁵⁰ Based on 1996 data, the Policy Study found that the average foreign tax rate on foreign earnings and profits was 21 percent.⁵¹ This is considerably less than the 35 percent U.S. statutory tax rate and Treasury’s estimate of the average federal income tax rate on the domestic income of U.S. manufacturing companies according to financial statement data (27 percent).⁵²

Thus, the sharp decline in foreign corporate income tax rates relative to the U.S. tax rate since 1986 suggests that the *overall* foreign tax credit limitation may now lead to a *more* efficient allocation of investment than a multiple-limitation system. Moreover, in the current environment, adding new foreign tax credit limitations, such as a per-country system, would likely move the tax system *away* from the standard of capital export neutrality.

C. Expense Allocation and Apportionment

To limit the credit for foreign income taxes to the applicable U.S. tax on *foreign* income, it is necessary to have rules that divide gross income and associated expenses between U.S. and foreign sources.⁵³ As discussed in previous chapters, the U.S. rules for allocating and apportioning income and expense between U.S. and foreign sources are highly elaborated.⁵⁴

⁵⁰ Based on information from Form 5471 filed by the 7,500 largest U.S.-controlled foreign corporations for parent companies with tax years ending after June 30, 1994 and before July 1, 1995. It should be noted this data includes earnings of controlled foreign corporations (CFCs) whether or not this income is subject to current U.S. tax. The data excludes foreign withholding taxes on payments of dividends, interest, rents, royalties, etc., which increase the effective rate of foreign tax on U.S. investments abroad.

⁵¹ Policy Study, *supra* note 1, 57.

⁵² See Table in IIA. of this chapter (“Tax rate Calculations in Policy Study”) for details.

⁵³ Foreign tax credit limitation systems with multiple categories of income, such as the current system, also require foreign income to be divided among the various income categories.

⁵⁴ See also, CARL DUBERT AND PETER MERRILL, TAXATION OF U.S. COMPANIES DOING BUSINESS ABROAD: U.S. RULES AND COMPETITIVENESS ISSUES (SECOND EDITION) (Financial Executives Research Foundation, Morristown, NJ, 2001) [hereinafter “Dubert & Merrill”].

Moreover, in a number of respects, these rules exacerbate the departure from capital export neutrality caused by the foreign tax credit limitation. The most important example of how the source rules increase the non-neutrality of the U.S. system for taxing multinational companies is the treatment of interest expense.

Under the Tax Reform Act of 1986, domestic interest expense generally is apportioned between domestic and foreign-source income based on gross assets. As foreign governments do not recognize any part of U.S. interest expense as a deductible expense against foreign income, the result of apportioning U.S. interest expense to foreign-source income is to reduce the U.S. foreign tax credit limitation with no corresponding reduction in foreign income tax liability. Thus, as a result of U.S. source rules, a U.S. company facing equal investment choices and tax rates at home and abroad will confront a tax disincentive to invest abroad or to borrow at home. By contrast, a foreign-headquartered multinational typically does not face these tax disincentives under U.S. rules. The interest allocation rules have the anomalous effect of allowing a U.S. subsidiary of a foreign multinational to borrow in the United States at a lower after-tax cost than a similarly situated U.S. multinational.

The effect of the interest allocation rules can be illustrated by the following example of a multinational corporation with \$2000 of assets equally divided between its U.S. and foreign subsidiary operations. The assets in both locations are equally productive, returning 20 percent before interest expense and taxes. The assets in both locations are financed 60 percent with local debt bearing a 10 percent interest rate. The foreign subsidiary is resident in a country with an income tax system identical to that of the United States, so that the foreign corporate income tax rate is 35 percent. For the sake of simplicity, the market and book values of assets are identical and withholding taxes are nil (see Table 6.6).

The foreign subsidiary's taxable income before interest and tax expense is \$200 (20 percent return on \$1000 of assets), its interest expense is \$60 (10 percent borrowing rate on \$600 of debt), its taxable income is \$140 (\$200 less \$60 of interest expense), its foreign income tax liability is \$49 (35 percent of \$140), and its profit after tax is \$91 (\$140 less \$49), all of which is remitted to the parent. From a U.S. perspective, the multinational has \$280 of taxable income⁵⁵ on a worldwide basis; however, because U.S. tax rules require U.S. interest expense to be apportioned against foreign-

⁵⁵ The calculation of taxable income is as follows: \$200 of taxable income before interest expense from U.S. assets, plus \$91 dividend from the foreign subsidiary, plus a \$49 "gross-up" for the foreign income taxes associated with the dividend, less \$60 of U.S. interest expense.

source income, less than half of the \$280 of worldwide income is treated as foreign-source income for purposes of the foreign tax credit limitation.

Under the facts of this example, current law generally would require the multinational to apportion \$17.10 of its \$60 of U.S. interest expense⁵⁶ against foreign-source income, resulting in net foreign-source income after interest allocation of \$122.90 (\$140 less \$17.10) and net U.S.-source income of \$157.10 (\$140 plus \$17.10). As a result, the foreign tax credit limitation is \$43.02 (35 percent of \$122.90), which is less than the \$49 of foreign taxes paid, and results in excess foreign tax credits of about \$6 (the excess of the \$49 of foreign taxes over the \$43.02 of foreign tax credit limitation). The net effect of the interest allocation rules is that the U.S. multinational bears a 37.1 percent effective tax rate on worldwide income, even though its only foreign operations are in a country that imposes corporate income tax at the U.S. rate of 35 percent. This occurs because the \$17.10 of U.S. interest expense apportioned against foreign-source income is not effectively deductible, resulting in about \$6 (35 percent of \$17.10) of additional tax.⁵⁷

Among other things, the interest allocation rule can result in a U.S. multinational reporting positive taxable income to foreign tax authorities at the same time that its foreign tax credit limitation is zero because, under U.S. rules, its foreign operations produce a loss after allocation of interest expense. This situation is common for a number of capital-intensive U.S. industries that increasingly are investing abroad, such as the public utility industry (including electric, gas and water companies). Not only do companies with overall foreign losses (OFLs) lose any ability to credit foreign income taxes, but even when these companies subsequently show a foreign profit (as measured under U.S. tax rules) they frequently are unable to utilize “excess” foreign tax credits generated in prior years. Although unused foreign tax credits may be carried forward for up to five years, they can be difficult to use because companies are required to “recapture” OFLs by recharacterizing foreign income as U.S.-source income to the extent OFLs reduced U.S.-source income in prior years. Thus, the loss recapture rules can operate to exacerbate the distortions to investment and financing decisions caused by the interest allocation rules.

⁵⁶ The calculation of the amount of U.S. interest expense apportioned to foreign-source income is as follows: \$60 of U.S. interest expense times the ratio of \$400 equity investment in the foreign subsidiary to the sum of \$1000 of U.S. assets plus \$400 of equity in the foreign subsidiary.

⁵⁷ For an analysis of the interest allocation rules and their impact on the cost of capital for U.S. multinationals, see Rosanne Altshuler and Jack Mintz, *U.S. Interest Allocation Rules: Effects and Policy*, INTERNATIONAL TAX AND PUBLIC FINANCE 2, 7-35 (1995) [hereinafter “Altshuler & Mintz”].

One proposal for mitigating the distortions created by the interest allocation rules is to adopt a “worldwide fungibility” approach, such as that contained in the Senate-passed version of the Tax Reform Act of 1986 and the Taxpayer Refund and Relief Act of 1999 (H.R. 2448), the tax cut bill vetoed by President Clinton. Under this approach, U.S. interest expense is apportioned against foreign-source income only if the debt-to-asset ratio is higher for U.S. than foreign investments. The principal reason the worldwide fungibility approach was not included in the 1986 Act, as enacted, was its revenue cost.

A recent Congressional Research Service report finds that: “Overall, the best system for minimizing the distortions in both the allocation of borrowing and the allocation of equity investment is to have no [interest] allocation rules at all.”⁵⁸

The Congressional Research Study observes that some have suggested that granting multinationals tax “benefits” through interest allocation revisions should be accompanied by restrictions on deferral, which allows taxes to be deferred on profits that are reinvested abroad.⁵⁹ The point of this argument seems to be that it is inappropriate to take foreign interest expense into account for purposes of interest allocation when the foreign income associated with this interest is deferred. However, the argument is flawed because the global allocation, as proposed under H.R. 2448, would not permit any foreign interest expense to be allocated against U.S.-source income; thus, global allocation would have no effect on U.S. tax liability unless and until foreign income is repatriated. It is difficult to find any justification for linking termination of deferral to reform of the interest allocation rules.

D. Domestic Losses

U.S. multinationals with foreign-source income and domestic losses suffer a reduction of their foreign tax credit limitation. For these companies, the foreign tax credit limitation generally is equal to their U.S. tax on worldwide income, and worldwide income is less than foreign income to the extent of domestic losses. As a result, U.S. multinationals with domestic losses may be unable to credit foreign taxes paid with respect to foreign income, resulting

⁵⁸ David L. Brumbaugh and Jane G. Gravelle, *The Taxpayer Refund and Relief Act of 1999 and the Foreign Tax Credit's Interest Allocation Rules* CONGRESSIONAL RESEARCH SERVICE (September 17, 1999) [hereinafter “Brumbaugh & Gravelle”]. Intuitively, the reason for this result is that investment efficiency requires an unlimited foreign tax credit, and any interest allocation has the effect of tightening the foreign tax credit limitation. Daniel Shaviro, *Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of American Multinationals*, 54 No. 3 TAX LAW REVIEW 353-420, reaches similar conclusions.

⁵⁹ Brumbaugh & Gravelle, *supra* note 58.

in double taxation of foreign-source income. Because the reduction in foreign-source income attributable to domestic losses is not restored when the company subsequently generates domestic profits, the utilization of excess foreign tax credits arising from domestic losses is deferred (or lost if credits cannot be used within the carryover period). U.S. tax law is asymmetric in this regard because foreign losses are recaptured (which reduces foreign-source income), but domestic losses are *not* recaptured (which would increase foreign-source income).

One proposal for addressing this asymmetry is to allow domestic losses to be recaptured, so that foreign-source income would be increased to the extent that domestic losses reduce foreign-source income in prior years. This approach to the treatment of domestic losses was contained in the vetoed Taxpayer Refund and Relief Act of 1999 (H.R. 2448) and in previous bills dating back to the late 1970s. There is little disagreement that domestic loss recapture is appropriate from a tax policy perspective. The ALI Study on international tax reform, for instance, has endorsed domestic loss recapture. The primary obstacle to the enactment of domestic loss recapture rules has been the revenue cost.

E. Summary

This section has examined the implications of the capital export neutrality principle—long advocated by the Treasury Department—for the design of U.S. international tax rules. In a world where countries impose unequal taxes, capital export neutrality requires a worldwide income tax system with an *unlimited* foreign tax credit. In the event that policymakers choose, however, to maintain some form of foreign tax credit limitation, the question arises as to what type of limitation is most consistent with economic efficiency? We find that multiple foreign tax credit limitations are likely to be relatively inefficient under current conditions and that the rules for allocating domestic losses and interest expense exacerbate the economic distortions inherent in the foreign tax credit limitation.

V. Competitiveness

In a highly competitive global economy, differences in the ways countries tax their resident multinational corporations can affect their global market share. The ability of companies to compete across national boundaries has been referred to by the Joint Committee on Taxation as “multinational

competitiveness.”⁶⁰ As noted by the Joint Committee, other measures of competitiveness should also be considered by tax policymakers, in particular “standard of living competitiveness,” which can be measured by a country’s per capita income. This section focuses on the narrower question of multinational competitiveness, which is most appropriate for evaluating the nation’s international tax rules.

As noted by Prof. Laura Tyson, former Chair of the Council of Economic Advisers and former Director of the National Economic Council, there are a number of important political, strategic, and economic reasons why maintaining a high share of U.S. control over global corporate assets remains in the national interest:⁶¹

- U.S. multinationals locate over 70 percent of their assets and employment in the United States;
- U.S. multinationals invest more per employee and pay more per employee at home than abroad in both developed and developing countries;
- U.S. multinationals perform the overwhelming majority of their research and development at home;
- The leadership of U.S. multinationals is overwhelmingly American;
- Trade barriers frequently require U.S. companies to invest abroad in order to sell abroad; and
- U.S. affiliates of foreign firms rely much more heavily on foreign suppliers than on domestic companies.

Tyson argues that under current conditions, the “competitiveness of the U.S. economy remains tightly linked to the competitiveness of U.S. companies.”

If policymakers wish to attract high-end jobs to the United States, they must consider whether the U.S. income tax system makes the United States a desirable location for establishing and maintaining a corporate headquarters. If the U.S. corporate income tax is not competitive, U.S. headquartered companies can be expected to lose world market share with a commensurate loss in the U.S. share of headquarter-type jobs. While the country of incorporation is not necessarily where headquarters functions are located,

⁶⁰ See JOINT COMMITTEE ON TAXATION, FACTORS AFFECTING THE INTERNATIONAL COMPETITIVENESS OF THE UNITED STATES (May 30, 1991).

⁶¹ Laura D’Andrea Tyson, *They Are not us: Why American Ownership Still Matters*, THE AMERICAN PROSPECT (Winter, 1991). These issues also are discussed in the NFTC Subpart F Report, *supra* note 35, Chapter 6.IV.

there is indisputably a very high correlation between legal residence and headquarters operations.

Multinational tax competitiveness can be assessed directly by comparing U.S. rules for taxing foreign-source income with those of other major industrial countries, and indirectly by measuring changes in U.S. multinationals' global market share. Both approaches are considered in this section.

The first part of this section reviews quantitative comparisons of the tax burden borne by a representative multinational company if subject to tax under U.S. as compared to foreign-country rules.⁶² The second part of this section indirectly assesses multinational tax competitiveness by examining data on U.S. multinationals' global market share.

A. Quantitative Assessment of Multinational Tax Competitiveness⁶³

A number of economic studies have attempted to quantify the tax burdens imposed on U.S. multinationals as compared to foreign-based multinationals, including the Organisation for Economic Cooperation and Development (1991), Prof. Jun (1995), and Profs. Altshuler and Mintz (1995).

1. Organisation for Economic Cooperation and Development (1991)⁶⁴

The OECD study calculates the cost of capital (including tax) for domestic investments in OECD member countries as well as the cost of capital for cross-border investment among pairs of these countries. In this study, the cost of capital for a marginal investment is defined as the real *pre-tax* rate of return required to obtain a yield of 5 percent after taxes and inflation. The cost of capital for a parent company's investment in a wholly-owned foreign subsidiary depends not only on the tax systems of the home and host countries, but on how the parent is financed, how the subsidiary is financed and the types of assets in which the subsidiary invests. To obtain representative cost of capital estimates, the OECD report assumes (under the base case) that the parent company is financed by a mixture of retained earnings (55

⁶² This type of "representative" taxpayer analysis is included specifically to respond to former Treasury Assistant Secretary Lubick's call for more concrete evidence regarding the competitiveness of tax systems. See, Lubick, *supra* note 1. Lubick refers to a speech by the Vice President of the Federal Reserve Bank of Boston, who argues that claims of competitive disadvantage should be backed by a quantitative comparison of the tax burdens that would be borne by a "representative" firm in alternative locations.

⁶³ This section is adapted from Dubert & Merrill, *supra* note 54.

⁶⁴ OECD, TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES (1991) [hereinafter "OECD"].

percent), debt (35 percent) and new equity (10 percent), and investment outlays are split among machinery (50 percent), buildings (28 percent) and inventories (22 percent). The parent company is assumed to finance foreign subsidiaries in equal measure by parent debt, parent equity and retained earnings of the subsidiary. The report assumes a constant inflation rate of 4.5 percent in all countries and fixed exchange rates.

The results of the OECD report for the Group of Seven (G-7) countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States) are summarized in Table 6.7. Taking into account corporate level taxes only (domestic and foreign income taxes and gross-basis withholding taxes), the report finds that the cost of capital for domestic investment by U.S. companies is slightly *below* the average for other G-7 countries (5.8 percent versus 5.9 percent); however, the cost of capital for U.S. companies investing abroad is slightly *above* the average for other G-7 countries (7.3 percent versus 7.2 percent).⁶⁵ One way to interpret these results is that U.S. companies, on average, must earn a premium of 1.5 percentage points (7.3 percent minus 5.8 percent) on foreign investment to obtain the same after-tax return as on domestic investment. For the other G-7 countries, a somewhat smaller premium—an average of 1.3 percentage points—is required.

Thus, the corporate tax systems of all G-7 countries appear to discourage outward investment (compared to domestic investment by resident companies), with the disincentive for U.S. companies slightly greater than for companies resident in the other G-7 countries. Much of the tax disincentive to cross-border investment is attributable to withholding taxes on interest, dividends, royalties, and other income paid to foreign investors.⁶⁶ Bilateral income tax treaties substantially reduce, but do not eliminate, tax barriers to cross-border investment among OECD member countries.⁶⁷

Taking into account individual-level taxes on shareholders and bondholders, the OECD report reveals a markedly different pattern.⁶⁸ The report

⁶⁵ The cost of capital for foreign investment is computed as a weighted average for investment from the home country into each of the other G-7 countries. The cost of capital is weighted by the proportion of investment flows from the home country into each of the other G-7 countries.

⁶⁶ See, Robert H. Dilworth, Carol A. Dunahoo, Peter R. Merrill, Melody Pan and Anastasia Parker, *Zero Withholding on Direct Dividends: Policy Arguments for a New U.S. Treaty Model*, TAX NOTES INT'L 1113-1131 (March 6, 2000) [hereinafter "Dilworth et al."].

⁶⁷ OECD, *supra* note 64, 142-144.

⁶⁸ The individual tax system in a particular country would not affect the competitiveness of resident corporations to the extent that there is complete international mobility of portfolio capital, *i.e.*, investors in one country are indifferent between purchasing otherwise similar debt and equity of domestic and foreign corporations. The marked lack of international diversification in individual portfolios suggests that portfolio capital is not completely mobile on a global basis.

finds that the cost of capital for both domestic (8.0 percent) and foreign investment (8.8 percent) by U.S. companies is significantly higher than the averages for the other G-7 countries (7.2 percent domestic and 8.0 percent foreign). The United States and Japan are tied as the least competitive G-7 countries for a multinational corporation to locate its headquarters, taking into account taxation at both the individual and corporate levels. The work of Prof. Joosung Jun (discussed in 2., below) confirms that this result is partly attributable to the fact that the United States and Japan are the only G-7 countries that do not relieve the double taxation of corporate dividends.

2. Jun (1995)⁶⁹

In a study of the relationship between taxes and international competitiveness, Prof. Joosung Jun links tax rules to multinational competitiveness through their affect on the cost of capital:⁷⁰

Tax rules affect the ability of U.S. foreign subsidiaries to compete in foreign markets with local companies and with local subsidiaries of companies based in other countries. The primary channel through which taxes exert this influence is by changing the cost of capital.

Jun used the methodology of the 1991 OECD report (discussed in 1., above) to examine the tax systems of 11 industrial countries (Australia, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States). Jun's paper focuses on the corporate integration systems that exist in many of these countries (but not the United States) and considers how the source of foreign subsidiary financing affects the cost of capital.

Like the OECD, Jun found that tax rules "significantly raise the cost of capital for foreign investment."⁷¹ Jun noted that this may put foreign subsidiaries at a competitive disadvantage compared to local companies. Jun also found that multinationals headquartered in countries with dividend imputation systems often may raise new equity capital at a significantly lower cost than multinationals headquartered in countries that do not have imputation systems, such as the United States. Jun observed,

⁶⁹ Joosung Jun, *The Impact of International Tax Rules on the Cost of Capital*, in M. FELDMAN, J. HINES, AND R. HUBBARD, EDS., *THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS* (The University of Chicago Press, 1995).

⁷⁰ *Id.*, 95.

⁷¹ *Id.*, 115.

“This result suggests the potential importance of integrating personal and corporate taxation in enhancing U.S. competitiveness.”⁷²

Jun also noted several other tax considerations that tend to reduce the competitiveness of U.S. firms operating abroad, although he was not able to quantify their effects. Jun specifically observes that, “Among major investor countries, the United States has the tightest rules regarding the exemption or deferral of home country tax on foreign-source income and regarding the limitation of foreign tax credits.”⁷³ Jun also points out that: (1) the United States treats loans from a foreign subsidiary as a dividend to the U.S. parent; and (2) the United States is the only major industrial country that does not include tax sparing clauses in its treaties with developing countries, “possibly making U.S. multinationals face a much higher effective tax rate in developing countries than firms from other countries with a treaty including tax-sparing credits.”⁷⁴

3. *Altshuler and Mintz (1995)*⁷⁵

Altshuler and Mintz focus specifically on how the U.S. interest allocation rules adopted in 1986 affect the tax burden on U.S. multinational corporations. The 1986 Act requires U.S. multinationals to apportion domestic interest expenses between U.S. and foreign-source income on a consolidated basis according to the U.S. and foreign assets. The effect of these rules is to increase the amount of interest expense allocated to foreign-source income, resulting in an increase in U.S. tax liability for companies with excess foreign tax credits. The United States is one of only a few countries that require allocation of interest expense based on assets.⁷⁶

Based on 1993 law, Altshuler and Mintz estimate the effective tax rates on investment by a U.S. multinational at home and in Canada, Japan, and the United Kingdom. The methodology for calculating effective tax rates is similar to that used in the 1991 OECD study, except that the authors take into account the effects of the U.S. interest allocation rules. The authors' estimates are based on a representative company with excess foreign tax credits and assume that 34.6 percent of U.S. interest expense is allocated to

⁷² *Id.*, 10. Since 1995, when Prof. Jun's study was published, France, Germany and the United Kingdom have modified their imputation credits, although each country continues to mitigate the double taxation of corporate income.

⁷³ *Id.*, 116.

⁷⁴ *Id.*

⁷⁵ Altshuler & Mintz, *supra* note 57.

⁷⁶ *Id.*, 8.

foreign-sources (based on the average for U.S. multinational corporations included in the authors' data set).

For a U.S. multinational corporation with excess foreign tax credits, Altshuler and Mintz find that the interest allocation rules increase the effective tax rate on both domestic and foreign investments, with the largest impact on foreign investments. The authors calculate that, as a result of the interest allocation rules, the effective tax rate on domestic investment increased by over 4 percentage points (from 17.6 to 21.9 percent). The effective tax rate increased by about 8 percentage points for U.S. multinational corporation investment in Canada, by 10 percentage points for U.S. investment in Japan, and by 9 percentage points for investment in the United Kingdom (see Table 6.8).

Altshuler and Mintz conclude that the interest allocation rules “had a substantial impact on the effective tax rates of U.S. multinationals, particularly for foreign investments. Compared to foreign corporations that do not have to allocate interest expense, U.S. corporations face a tax disadvantage when undertaking new investments since some of the debt costs may not be deductible.”⁷⁷

B. U.S. Multinationals' Global Market Share

If companies headquartered in the United States pay higher taxes on their international operations than companies headquartered in other major industrial countries, one would expect over time to see a decline in the global market share of U.S. companies. In fact, the U.S. share of the global cross-border direct investment stock has declined from over 50 percent in 1960 to 25 percent in 1996.⁷⁸ One cannot, of course, attribute this decline in the U.S. share of the world's foreign direct investment to differences in tax rules; many other factors—not least the recovery of Europe and Japan from World War II—are important.

Another way to assess the potential competitiveness of U.S. international tax rules is to see where U.S. companies involved in cross-border mergers choose to establish their legal headquarters. If the U.S. tax system were relatively unattractive for multinational companies, one would expect to see U.S. companies involved in cross-border mergers moving their headquarters outside of the United States. An examination of all cross-border mergers and acquisitions in 1998 through 2000 involving U.S. companies with terms in excess of \$500 million shows that foreign

⁷⁷ *Id.* 29.

⁷⁸ INTERNATIONAL MONETARY FUND, INTERNATIONAL FINANCIAL STATISTICS (March 1998).

acquisitions of U.S. companies far exceeded U.S. acquisitions of foreign companies, both in terms of the number of transactions and the dollar value of these transactions (see Table 6–10).

In 1998, 1999 and 2000 (through November), U.S. companies were the target (and foreign companies the acquirer) in 86, 73 and 79 percent, respectively, of the large cross-border mergers and acquisitions as measured by value. In the financial services sector, where U.S. rules have deviated significantly from international norms, 76, 96 and 80 percent of cross-border deals (measured by value) involved foreign acquisitions of U.S. companies over the 1998–2000 period (see Table 6–10).⁷⁹

By merging into a foreign-headquartered company, a U.S. multinational may enjoy significant tax advantages over its U.S. competitors:

- If the foreign parent is headquartered in a country with a territorial income tax system (e.g., France, Germany, the Netherlands, Switzerland), the merged company typically can invest abroad without incurring any home country tax on foreign profits. By contrast, a U.S. multinational that invests abroad is subject to U.S. tax on foreign profits when distributed.
- The merged company can invest abroad or borrow in the United States without increasing the amount of U.S. interest allocated to foreign-source income. By contrast, a U.S. company that invests abroad or borrows in the United States suffers a reduction in its foreign tax credit limitation as a result of the U.S. interest allocation rules.
- The merged company generally can earn foreign personal holding company income, foreign base company sales and services income, and foreign insurance income through its foreign affiliates without triggering home country tax. By contrast, a U.S. multinational that earns these types of income, or borrows money from one of its foreign affiliates, is subject to current U.S. tax on this income.⁸⁰
- The merged company can invest abroad taking advantage of the foreign parent country's income tax treaty network. Most major industrial countries have a larger income tax treaty network than the United

⁷⁹ See, Carol Dunahoo, Andrew Lyon and Peter Merrill, *International Competitiveness of U.S. Life Insurance Companies: Vetoed Section 1175 of the Taxpayer Relief Act of 1997*, TAX NOTES INT'L 1769-1773 (September 29, 1997); and THOMAS HORST, TAXATION OF FOREIGN INCOME OF FINANCIAL SERVICES COMPANIES (American Council for Capital Formation, Monograph Series on Tax, Regulatory and Environmental Policies and U.S. Economic Growth, July 1997).

⁸⁰ See, NFTC Subpart F Report, *supra* note 35.

States. Moreover, the United States is the only major industrial country that does not enter into tax treaties with developing countries that contain tax sparing clauses.

- As it is a foreign-headquartered company, dividends distributed by the foreign parent to its local shareholders typically benefit from the double taxation relief offered by most other major industrial countries. By contrast, dividends distributed by a U.S. multinational do not qualify for relief from double taxation, either in the United States or abroad, because foreign governments limit relief to dividends paid by local companies.

While the recent cross-border merger and acquisition data are consistent with the hypothesis that U.S. multinational tax rules are not competitive, they cannot be taken as proof of this hypothesis.⁸¹ It is noteworthy, though, that the tax director of Chrysler Corporation testified before the Senate Committee on Finance that the Daimler-Chrysler merger was structured as a German rather than a U.S. company in part because of the tax disadvantages confronted by U.S.-headquartered multinationals.⁸²

C. Summary

While it is difficult to compare the overall impact of countries' income tax systems on the cost of cross-border investment, the data and analyses reviewed in this section suggest that, from a tax perspective, the United States is a relatively undesirable location for a multinational company's legal domicile. Recent trends show that the vast majority of cross-border mergers and acquisitions have been structured as foreign acquisitions of U.S. companies, and that the proportion of *inward* investment that is direct (rather than portfolio) increased in the 1990s, while the share of *outward* investment in direct form decreased. If these trends continue, over time we would expect to see a larger portion of U.S. and foreign economic activity carried out by companies domiciled outside the United States.

VI. International Norms

The last international tax policy goal set forth by Treasury was that the United States should seek to conform to international tax norms, to the extent possible. As defined by Treasury, this does not mean conformity of

⁸¹ The concern raised here is not with the *ownership* of U.S. companies but rather the location of worldwide corporate headquarters, to the extent this may be affected by U.S. tax laws.

⁸² See, JOHN L. LOFREDDO, TESTIMONY BEFORE THE SENATE COMMITTEE ON FINANCE (March 11, 1999).

rate or base, but rather the adoption of policies historically used by other developed countries to avoid double taxation.

To judge how well the U.S. tax system ranks, we propose three different measures of international conformity:

- Are the U.S. international tax rules similar to those used by a majority of the United States' largest trading partners?
- Do the U.S. international tax rules avoid international double taxation of income?
- Are the U.S. international tax rules “harmonizable,” meaning that double taxation would be eliminated if other countries adopted identical tax rules.⁸³

A. Do U.S. International Tax Rules Conform to Those of the United States' Major Trading Partners?

The first question is addressed in the extensive cross-country comparisons of the anti-deferral rules and foreign tax credit rules in the NFTC Subpart F Report and in Chapter 5 of this report. The reports compare the U.S. rules with those of Canada, France, Germany, Japan, the Netherlands, and the United Kingdom. These countries, together with the United States, are home to 412 of the 500 largest corporations in the world.

The comparison of anti-deferral regimes in the NFTC Subpart F Report found that for every category of income considered, the United States imposed the severest regime, although, in a few cases, a minority of the other countries imposed a comparable rule. The French rules were found to be closest to the U.S. rules, although they too were narrower in several respects. However, the rules of the other countries were all narrower than the U.S. rules in significant respects.

The international comparison in Chapter 5 of this report finds that the foreign tax credit system, the dividend exemption system and hybrid systems can each, in theory, eliminate the double taxation of foreign-source income. However, for the reasons outlined below, U.S.-based multinationals can confront double taxation in situations where their foreign-based competitors do not.

⁸³ The “harmonizability” standard is suggested in Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, Tax Notes 581-591 (April 30, 1990).

In summary, the NFTC Reports document significant features of the U.S. anti-deferral and foreign tax credit regimes that depart from the practices of major U.S. trading partners and hamper the ability of U.S. companies to compete abroad.

B. Do U.S. International Tax Rules Avoid Double Taxation?

We define international double taxation to occur when an item of multinational income effectively is taxed at a rate in excess of the *greater* of the home or host country income tax rates. In theory, either a pure foreign tax credit system or a pure territorial income tax system would avoid double taxation, as defined, and thus would be consistent with international tax norms. In practice, however, the U.S. foreign tax credit system fails to eliminate double taxation completely for a variety of reasons:

- The United States allocates U.S. interest and certain other U.S. expenses (e.g., certain research expenses) against foreign-source income for purposes of the foreign tax credit. Because foreign governments do not allow a deduction for these allocated expenses, U.S. taxpayers in an excess foreign tax credit position effectively are unable to deduct these allocated expenses.
- Companies that experience losses at home while earning income abroad suffer a reduction in foreign tax credit limitation. Consequently, it may not be possible to credit fully foreign taxes paid on foreign income, even though the foreign tax rate is less than or equal to the U.S. rate.
- Companies subject to the alternative minimum tax face an additional limitation on the foreign tax credit that specifically is designed to ensure the payment of a minimum amount of U.S. tax even where foreign-source income has been taxed at rates that exceed the U.S. rate.

Thus, the U.S. foreign tax credit system does not fully relieve double taxation of cross-border income.

C. Are the U.S. International Tax Rules Harmonizable?

A third measure of compatibility with international tax norms is whether the U.S. tax system is harmonizable. Under this standard, the U.S. tax system also must be judged as falling short. As illustrated in the interest allocation example (see IVC., above), a U.S. multinational that operates exclusively in a foreign country with a tax system mirroring that of the United States can be subject to a higher tax burden than if it operated solely within

U.S. borders. The lack of harmonization is exacerbated by withholding taxes imposed on distributed profit.⁸⁴

D. Summary

By any standard, U.S. rules for taxing international income are exceedingly complex and burdensome. Certain features of these rules fall outside the spectrum of tax practices used by other major industrial countries in ways that are burdensome for U.S. multinationals measured in terms of compliance cost and tax liability. From a policy perspective, these non-conforming features of the U.S. foreign tax credit regime are particularly troublesome where they result in double taxation of cross-border income. The comparative analyses in the NFTC Subpart F Report and this Report demonstrate that there is scope for adopting measures to simplify U.S. rules and reduce double taxation of international income that would *improve* conformity with international tax norms.

VII. Recent Policy Trends

On December 23, 1997, the IRS issued Notice 98-5 to address purported abuses of the foreign tax credit system.⁸⁵ The Notice states that Treasury will issue regulations that deny a foreign tax credit for foreign taxes paid or accrued after December 23, 1997, in two types of transactions. The first type of transaction involves the acquisition of assets subject to gross-basis foreign withholding taxes, and the second type involves structures designed to reduce domestic and foreign taxes by exploiting inconsistencies between U.S. and foreign tax laws. These transactions are deemed to be abusive, and the foreign tax credit will be denied if the “expected economic profit is insubstantial compared to the foreign tax credits generated.”⁸⁶

Specifically, the five examples in the Notice compare income net of foreign taxes with U.S. tax benefits (*i.e.*, the foreign tax credit). Where this ratio is insubstantial (*e.g.*, 12 percent in Example 5 of the Notice), the “economic substance” test is not passed. For taxpayers with excess foreign tax credit limitation, the foreign tax credit is equal to foreign taxes paid or incurred with respect to the transaction. Thus, the Notice’s “economic substance” test is failed in Example 5 under the following condition:

⁸⁴ For a discussion of the policy rationale for reducing the direct dividend withholding rate in the U.S. Model Income Tax Treaty to zero, see Dilworth, et al, *supra* note 66.

⁸⁵ 1998-3 I.R.B. 49.

⁸⁶ *Id.*, 3.

$$\frac{(\text{Foreign-source Income—Foreign Taxes})}{\text{Foreign taxes}} < .12$$

which will occur whenever foreign taxes are greater than 89 percent of foreign-source income (as measured for U.S. tax purposes). For example, if foreign taxes are \$90 and the U.S. definition of foreign-source income is \$100, then net foreign-source income (\$10) will be just 11 percent of foreign taxes.⁸⁷

Foreign income streams subject to gross basis withholding taxes, such as interest, royalties and dividends, may fall foul of the “economic substance” test as a result of U.S. expenses allocated against this income. For example, if a taxpayer earns \$1000 of foreign royalty income against which the United States allocates \$670 of domestic expense and the foreign government withholds \$300 (based on a 30 percent withholding tax), then the transaction will fail the “economic substance” test because the \$30 of net foreign-source income (\$1000 less \$300 of foreign withholding tax and \$670 of U.S. expense allocation) is just 10 percent of the foreign tax credit generated by the withholding tax. The test also may be flunked if the taxpayer holds an asset subject to withholding tax for only a short period of time around the date of a scheduled income distribution. In such circumstances, the income from the distribution may be offset, in whole or in part, by a loss on the sale of the asset, so the income on the transaction may be relatively small compared to the withholding tax imposed on the distribution.

Transactions that are accounted for differently by the United States and foreign countries also may fail the “economic substance” test where deductions are allowed under U.S. but not foreign rules. For example, if a foreign affiliate is capitalized by an instrument that is viewed as debt by the United States, and as preferred stock by the foreign government, the U.S. measure of foreign income will be reduced by interest deductions that are not recognized under foreign law.

Instead of adding a new layer of complexity to the foreign tax credit system, the IRS and Treasury might consider using established foreign tax credit tools to address the problems discussed in Notice 98-5. Short-term holdings of foreign-income-producing assets—featured in the Notice’s Examples 1 and 2—could be addressed, for example, by broadening the mechanical, minimum holding period requirements for credits now in section 901(k) of the Code. For taxpayers outside the financial services

⁸⁷ It should be noted that Example 5, like the other examples in the Notice, is merely illustrative. The Notice does not indicate a minimum acceptable ratio of income-to-foreign tax credit benefit. The ratios in the five examples vary widely and the IRS and Treasury have indicated informally that there is no plan to include “safe harbor” ratios in the forthcoming regulations.

industry, allocation of any “purchased” foreign tax credits to the passive (rather than overall) limitation, coupled perhaps with an additional anti-abuse rule in the sourcing provisions of Reg. §1.865-1T, would render these credits far less valuable. An allocation to the passive limitation could be accomplished in many cases simply by repealing the passive limitation high-tax kick-out, a promising reform in any event as discussed above. Finally, the perceived abuses in the Notice involving hybrid instruments and hybrid entities (Examples 4 and 5) might alternatively be addressed using targeted fixes, as have been used in the past with hybrid instruments and entities.⁸⁸

VIII. Conclusion

Congress’s expectation that U.S. rate reductions would place U.S. tax rates below foreign rates, and thereby encourage marginal investments overseas, played a major role in the enactment of the 1986 Act separate foreign tax credit limitations. This neutrality-related rationale for adopting these separate limitations has been eroded by the worldwide rate reductions occurring since 1986. Moreover, in the decade-and-a-half since the enactment of the 1986 Act, experience has shown that the administrability and complexity problems created by the foreign tax credit changes enacted in 1986 were vastly underestimated, and that other countries have not modified their foreign tax credit rules to emulate the United States. Judged by the principles that Treasury has set forth for evaluating international tax systems—fairness, simplicity, neutrality, competitiveness, and conformity with international norms—this Chapter provides evidence that the current foreign tax credit regime leaves much to be desired. Stated differently, there is now an opportunity to reform the existing foreign tax credit rules in ways that enhance simplicity, ameliorate double taxation of international income, and improve competitiveness without departing from international norms or worsening the efficiency of international capital allocation.

⁸⁸ See, e.g., I.R.C. §§ 385(c), 1504(a)(4) and 894(c); Prop. Reg. § 301.7701-3(h).

Table 6–1. Marginal Tax Rates on Corporate Income, Including Shareholder Tax

Regular corporate tax rate	35%	35%	35%	35%	35%
Individual tax rates:					
Ordinary income	15.0%	28.0%	31.0%	36.0%	39.6%
Long-term capital gains	10.0%	20.0%	20.0%	20.0%	20.0%
Combined corporate and individual tax rate:					
Distributed income ¹	44.8%	53.2%	55.2%	58.4%	60.7%
Retained income ²	41.5%	48.0%	48.0%	48.0%	48.0%
Excess tax on corporate vs. labor income: ³					
Distributed income	29.8%	25.2%	24.2%	22.4%	21.1%
Retained income	26.5%	20.0%	17.0%	12.0%	8.4%
Percentage excess tax on corporate income: ⁴					
Distributed income	198.3%	90.0%	77.9%	62.2%	53.4%
Retained income	176.7%	71.4%	54.8%	33.3%	21.2%
<p>¹ 35% corporate rate plus ordinary income tax rate applied to 65% of corporate profits after tax.</p> <p>² 35% corporate rate plus capital gains rate applied to 65% of corporate profits after tax. Note that effective tax rate may be higher because capital gains are not indexed for inflation, and may be lower because tax on capital gains is deferred until realized. Gains held until death are not subject to income tax, but may be subject to estate and gift tax at rates up to 55 percent.</p> <p>³ Combined corporate and individual tax rate minus individual tax rate.</p> <p>⁴ Excess tax on corporate income as a percentage of tax on labor income.</p>					

Table 6–2. Taxation of Corporate Dividends in OECD Countries, 1999

No relief from double taxation of corporate dividends	Method of relieving double taxation of corporate dividends				
	Shareholder level			Corporate level	
	Imputation system (partial or complete)	Tax credit method	Special personal tax rate		
Netherlands	Australia	Canada	Austria	Iceland ⁵	
Switzerland	Finland ²	Rep. of Korea	Belgium ⁵		
United States	France	Spain	Czech Republic		
	Ireland ³		Denmark		
	Mexico	Germany ¹			
	New Zealand	Greece ⁵			
	Norway	Hungary			
	Portugal	Italy			
	United Kingdom		Japan		
			Luxembourg ⁴		
			Poland		
			Sweden		
			Turkey		
			United Kingdom		

¹ Germany recently has adopted a 50 percent dividend exclusion.

² Information as of 1996 based on S. Cnossen.

³ Ireland eliminated its imputation credit effective April 6, 1999.

⁴ Luxembourg has a 50 percent dividend exclusion.

⁵ Information as of 1996 based on S. Cnossen.

Sources:

(1) PRICEWATERHOUSECOOPERS, *INDIVIDUAL TAXES 1999–2000: WORLDWIDE SUMMARIES* (John Wiley & Sons, 1999).

(2) SIBBREN CNOSSEN, *REFORM AND HARMONIZATION OF COMPANY TAX SYSTEMS IN THE EUROPEAN UNION* (Research Memorandum 9604, Erasmus University, Rotterdam, 1996).

**Table 6–3. Taxation of Foreign Subsidiary
Dividends in OECD Countries, 1999**

Exemption system (Either by statute, by treaty or for listed countries)	Worldwide taxation system
1. Australia	1. Czech Republic
2. Austria	2. Greece
3. Belgium	3. Iceland ²
4. Canada	4. Italy
5. Denmark	5. Japan
6. Finland ²	6. Rep. of Korea
7. France	7. Mexico
8. Germany	8. New Zealand
9. Hungary	9. Norway
10. Ireland ¹	10. Poland
11. Luxembourg	11. Portugal
12. Netherlands	12. Spain ³
13. Sweden	13. Turkey
14. Switzerland	14. United Kingdom
	15. United States

¹ Although Ireland nominally has a worldwide tax system, under the Finance Act of 1988, foreign subsidiary dividends generally are exempt if re-invested in employment-generating activities within Ireland.

² Information as of 1990 based on OECD.

³ Some treaties provide for the exemption method.

Sources:

PRICEWATERHOUSECOOPERS, *INDIVIDUAL TAXES 1999–2000: WORLDWIDE SUMMARIES* (John Wiley & Sons, 1999).

OECD, *TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES* (1991).

**Table 6–4. Central Government
Corporate Income Tax Rates, 1986–1995**

Country	1986	1991	1995
Australia	49.0	39.0	33.0
Austria	30.0	30.0	34.0
Belgium	45.0	39.0	39.0
Canada	36.0	29.0	29.0
Denmark	50.0	38.0	34.0
Finland	33.0	23.0	25.0
France	45.0	34/42	33.0
Germany	56.0	50/36	45/30
Greece	49.0	46.0	35/40
Iceland	51.0	45.0	33.0
Ireland	50.0	43.0	40.0
Italy	36.0	36.0	36.0
Japan	43.0	38.0	38.0
Luxembourg	40.0	33.0	33.0
Netherlands	42.0	35.0	35.0
New Zealand	45.0	33.0	33.0
Norway	28.0	27.0	19.0
Portugal	42/47	36.0	36.0
Spain	35.0	35.0	35.0
Sweden	52.0	30.0	28.0
Switzerland	4–10	4–10	4–10
Turkey	46.0	49.0	25.0
United Kingdom	35.0	34.0	33.0
United States	46.0	34.0	35.0
Unweighted averages:¹			
EU	42.8	35.9	34.4
OECD	41.4	35.0	32.0

¹Midpoint tax rate used for countries with multiple rates.

Sources: Jeffrey Owens, *Tax Reform for the 21st Century*, TAX NOTES INTERNATIONAL and PricewaterhouseCoopers calculations.

**Table 6–5. Foreign Income and Taxes of
U.S.-Controlled Foreign Corporations, 1994**

*[7500 largest controlled foreign corporations of U.S. parents with
assets of \$500 million or more; millions of dollars]*

Sample	Current earnings and profits (less deficit) before income taxes	Foreign income taxes	Weighted average foreign income tax rate
With and without earnings and profit	98,428	23,268	23.6%
With earnings and profit	115,271	22,836	19.8%

Sources: IRS, SOI BULLETIN 116 (Summer 1998) and PricewaterhouseCoopers calculations.

Table 6–6. Illustration of Non-Neutrality of U.S. Interest Allocation Rules

Base Case Assumptions			
Item	US	Foreign	Worldwide
Interest rate	10%	10%	
Return on assets	20%	20%	
Assets	1000	1000	2000
Debt	600	600	1200
Equity	400	400	800
Income tax rate	35%	35%	
Percentage of foreign income remitted	na	100%	
Income Tax Calculations			
Item	Case 1. Base Case	Case 2. Move \$100 debt offshore	Case 3. Move \$100 assets offshore
Foreign tax calculation			
Foreign income before interest expense	200.0	200.0	220.0
Foreign interest expense	60.0	70.0	60.0
Foreign taxable income	140.0	130.0	160.0
Foreign income tax	49.0	45.5	56.0
Foreign profits after tax	91.0	84.5	104.0
U.S. tax calculation			
U.S. income before interest expense	200.0	200.0	180.0
Foreign source income	140.0	130.0	160.0
U.S. interest expense	60.0	50.0	60.0
U.S. taxable income (worldwide)	280.0	280.0	280.0
U.S. tax before foreign tax credit	98.0	98.0	98.0
U.S. interest allocated to foreign sources ¹	17.1	11.5	21.4
Net foreign source income after interest allocation	122.9	118.5	138.6
Foreign tax credit limitation	43.0	41.5	48.5
Foreign tax credit	43.0	41.5	48.5
U.S. tax after foreign tax credit	55.0	56.5	49.5
Worldwide tax	104.0	102.0	105.5
Foreign tax	49.0	45.5	56.0
U.S. tax	55.0	56.5	49.5
Worldwide income before income taxes	280.0	280.0	280.0
Worldwide effective tax rate	37.1%	36.4%	37.7%

¹ U.S. interest expense times ratio of foreign equity to sum of U.S. assets and foreign equity.

Table 6–7. Cost of Capital (Percent), G-7 Countries, 1991[Pre-tax rate of return required to earn 5.0% after inflation and taxes]^a

Home country	Corporate-level taxes only ^b		Corporate and personal taxes ^c	
	Domestic investment	Foreign investment ^d	Domestic investment	Foreign investment ^d
Canada	6.2	7.1	8.5	8.5
France	5.4	5.7	7.3	8.2
Germany	5.6	7.8	5.9	6.8
Italy	5.9	8.4	7.6	8.6
Japan	6.4	7.8	7.0	8.8
United Kingdom	5.9	6.5	7.0	6.9
United States	5.8	7.3	8.0	8.8
Average ^e	5.9	7.2	7.3	8.1
Avg. excl. U.S. ^e	5.9	7.2	7.2	8.0

^a Parent raises finance by a weighted average of retentions, new equity and debt. Subsidiary financed equally by parent debt, parent equity, and retained earnings. Weighted average of investment in three different assets. Inflation of 4.5 percent in each country and fixed exchange rates.

^b Home and host country corporate income taxes and host country withholding taxes.

^c Includes home country personal income tax for top-rate individual.

^d Investment from home country into other G-7 countries weighted by proportion of investment flows from the home country into each of the other G-7 countries for which there are data.

^e Unweighted average.

Sources: OECD, *TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES* 147–149, 154, 460 (1991) and PricewaterhouseCoopers calculations.

Table 6–8. Impact of Interest Allocation Rules on Effective Tax Rates for U.S. Multinationals, 1993

Location of U.S. multinational investment	Effective tax rate		
	With interest allocation	Without interest allocation	Difference
United States	21.9	17.6	4.3
Canada:			
Manufacturing	34.1	25.9	8.2
Nonmanufacturing	41.5	33.9	7.6
Japan	28.3	18.0	10.3
United Kingdom	26.5	17.4	9.1

Source: R. Altshuler and J. Mintz, *U.S. Interest Allocation Rules: Effects and Policy*, *INTERNATIONAL TAX AND PUBLIC FINANCE*, vol. 2., no. 1, 26 (May 1995).

Table 6-9a. Foreign Tax Credit Returns, 1990

Limitation category and major industry	Amounts in millions of dollars					Percentages		
	Separate limitation income ¹	Foreign taxes ²	Foreign taxes including carryovers ³	Foreign tax credit limitation	Separate limitation income	Income in excess credit baskets ⁴	Income in excess credit baskets without carryovers ⁵	
All limitation categories	225,181	26,352	30,761	29,620	100.0%	57.3%	38.4%	
Limitation category								
Passive income	6,048	404	431	1,462	4.9%	5.8%	3.8%	
High withholding tax interest	683	59	66	71	0.2%	46.1%	42.2%	
Financial services income	64,998	1,757	1,889	2,424	8.2%	47.7%	37.4%	
Shipping income	5,505	53	53	253	0.9%	5.4%	5.4%	
Dividends from each "10-50" corp.	1,768	609	930	619	2.1%	84.3%	34.2%	
Dividends from DISC or former DISC	110	0	0	33	0.1%	2.0%	**	
Miscellaneous separately calculated limitation	-	-	-	-	-	**	**	
Distributions from a FSC or former FSC	571	-	-	63	0.2%	60.0%	60.0%	
General limitation income	145,497	23,469	27,391	24,695	83.4%	65.4%	41.5%	

Table 6-9a. Foreign Tax Credit Returns, 1990 (continued)

Limitation category and major industry	Amounts in millions of dollars						Percentages	
	Separate limitation income ¹	Foreign taxes ²	Foreign taxes including carryovers ³	Foreign tax credit limitation	Separate limitation income	Income in excess credit baskets ⁴	Income in excess credit baskets without carryovers ⁵	
Major industry of U.S. taxpayer (all limitation categories)								
Agriculture, forestry and fishing, and mining	6,171	1,051	1,368	873	2.9%	77.9%	34.0%	
Construction	1,324	98	112	112	0.4%	46.9%	6.5%	
Manufacturing	128,305	21,405	24,881	23,390	79.0%	65.4%	44.0%	
Transportation and public utilities	8,690	158	201	783	2.6%	6.2%	1.7%	
Wholesale trade	16,369	269	384	397	1.3%	6.1%	3.2%	
Retail trade	3,082	768	823	679	2.3%	87.1%	15.6%	
Finance, insurance and real estate	54,132	1,934	2,145	2,566	8.7%	60.2%	46.6%	
Services	7,109	668	847	819	2.8%	39.1%	18.7%	

** Value omitted to avoid disclosure of about specific taxpayers

1 Deemed and actual dividends, interest, gross rents, royalties and license fees, gross income from performance of services and other income.

2 Foreign taxes paid or accrued plus taxes deemed paid less reductions of taxes paid, accrued, or deemed paid.

3 Includes carrybacks and carryovers of foreign taxes from other years.

4 Separate limitation income in limitation categories with excess foreign tax credits as a percent of all separate limitation income.

5 Separate limitation income in limitation categories with excess foreign tax credits excluding carryovers as a percent of all separate limitation income.

Source: IRS Statistics of Income Division tabulation of Form 1118 and PricewaterhouseCoopers calculations.

Table 6-9b. Foreign Tax Credit Returns, 1996

Limitation category and major industry carryovers ⁵	Separate limitation income ¹	Foreign taxes ²	Foreign taxes including carryovers ³	Foreign tax credit limitation	Separate limitation income	Income in excess credit baskets ⁴	Income in excess credit baskets without
All limitation categories	331,079	39,405	48,085	50,680	100.0%	39.9%	14.1%
Limitation category							
Passive income	5,340	462	512	1,257	2.5%	17.4%	14.3%
High withholding tax interest	1,801	229	365	348	0.7%	36.6%	12.4%
Financial services income	91,085	6,338	6,949	10,094	19.9%	20.7%	10.3%
Shipping income	12,992	73	102	412	0.8%	14.4%	12.6%
Dividends from each "10-50" corp.	3,623	1,253	1,666	1,090	2.2%	71.5%	40.9%
Dividends from DISC or former DISC	5	-	-	2	0.0%	**	**
Miscellaneous separately calculated limitation	93	11	12	28	0.1%	**	**
Distributions from a FSC or former FSC	3,351	-	-	12	0.0%	77.3%	77.3%
General limitation income	212,789	31,040	38,481	37,438	73.9%	49.1%	14.4%

Table 6-9b. Foreign Tax Credit Returns, 1996 (continued)

Limitation category and major industry	Amounts in millions of dollars						Percentages	
	Separate limitation income ¹	Foreign taxes ²	Foreign taxes including carryovers ³	Foreign tax credit limitation	Separate limitation income	Income in excess credit baskets ⁴	Income in excess credit baskets without carryovers ⁵	
Major industry of U.S. taxpayer (all limitation categories)								
Agriculture, forestry and fishing, and mining	7,886	1,010	1,572	1,096	2.2%	73.6%	31.8%	
Construction	2,038	200	214	212	0.4%	15.2%	10.7%	
Manufacturing	173,377	28,111	35,004	33,671	66.4%	53.1%	14.9%	
Transportation and public utilities	25,775	437	523	1,323	2.6%	11.9%	7.0%	
Wholesale trade	7,859	584	661	769	1.5%	26.6%	15.6%	
Retail trade	4,745	799	851	861	1.7%	74.0%	68.6%	
Finance, insurance and real estate	89,842	6,363	7,102	10,137	20.0%	22.7%	11.8%	
Services	19,556	1,902	2,159	2,610	5.1%	24.1%	7.1%	

** Value omitted to avoid disclosure of about specific taxpayers

1 Deemed and actual dividends, interest, gross rents, royalties and license fees, gross income from performance of services and other income.

2 Foreign taxes paid or accrued plus taxes deemed paid less reductions of taxes paid, accrued, or deemed paid.

3 Includes carrybacks and carryovers of foreign taxes from other years.

4 Separate limitation income in limitation categories with excess foreign tax credits as a percent of all separate limitation income.

5 Separate limitation income in limitation categories with excess foreign tax credits excluding carryovers as a percent of all separate limitation income.

Source: IRS Statistics of Income Division tabulation of Form 1118 and PricewaterhouseCoopers calculations.

Table 6–10. Large Cross-Border Mergers and Acquisitions, 1998–2000

Item	Firms		Transaction value	
	Number	Percent	Amount	Percent
<i>1998 Mergers and acquisitions</i>				
All target firms	51	100.0%	\$175,464	100.0%
Foreign acquisition of U.S. firm	34	66.7%	\$151,283	86.2%
U.S. acquisition of foreign firm	17	33.3%	\$24,181	13.8%
Financial services target firms	15	100.0%	\$14,867	100.0%
Foreign acquisition of U.S. firm	12	80.0%	\$11,316	76.1%
U.S. acquisition of foreign firm	3	20.0%	\$3,551	23.9%
<i>1999 Mergers and acquisitions</i>				
All target firms	77	100.0%	\$224,458	100.0%
Foreign acquisition of U.S. firm	45	58.4%	\$163,579	72.9%
U.S. acquisition of foreign firm	32	41.6%	\$60,879	27.1%
Financial services target firms	9	100.0%	\$35,166	100.0%
Foreign acquisition of U.S. firm	8	80.0%	\$33,796	96.1%
U.S. acquisition of foreign firm	1	20.0%	\$1,370	3.9%
<i>2000 Mergers and acquisitions (through November)</i>				
All target firms	96	100.0%	\$243,436	100.0%
Foreign acquisition of U.S. firm	65	67.7%	\$192,793	72.9%
U.S. acquisition of foreign firm	31	32.3%	\$50,643	20.8%
Financial services target firms	16	100.0%	\$60,233	100.0%
Foreign acquisition of U.S. firm	12	75.0%	\$48,093	79.8%
U.S. acquisition of foreign firm	4	25.0%	\$12,140	20.2%

Source: MERGERS & ACQUISITIONS (Marsh & McLennan Companies). PricewaterhouseCoopers calculations.