institute for research on the economics of taxation

Economic Report

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THE ECONOMICS OF THE FOREIGN TAX CREDIT*

For most U.S. taxpayers, the foreign tax credit provisions of the Internal Revenue Code are not only arcane, they are also uninteresting. But the U.S. federal income tax treatment of income produced by U.S. firms operating in foreign jurisdictions has important consequences for the efficiency with which the U.S. economy performs. Moreover, the foreign tax credit provisions raise some basic, long-standing conceptual issues. The economic fundamentals involved in addressing these issues need to be well in hand if those interested in tax policy are to grasp the economic implications of proposals and developments in this field. For example, if the current interest in broad-based, "flat-rate" taxes materializes as serious legislative efforts, tax policy makers should be aware of what the alternative flat-tax approaches call for with respect to income produced abroad.

Role of the Foreign Tax Credit

The first question to be addressed is what is the foreign tax credit supposed to do? Why is it part of the Federal income tax?

Like so much of the U.S. income tax law, the foreign tax credit reflects the eclectic approach of tax policy makers. It is an uneasy compromise between two opposing "principles" --- the residence principle and the origin principle. The residence principle holds that the citizen's liability for tax payments to this country of citizenship doesn't depend on where the income is earned; tax liability follows the flag; the country of which one is a citizen has the right to tax one's income irrespective of where it is earned and presumably in precisely the same manner as if the income were earned domestically. The origin principle, on the other hand, holds that the jurisdiction in which the income is produced has the right to levy on it, irrespective of the citizenship of the producer.

The foreign tax credit provisions affirm the right of the U.S. to levy its tax, based on its taxable income concepts, on its citizens' foreign-source income, but at the same time these provisions require the U.S. to forego the exercise of this right to the extent that (1) the foreign jurisdiction has imposed an income tax --- or what is, by regulation, deemed to be its

* This paper is based on a speech delivered on June 30, 1983, at a National Foreign Trade Council Foundation conference on proposed foreign tax credit regulations.

equivalent --- on the income which the U.S. citizen produced within its borders, but (2) only insofar as the foreign tax doesn't exceed the U.S. tax.

The obscurity of any unifying logic in this treatment is deepened by the facts that (1) the FTC's compromise treatment applies only with respect to income taxes or their equivalent, and (2) the application of U.S. tax and of the offsetting credit is triggered by the repatriation of foreign earnings.

The "reasoning" behind limiting the FTC to foreign taxes that are deemed to be income taxes or their equivalent is itself obscure. One must presume that it rests on the notion that only income taxes are "borne" by the taxpayer, that other taxes are "passed on," hence impose no burden on the income-producing activity. In this latter case, the imposition of the U.S. income tax on the foreign-produced income will not result in a double tax which would arise in the case of failure to allow a credit for income taxes paid to the foreign government.

This reasoning is faulty. The idea that only income taxes, or their equivalent, are borne by the taxpayer is without solid substance. Presumably, the operational sense of "borne" is that the income tax erodes the income of the taxpayer without the taxpayer's being able to repair this erosion at all by charging customers more or paying suppliers of production inputs less. It is difficult to identify any tax which "sticks" completely to the entity which has the legal responsibility for paying it, except in the most literal and superficial sense. For any tax to be "borne" in this sense, the taxpayer must be entirely unable to adjust his behavior in response to the levy. There is no tax of which this is true, which elicits a zero response. A zero response would mean that the tax does not change any relative price or cost and/or that the elasticity of response to the price or cost change is zero. Nature abhors zero elasticities just as much, if not more, than a vacuum. Every tax ever devised alters one or more relative prices. A personal income tax, for example, raises the cost of working to earn taxable income compared with the cost of using one's time and resources to produce nontaxable income, i.e., leisure. It raises the cost of saving relative to consumption. The responses to these relative cost effects are reflected, in part, in higher market wage rates and higher interest rates and other pretax returns on capital than would otherwise prevail. The tax is in some degree "passed on."

In much the same manner, the corporate income tax is "passed on." It is in this sense that it is literally true that corporations don't pay income, or any other, taxes. Since a substantial number of the U.S. "persons" producing income abroad are corporations, the distinction between income and other taxes for foreign tax purposes is gauzy indeed.

The flip side of this is that in general the taxes that are usually deemed to be fully "passed on" in fact rest in some considerable part on the same persons who ultimately bear the burden of the taxes that are deemed to stick like glue. Excise and other so-called indirect taxes are widely and mistakenly thought to be passed forward to ultimate consumers of the taxed thing(s). But this is true only if the demand for the taxed thing(s) is perfectly inelastic; i.e., if the producer-seller can charge any price for it without changing the quantity of it which people will buy. Since this is a completely unreal situation, it follows that all excises or other indirect taxes come out of the income of the suppliers of production inputs who respond to such exactions in virtually the same way as they do to income or direct taxes.

The distinction between direct and indirect taxes is a semantic one of little, if any, basic economic substance. The difference in their treatment for FTC purposes is not warranted by differences in the incidence of these taxes.[1] The so-called "deferral" provision also obscures the logic of the FTC. Clearly, the question of deferral would be irrelevant if the origin principle were followed because there would be no U.S. tax on income derived abroad. The repatriation test for the timing of U.S. tax liability is applicable only by virtue of basing U.S. tax treatment of foreign-source income on the residence principle. But the unqualified application of the residence principle, in logic, should completely disregard where the income is earned and when it "comes home" for purposes of determining when the U.S. tax liability on foreign-source income arises and when that liability is to be discharged.

It must be clear that U.S. tax-policy makers have, to date, rejected the unqualified application of the residence principle. The FTC and the repatriation test for realization of foreign-source income strongly argue that U.S. tax policy has sought an accomodation between opposing perspectives on how the Federal income tax should apply to income produced by U.S. nationals in foreign jurisdictions. But this accomodation rests on a flimsy logical foundation, which means that it is more or less continuously in peril. It is subject to frequent tinkering which might well turn into drastic legislative modification under the revenue-raising pressure generated by huge budgetary deficits.

So long as we continue to rely on an income tax of the present configuration, the FTC is essential to avert economic isolationism. Any significant constraint on the FTC's availability or effectiveness in offsetting foreign against U.S. taxes would place U.S. business at an enormous competitive disadvantage in attempting to undertake operations in foreign jurisdictions. There is, to be sure, a widely-held view that increasing the combined tax burdens on the profits of U.S. businesses abroad would result in relocating currently foreign-sited capital to the U.S., with resulting gains in U.S. output and employment. This view is mistaken. Tax constraints on the location of capital must reduce the efficiency --- productivity --- of its use. For the same reason, such constraints would make the economy poorer, not more productive.

Neutrality and Taxation of Foreign-Source Income

In recent years, economists have come more and more to address the question of how income produced abroad should be taxed in order to minimize the so-called dead-weight losses of taxation. In a less esoteric lexicon, the focus is on what kind of tax treatment conforms most closely with the requirements for tax neutrality.

The concept of tax neutrality as applied in this field of tax policy, I believe, has more often than not been poorly delineated, if not actually misrepresented. The standard treatment is to hold that there are alternative meanings of neutrality, each depending on a particular objective of tax policy. Neutrality concepts proliferate along with policy objectives. But ultimately we come down to two basic alternatives. One holds that tax arrangements are neutral if they result in an allocation of capital among sovereign jurisdictions which maximizes total or worldwide output. The other maintains that tax provisions are neutral from the point of view of any one sovereign jurisdiction if they result in an allocation of capital which maximizes that jurisdiction's gross domestic product.

There is something quite unsatisfactory in this flexible approach to defining a term. Indeed, there is a uniquely satisfactory meaning of the term neutrality which leads to a single correct prescription for tax provisions pertaining to income produced abroad.

Neutrality means that the tax provisions do not alter the <u>relative</u> costs and prices which would exist in the absence of the tax. What does this concept call for regarding the tax treatment a country should apply to the income its nationals produce in some other country's jurisdiction?

Suppose that two countries, D and F, each has its own and different tax system. Since no tax yet devised has been perfectly neutral as defined above, this means that there are some price distortions in both countries and these distortions differ. For this reason, the price structure in D will differ from that in F. Neutrality cannot be construed to mean that because D chose to alter its relative price structure in a particular way through the taxes it levies, it should require the same relative price structure in F. In other words, in the interests of neutrality, D must not attempt to impose its tax system on F. Neither country will try to use its fiscal powers to alter the other's price structure, either for its nationals or those of the other country. If D's nationals conduct business in F, or F's in D's, their activities will be governed solely by the opportunities and constraints presented by the host country's price structure. In turn, this means that each country imposes no taxes whatever on the income its national produce in the other country, leaving that income fully exposed only to the tax system of the country in which the production occurs.

The tax approach called for by this definition of neutrality is <u>territoriality</u>. A fully implemented territorial tax system would provide that a country would impose no tax whatever on the income its nationals produce in a foreign jurisdiction; such income would bear only the taxes, if any, imposed by the foreign jurisdiction. The no-tax rule would apply no matter what the legal relationship --- branch, division, subsidiary --- between the domestic company and the foreign-sited business. Moreover, no domestic tax would apply whether or not the earnings were repatriated.

Territoriality not only conforms with a rigorous definition of neutrality, it also is the only tax regimen which maximizes both world and domestic output.

There are important implications in this approach with respect to many U.S. tax policy concerns. The most obvious is that with a tax structure that is consistent with neutrality, the FTC provisions of the Code and regulations would vanish becuase they'd have no function. Perhaps not so obvious but equally demanded by neutrality would be the excising of subpart F. Numerous other areas can be identified in which the aplication of tax treatment consistent with neutrality would resolve many of the thorny issues of existing tax policy.

Not all such sticky questions would go away, however, if the territorial approach were adopted in the context of our existing tax system. Indeed, in this context all of the allocation problems under Section 482 and 861 would become more severe. The urgency of basic revisions of Section 482 to conform its rules with the facts of economic life would be enormously intensified. The how and why of such revisions, however, would not come any readier to hand.

"Flat" Taxes and the Foreign Tax Credit

On the other hand, if the current sparks of interest in so-called "flat taxes" turn into a major policy conflagration, the resulting tax treatment of foreign-source income is likely to differ dramatically from that under present law and to afford differing solutions to the diverse problems currently posed.

There are two basic flat-tax approaches, one of which may be called the expanded income tax, the other the expenditure tax. A major feature in both approaches is that the corporate income tax would be eliminated as a separate levy. In the expanded income tax, all net income generated in a corporation would be attributed to its shareholders and taxed under the individual income tax. Under the expenditure tax, the exclusion of current savings from the tax base would automatically exclude corporate retained earnings from tax, limiting the tax to the dividends distributed to shareholders to the extent they were not reinvested.

In a pure expanded income tax, all of a U.S. citizen's income in whatever form and wherever obtained would be included in the tax base. Earnings of foreign subsidiaries of U.S. corporations would flow through the U.S. parent to its individual shareholders as that income is earned. Distribution by the foreign subsidiary to the domestic parent would not be a factor in determining when tax liability would arise; the attribution of the foreign subsidiary's earnings to the U.S. parent company would not depend on whether the earnigns were remitted to the U.S. parent.

The basic principle which the expanded income concept incorporates would also dictate eliminating the FTC and allowing only a deduction from the tax base for taxes paid to a foreign jurisdiction. In determining the income of a trade or business, in other words, all foreign taxes would be treated as business expenses, deductible from the tax base.

Implementing the residence principle in the expanded income tax would substantially eliminate the problems encountered under present law in determining the allocation of income between domestic parent and foreign subsidiary companies. Virtually all of the Section 482 requirements for the allocation of income among related companies would automatically be eliminated. Similarly, the Section 861 requirements for the allocation of overhead items, joint costs, interest, etc., among related parties would become redundant.

The *expenditure* tax would provide automatically for implementing the origin principle with respect to the taxation of returns on foreign-sited capital. Under the expenditure tax, retained corporate earnings would not be included in the individual shareholder's tax base, because such earnings, by definition, are saved. Thus, earnings of a foreign subsidiary would not enter into determination of the expenditure tax base so long as these earnings were retained abroad. Even when remitted to a domestic company, the foreign subsidiary's earnings would have no U.S. tax consequences if retained by the U.S. company. Only if the domestic firm distributed some or all of the earnings derived abroad to its individual shareholders would any tax consequences follow and then only to the extent that the shareholders used the dividends to purchase consumption goods and services rather than reinvesting them.

The expenditure tax would present no occasion for either a credit or deduction for foreign taxes. Because there would be no corporation tax, the tax paid by a U.S. subsidiary in a foreign jurisdiction would have no bearing on U.S. taxpayers. Any such foreign earnings would enter into the U.S. tax only insofar as they were remitted to U.S. resident individuals and were not saved. The taxes on such earnings paid to foreign governments, however, would not be included in the amount of these earnings spent on consumption items in the U.S. In short, because the income produced abroad would not be included *per se* in the expenditure tax base, there would be no reason to allow either a deduction from that base or a credit against the expenditure tax for any tax paid to a foreign jurisdiction.

The income and cost allocation questions addressed under the present Internal Revenue Code Sections 482 and 861 would cease to be relevant for U.S. tax purposes under an expenditure tax. No U.S. tax consequences would follow from a company's determination that more or less of its consolidated income was produced by a foreign subsidiary, although such determinations might well remain consequential for purposes of the foreign jurisdiction's tax. By the same token, the way overhead and joint costs were allocated among the related companies would be of no significance for U.S. tax purposes but might well become even more important factors in terms of minimizing foreign tax liabilities.[2]

It is unlikely, of course, that any significant tax base revisions which might be legislated would implement fully either the pure expanded income or the pure expenditure tax concepts. For this reason, it is difficult to project the outcome with respect to the treatment, in any such new tax, of income produced abroad. The expenditure tax would comply very closely with the standards of tax neutrality applied to both domestic and foreign-source income; as such, it offers the best opportunity to conform our tax system with the requirements of a progressive, dynamic, and free-market oriented economy. Even if no sturdy movement in this direction develops, however, the economic principles of tax neutrality underlying this approach should offer useful guides to a more constructive tax policy regarding American businesses abroad than we have often followed in the past.

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[1] If one insists there is a difference in incidence --- i.e., direct taxes aren't passed on but indirect taxes are, one should be hard pressed to justify even a deduction for the latter. This point is ignored in the standard tax reform pitch that the FTC should be replaced by a deduction of foreign taxes from income. If implemented, this would presumably result in equal U.S. income tax treatment of foreign income and indirect taxes, just as state income taxes and sales taxes are both only deductible from income. The non-differentiated federal income tax treatment of state direct and indirect taxes should certainly raise questions either about the distinction in the FTC's application to different types of foreign taxes or the lack of such a distinction regarding domestic state taxes.

[2] In many cases, present U.S. tax law provides a stong impetus to allocate as much as possible of the consolidated entities' gross income to one or more foreign subsidiaries while allocating as much of the overhead and joint costs as possible to the U.S. parent firm. The expenditure tax would substantially reverse this impetus.

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July 27, 1983