PPL: Exposing the Flaws Of the Foreign Tax Credit

By Alan D. Viard

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In this article, Viard explains that PPL Corp. v. Commissioner highlights the lack of a sound policy reason for the foreign tax credit’s favorable treatment of foreign income taxes relative to other foreign taxes and nontax costs of earning foreign income. He argues that relief from excessive taxation of cross-border investment is better achieved by eliminating corporate-level taxes on overseas income and the remaining source-based taxes on portfolio income.

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On February 20 the Supreme Court heard oral arguments in PPL Corp. v. Commissioner. The Court will decide in the next few months whether a windfall tax imposed by the United Kingdom on privatized utilities in 1997 falls within the category of “income, war profits, and excess profits taxes” that qualify for the foreign tax credit under section 901. Rather than seeking to answer that question, I argue that relief from excessive taxation of cross-border investment is better achieved by eliminating corporate-level taxes on overseas income and the remaining source-based taxes on portfolio income.

One possible response, suggested by some commentators, is to broaden the set of foreign taxes that are creditable. The best reform, however, would move in the opposite direction and make all foreign taxes deductible at the tax rate imposed on foreign income, the treatment extended to other foreign business costs. Reiterating a point made a half-century ago by Peggy Musgrave, Daniel N. Shaviro of the New York University School of Law recently emphasized that from the standpoint of American well-being, U.S. taxpayers’ foreign income tax payments are no different than their other foreign tax payments, nontax foreign business costs, and reductions in foreign income. The credit reduces American well-being by artificially and inefficiently diluting U.S. taxpayers’ incentives to minimize foreign income taxes, because those taxes can be offset by the credit. The credit prompts American companies to operate in high-tax countries, to be less zealous in challenging foreign tax assessments, and to enter transactions that reallocate other parties’ foreign income tax liabilities to them in exchange for other benefits. Statutory and regulatory restrictions on the credit cannot satisfactorily combat those incentives.

Moreover, the credit is not the best way to achieve global cooperation to combat excessive taxation of cross-border investment. That goal is better achieved by continuing the international movement toward a regime in which capital income is taxed only at the individual level in the individual investor’s country of residence.

The Foreign Tax Credit

Section 27(a) allows a nonrefundable credit, computed under section 901, for income, war profits, and excess profits taxes paid by U.S. taxpayers, both the U.S. income tax system to treat foreign income taxes more generously than foreign taxes on asset values.

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individual and corporate, to foreign countries. Sections 901(b) and 906 generally allow the credit to be claimed only by citizens and residents of the United States and nonresident aliens carrying on a trade or business within the United States. In 2009, corporations claimed $93 billion of FTCs and individuals claimed $13 billion.

Section 904 provides that a taxpayer’s credit may not exceed a proportion of the taxpayer’s before-credit U.S. tax that is equal to the proportion of the taxpayer’s income that is derived from sources outside the United States. Section 59(a) prescribes a similar limit under the alternative minimum tax. The limit is applied separately to passive category income, as defined in section 904(d)(2), and other income. For a taxpayer who owes $35 of U.S. tax before credit on $100 of income of which $40 is foreign passive income, $20 is other foreign income, and the remainder is domestic income, credit may be claimed for only $14 (35 percent of $40) of taxes on the foreign passive income and only $7 (35 percent of $20) of taxes on the other foreign income. Under section 904(c), foreign income taxes in excess of the limit may be carried back one year or forward 10 years. Section 904(j) exempts individual taxpayers with small amounts of foreign portfolio income from the limitation.

Because the availability of the credit is not conditioned on reciprocity, credit may be claimed for taxes paid to a country that does not offer a similar credit. But section 901(j) provides that credit may not be claimed for taxes paid to countries whose government the United States does not recognize (except those entitled to purchase defense articles or services under the Arms Export Control Act) or with which the United States has severed, or does not conduct, diplomatic relations, or governments that the secretary of state has designated as supporters of terrorism. Section 908 also reduces the credit for a taxpayer with operations in a country that requires participation in an international boycott described in section 999, if the taxpayer participates in or cooperates with the boycott. Section 901(b) prescribes tracing rules that allocate each dividend to the foreign corporation’s earnings in previous years to determine which portion of each year’s foreign income taxes are attributed to the dividend. Section 960 similarly provides an indirect FTC for foreign income taxes attributed to subpart F income that is taxed under section 951; the section 78 gross-up also applies.

3The credit may also be claimed for income taxes paid to possessions of the United States. That provision lies outside the scope of this article, as does the credit for foreign estate and gift taxes provided by section 2014.

4Cuba, Iran, Libya, North Korea, Sudan, and Syria meet these criteria, but taxes paid to Libya are creditable because of a 2004 presidential waiver granted under section 901(j)(5).

5According to Treasury’s most recent quarterly list, 78 F.R. 10690 (Feb. 14, 2013), Iraq, Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, the United Arab Emirates, and Yemen, which take part in the Arab League’s boycott of Israel, are subject to the provision.

6Section 901(j) provides that credit may not be claimed for taxes paid to countries whose government the United States does not recognize (except those entitled to purchase defense articles or services under the Arms Export Control Act) or with which the United States has severed, or does not conduct, diplomatic relations, or governments that the secretary of state has designated as supporters of terrorism.

7Portfolio investors in a corporation may claim credit for dividend withholding taxes and other foreign income taxes directly imposed on them, but not for foreign income taxes imposed on the corporation. Because the taxes diminish the corporation’s dividends, however, investors receive an implicit deduction for the corporation’s taxes. For example, if a corporation earns $100 of pretax profits, pays $30 of foreign income taxes, and distributes the remaining $70 as dividends to U.S. investors, the investors pay U.S. income tax on only the $70 that they receive, effectively deducting the $30 of foreign income taxes from the $100 of pretax profits.

Congress has provided more generous treatment in one context. Section 902 permits a domestic corporation that owns more than 10 percent of a foreign corporation’s voting stock to claim an indirect FTC for its proportionate share of foreign income taxes paid by the foreign corporation. The imposition of U.S. tax and allowance of the credit generally are deferred until a dividend is paid to the U.S. parent. To ensure that the indirect credit replaces rather than supplements the implicit deduction described above, section 78 requires that taxable dividends be grossed up by the foreign income taxes. In the above example, if the foreign corporation pays a $70 dividend to its U.S. parent, the parent is taxed on $100 of income consisting of the $70 actual dividend and $30 of deemed dividends equal to the foreign income taxes, and then claims the credit for the $30 of foreign income taxes. A parent corporation may claim credit for foreign income taxes paid by its subsidiaries through six tiers of ownership.

When Congress adopted the modern income tax in 1913, it only allowed a deduction for foreign income taxes. The credit was introduced in 1918. It was initially allowed to offset all U.S. tax liability, but the forerunner of the section 904 limitation was imposed in 1921.

A 100 percent credit for a taxpayer’s outlay is extraordinarily generous because it results in the taxpayer bearing no after-tax cost until some limit such as that imposed by section 904 becomes applicable. Other tax credits provided by the code tend to feature rates of 10 to 50 percent, thereby requiring
taxpayers to bear 50 to 90 percent of the pretax costs. Deductions are equivalent to credits with rates equal to the taxpayer’s marginal tax rate; for corporate taxpayers, a deduction is equivalent to a 35 percent credit. Congress has rarely granted 100 percent credits.7

Despite its unusual generosity, the FTC has enjoyed almost unanimous support.8 It has frequently been given favorable treatment relative to other credits and deductions. Although the FTC is far more generous than the itemized deduction for state, local, and tribal taxes offered by section 164, only that deduction, not the credit, appears on the lists of tax expenditures published by the Joint Committee on Taxation and the Office of Management and Budget. The OMB explains that the credit is not a tax expenditure because its tax baselines “allow a tax credit for foreign income taxes paid (up to the amount of U.S. income taxes that would otherwise be due), which prevents double taxation of income earned abroad.”9 The FTC, unlike most business tax credits, is allowed under the individual and corporate AMT.10 The Buffett tax bill considered by the Senate on February 28, 2013, would have allowed the FTC, but no other credits, to be claimed against the bill’s proposed minimum tax on millionaires.11 President George W. Bush’s 2003 proposal to integrate the individual and corporate income taxes also provided favorable treatment. Under that proposal, dividends would generally have been subject to individual income tax only to the extent they were attributed to corporate profits that had escaped corporate income tax. The proposal stipulated, however, that dividends attribute-able to corporate profits that had been shielded from corporate income tax by the FTC would be exempt from individual income tax.12 Tax reform plans rarely propose elimination of the FTC.

Because foreign income taxes are creditable while other foreign taxes and costs are merely deductible, a definition of income taxes is imperative. The Supreme Court said in 1938 that the definition of income taxes for purposes of the credit is controlled by the “well understood meaning” of the term in U.S. parlance rather than by a “shifting standard” that depends on “foreign characterizations and classifications of tax legislation.”13 Reg. section 1.901-2 sets forth detailed rules for determining which payments constitute taxes and which taxes constitute creditable income taxes (a category apparently deemed to include the war profits taxes and excess profits taxes referred to in section 901).

The regulation says that payments qualify as taxes only if they are compulsory payments imposed under a foreign country’s authority to levy taxes; there is no credit for voluntary payments, penalties, fines, and interest. Under reg. section 1.901-2(a), a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. To qualify as a creditable income tax, the foreign levy must have the “predominant character” of an “income tax in the U.S. sense,” as manifested by three criteria. Reg. section 1.901-2(b)(2) requires, with some exceptions, that the levy be imposed on or after realization events. Reg. section 1.901-2(b)(3) generally requires that the tax base include gross receipts or an estimate thereof. Reg. section 1.901-2(b)(4) requires that the foreign tax system permit recovery of significant costs and expenses, so that the tax is ultimately imposed on net income.14 Taxes on asset values generally do not satisfy those criteria and are therefore not creditable. Congress’s decision to allow only foreign income taxes to be credited against U.S. income tax presumably

7Section 1400A(a) provides a 100 percent credit to some individuals for the costs of purchasing a home in the District of Columbia, but the credit is limited to $5,000, far less than the full cost of buying a home. Section 25A(i)(1)(A) offers a 100 percent credit for some tuition payments and related expenses, but the 100 percent rate applies only to the first $2,000 of outlays.

8There have been a few dissenting voices. In Continental Illinois Corp. v. Commissioner, 998 F.2d 513, 517 (7th Cir. 1993), Judge Richard A. Posner rejected the taxpayer’s claim that a change in the IRS’s position on the allowability of the credit must apply uniformly to past and future transactions, saying, “There is no basis in law, public policy, natural justice, or any other source of norms for such an insistence with respect to so artificial an entitlement as the foreign tax credit.” Also, Michael J. Graetz and Itai Grinberg, in “Taxing International Portfolio Income,” 56 Tax L. Rev. 537, 568-578 (2003), argued that there should be a deduction rather than a credit for foreign taxes on portfolio income.


10From 1987 through 2004, section 59(a)(2) limited the FTC under the AMT to 90 percent of the taxpayer’s before-credit AMT liability.

11See proposed code section 59B(a)(2)(B)(ii), as set forth in section 302(a) of S. 388.

12See proposed code section 281(d)(1)(A)(ii), as set forth in section 202(a) of H.R. 2, as introduced in the 108th Congress on February 27, 2003.


14Bilateral tax treaties may guarantee creditability of taxes that do not meet the section 901 standards. See Pamela B. Gann, “The Concept of an Independent Treaty Foreign Tax Credit,” 38 Tax L. Rev. 1 (1982). In Rev. Rul. 2002-16, 2002-1 C.B. 740, the IRS concluded that a 1.2 percent annual tax on asset values imposed by the Netherlands was creditable under the Netherlands-U.S. treaty. In the absence of the treaty, it is unlikely that the tax would have been creditable under section 901. David L. Cameron, in “PPL Corp.: Where’s the Treaty Argument?” Tax Notes, Mar. 4, 2013, p. 1117, contends that the tax at issue in PPL may be creditable under the U.K.-U.S. tax treaty, even if it is not creditable under section 901, an argument not addressed before the Supreme Court.
reflected its belief that the double taxation about which it was concerned arises only when both of the taxes involved are income taxes.

PPL vividly illustrates the arbitrariness of the distinction between foreign income taxes and other foreign taxes. Commentators and the parties have engaged in futile efforts to determine whether the U.K. windfall tax is an income tax or a tax on asset values. Because there is no economic reason to distinguish income taxes and asset taxes and because the U.K. tax lies at the borderline between them, the case cannot be satisfactorily resolved.

The Path to the Supreme Court

After the Conservative Party came to power in the United Kingdom in 1979, it privatized more than 50 companies that had previously been nationalized. Shares of the companies’ stock were sold to the public at fixed flotation prices, after which the shares traded at market prices on the London Stock Exchange. Many of the privatized companies were utilities that operated as monopolies. Although those companies were subject to price regulation after privatization, some of them posted large profits as a result of unexpected cost reductions, and their stockholders reaped high rates of return on their investments.

The opposition Labour Party condemned the companies’ allegedly excessive profits and pledged to recapture some of the money for the public treasury to finance youth employment training. The party retained the services of an Arthur Andersen LLP team in May 1996 to design a suitable tax, and the party leadership approved the Andersen team’s proposal in November 1996. The Labour Party won a solid majority in the House of Commons in the May 1, 1997, election. On July 31, 1997, Parliament enacted the tax as Part I of chapter 58, Finance (No. 2) Act 1997.

The statute imposed a tax on each privatized company that operated as a regulated monopoly. The tax was equal to 23 percent of the excess, if any, of the company’s “value in profit-making terms” over the total price at which the company’s stock was sold at the time of its privatization (its flotation value). The statute defined each company’s value in profit-making terms as its average annual profits during an initial period, multiplied by a constant price-earnings ratio that Parliament set equal to 9. A company’s initial period was its first four financial years after privatization, unless the company had less than four such years before April 1, 1997, in which case its initial period was the truncated interval from the privatization date through the end of the last financial year ending before April 1, 1997. Profits were defined as “profit on ordinary activities after tax” as set forth in the financial accounting reports that each company filed with the U.K. Registrar of Companies. The tax was a one-time levy, with half of the tax due by December 1, 1997, and the other half by December 1, 1998.

Parliament apparently viewed the value in profit-making terms as the price at which the company should have been sold to investors. In the statutory text, it defined any excess of that value over the flotation value as “the windfall from which a company was benefiting.” Thirty-one companies had a value in profit-making terms greater than flotation value and therefore owed tax.

In a 2002 coordinated issue paper and in a 2007 technical advice memorandum, the IRS concluded that the U.K. windfall tax was not a creditable income tax. That position was later tested in litigation.

On its 1997 return, PPL Corp. claimed an indirect FTC for its share of the windfall tax paid by its subsidiary, South Western Electricity PLC. After the IRS disallowed the credit and issued a deficiency notice, PPL petitioned the Tax Court. Following a trial that featured extensive testimony about the adoption and implementation of the tax, Judge James S. Halpern held in favor of PPL on September 9, 2010. On December 22, 2011, a three-judge panel of the Third Circuit unanimously reversed the Tax Court and held that the tax was not creditable. PPL’s petition for rehearing was denied on March 9, 2012.

PPL was not the only taxpayer to litigate the issue. Entergy Corp. claimed an indirect FTC on its 1998 return for the windfall tax paid by its subsidiary, London Electricity PLC. After the IRS disallowed the credit and Entergy petitioned the Tax Court, Halpern held in the company’s favor in a September 9, 2010, memorandum decision that relied on his decision that same day in PPL. On June 5, 2012, a three-judge panel of the Fifth Circuit unanimously affirmed the Tax Court, holding that the tax was creditable. Writing for the entire panel, Judge Edith H. Jones rejected the position taken by the Third Circuit several months earlier.

On July 9, 2012, PPL petitioned the Supreme Court for certiorari. On October 29, the Court granted certiorari to resolve the conflict between the Third and Fifth circuits. The government petitioned...
The parties dispute whether the U.K. windfall tax is a tax on excess value or a tax on excess profits. This question cannot be satisfactorily answered because there is no meaningful distinction between these two concepts for a retroactive tax such as the U.K. tax. Although each side argues that it is correctly characterizing the substance of the tax and disregarding its form, their rival characterizations have few substantive differences, and their disagreements are primarily about form.

The parties, the amici, and the commentators describe the dispute in algebraic terms. If a taxed company had an initial period comprising four full years (as 29 of the 31 taxed companies did), its tax liability is given by the following formula:

\[(1) \text{Tax} = 0.23 \times [2.25 \times (\text{Initial-Period Profits}) - \text{Flotation Value}]\]

The 2.25 value reflects that the company must divide its initial-period profits by 4 to obtain average annual profits and must then multiply by 9, the assumed price-earnings ratio, to obtain the amount that, after subtraction of flotation value, is subject to tax. The company’s tax liability is also given by the following formula:

\[(2) \text{Tax} = 0.5175 \times [(\text{Initial-Period Profits}) - 0.444 \times \text{Flotation Value}]\]

The parties debate which of the two formulas provides a more correct statement of the substance of the tax. To pose the question is to reveal its absurdity. Because the two formulas are algebraically equivalent to each other, it is impossible for one to be more correct or more substantive than the other.

PPL contends that formula 2 correctly captures the substance of the tax and that the tax described by the formula is creditable. The formula refers to a 51.75 percent tax on the profits earned during a specific four-year period in excess of a base amount equal to 44.4 percent of the company’s flotation value. The parties agree that the profits that enter the formula are computed in a manner consistent with reg. section 1.901-2. PPL also argues that the presence of the base amount and its link to a past market value cannot defeat creditability. Section 901 allows a credit not only for income taxes but also for excess profits taxes. By setting the base amount at 44.4 percent of the flotation value, formula 2 imposes tax on the four-year profits to the extent that they exceed an 11.1 percent annual return on the flotation value. PPL notes that it is common for an excess profits tax to be imposed on profits above a specified rate of return on a company’s value.

In contrast, the government claims that formula 1 correctly captures the substance of the tax and further contends that the substance of the quantity 2.25 x (Initial-Period Profits) is an estimate of the company’s market value. The government notes that market values are often estimated by applying a multiplier to future profits. Although formula 1 uses profits from a period that preceded the enactment and payment of the tax, the formula seeks to estimate the company’s true value on the privatization date; viewed from the vantage point of that date, the profits during the four-year period were future profits. Of course, the use of additional years’ profits might have provided a more accurate measure of value, but a tax imposed on an imperfect measurement of value is still a tax on value. Because formula 1 imposes a tax on the difference between two market values, the tax fails to satisfy the requirements in reg. section 1.901-2(b)(2) and is not creditable. The government further argues that even if the quantity 2.25 x (Initial-Period Profits) is not viewed as an estimate of market value, it certainly cannot be viewed as a measure of profits. The government notes that this quantity differs dramatically from profits; indeed, it is always and inevitably more than twice as large as profits.

By using formula 2, PPL correctly observes that the U.K. windfall tax is economically similar to some taxes that clearly qualify for the credit. By using formula 1 and Parliament’s terminology, the government correctly observes that the U.K. tax is economically similar to some taxes that clearly do not qualify for the credit. The fact that both parties are correct reveals that the credit provides disparate treatment of economically similar foreign levies.

Even when taxes are prospective, income taxes and taxes on asset values have significant similarities. But they do generally have different risk properties. Consider a $1,000 investment that is equally likely to yield $50 of income, $100 of income, or $150 of income. A 10 percent tax on income would have the same $10 expected revenue as a 1 percent tax on the $1,000 asset value. But the 10 percent income tax is as likely to yield $5 or $15 of revenue as it is to yield $10, whereas the 1 percent tax on asset value is certain to yield $10.

In some economic environments, the risk differences between income taxes and asset taxes ultimately do not matter because investors adjust their portfolios in response to tax changes in ways that leave the allocation of risk between investors and...
the government unchanged. In other economic environments, investors do not fully adjust their portfolios, and the risk differences between the two kinds of taxes have real economic consequences.\textsuperscript{19} Even when the risk differences between income taxes and asset taxes have real effects, however, it is hard to see why those differences should affect the U.S. treatment of the taxes. Allowing credit for foreign income taxes while denying credit for foreign asset taxes represents an economically arbitrary distinction; there is no coherent reason why the risk differences should make some taxes creditable and others merely deductible.

For prospective taxes, however, the distinction between income taxes and asset taxes is at least administrable. We can distinguish the two kinds of taxes and can treat them differently, even if the differential treatment does not make sense.

For retroactive taxes, however, the distinction between taxes on value and taxes on income becomes essentially meaningless. The risk differences that allowed us to distinguish the two kinds of taxes vanish once actual income becomes known. If the investment in the above example ended up yielding $150 of income, a 10 percent retroactive tax on the income is identical to a 1.5 percent retroactive tax on the asset value. If the investment ended up yielding $50, the 10 percent retroactive income tax is identical to a 0.5 percent retroactive tax on the asset value. If it ended up yielding $100, the 10 percent retroactive income tax is identical to a 1 percent retroactive tax on the asset value. The distinction between income and value taxes, which never had any logical relevance for creditability, no longer exists.

That situation applies to the U.K. windfall tax, which was enacted on July 31, 1997, but was computed using profits earned during intervals that ended no later than April 1, 1997, and sometimes much earlier. Because retroactive income taxes and retroactive value taxes are the same, it is logically impossible to decide whether a specific retroactive tax is really one or the other.

The fundamental indeterminacy was quickly noted during the oral arguments. Minutes after the arguments began, Justice Sonia Sotomayor asked Paul D. Clement of Bancroft LLP, who argued on behalf of PPL that:

“...whether you paid too much or too little money depends on the value of the investment...”

Later in the argument, Justice Anthony M. Kennedy asked Clement whether it would be different if the statutory text had stated that the purpose of the tax was to compensate the government for having valued the share at too low a price. Clement replied that it would make no difference because the substance rather than the purpose of the tax mattered, but he added the following revealing observation:

“...You always have to look at it their way? Why does it have to be your way?\textsuperscript{20}”

Slicing the Shadow

The obvious way to seek an escape from the fundamental indeterminacy is to claim that an economically unimportant characteristic of the tax provides a determinate answer. Both lawyers took that route. Three criteria were advanced during oral arguments as ways to distinguish between income taxes and asset taxes.

Clement answered the questions posed by Sotomayor and Kennedy by invoking a tax computation criterion. He said that the tax was a tax on profits rather than value because it was computed using profits during the initial period rather than by using an observation of market value.\textsuperscript{23} Returning to the previous example, consider the case in which the $1,000 investment ended up yielding $100 of income. According to the tax computation criterion, a


\textsuperscript{20}Transcript of oral argument in \textit{PPL}, at 4.

\textsuperscript{21}Id. at 24-25.

\textsuperscript{22}Id. at 39.

\textsuperscript{23}Id. at 7.
retroactive tax law instructing taxpayers to compute their tax as 10 percent of the $100 income imposes a creditable tax on income while a retroactive tax law instructing taxpayers to compute their tax as 1 percent of the $1,000 investment value imposes a non-creditable tax on value, despite the complete equivalence of the two procedures. Clement insisted that any tax predominantly based on actual profits would be creditable no matter how it was labeled, although a tax based on expected future profits or in which actual profits were only a minor factor would not be creditable.\textsuperscript{24}

On the other hand, O'Connell invoked a legislative terminology criterion. She insisted that the tax was a tax on value rather than profits because Parliament labeled the quantities entering the tax computation as measures of asset value. She said that the Court “should go with the tax that parliament actually wrote.”\textsuperscript{25} According to the legislative terminology criterion, a retroactive law that describes the 10 percent tax on the income as a 1 percent tax on 10 times the income and refers to 10 times the income as an estimate of asset value imposes a non-creditable tax on asset value, while a retroactive law that is written as a 10 percent tax is a creditable income tax. Throughout the argument, O'Connell insisted that any tax that is computed by applying a price-earnings multiplier to profits is non-creditable.\textsuperscript{26}

Last, Justices Elena Kagan and Stephen Breyer explored a rate uniformity criterion, which relies on the fact that the U.K. windfall tax has greater uniformity of rates across companies when it is described as a tax on value than when it is described as a tax on income. The government’s brief did not rely on this criterion, but an amicus brief filed by nine distinguished tax professors argued for the criterion.\textsuperscript{27} As the brief emphasized, two of the 31 taxed companies had initial periods of less than four full years because they were privatized less than four years before April 1, 1997. The use of the 23 percent tax rate and the assumed price-earnings ratio of 9 resulted in each company paying tax equal to 2.07 (= 9 x 0.23) times initial-period average annual profits. For companies with four full years in their initial periods, a tax payment of 2.07 years’ profits is 51.75 percent of the cumulative initial-period profits, as reflected in formulas 1 and 2. But for the two companies with shorter initial periods, a tax equal to 2.07 years’ profits is more than 51.75 percent of initial-period profits, and formulas 1 and 2 do not apply.

Of course, each company’s tax payment can still be written as a fraction of its initial-period profits minus the flotation value term, but the resulting fraction varies across companies. Specifically, the U.K. windfall tax can be described as a tax on initial-period profits (minus an 11.1 percent annual return on flotation value), imposed at a 54.75 percent rate on Northern Ireland Electricity, a 239.1 percent rate on Railtrack Group, and a 51.75 percent rate on the 29 other taxed companies.\textsuperscript{28} The rate variation is dramatic, with an effective tax rate far more than 100 percent on Railtrack Group, although the company’s final tax, reflecting the subtraction of the flotation value term, was less than 100 percent of its initial-period profits. In contrast, if the tax is described as a tax on the estimated asset value given by 9 times average annual profits, every company faces the same 23 percent tax rate.

The rate uniformity criterion has some appeal. Returning yet again to the example, suppose that different taxpayers make different $1,000 investments. In the end, some of the taxpayers earn $50, others earn $100, and still others earn $150. Consider a retroactive tax that imposes a $10 liability on all the taxpayers. The tax can be described as an income tax that imposes a 20 percent rate on the first group of taxpayers, a 10 percent rate on the second group, and a 13.3 percent rate on the third group. Alternatively, it can be described as a tax on asset value that imposes a 1 percent rate on all taxpayers. The rate uniformity criterion argues that the latter description should be preferred because it allows the tax to be described without the introduction of rate variations across taxpayers. It seems simpler and more plausible to think of the tax as a uniform tax on value rather than as a highly non-uniform tax on income.

After the issue was briefly posed by Sotomayor,\textsuperscript{29} Breyer and Kagan began an extensive discussion that occupied most of Clement’s argument time. Clement replied that the tax should be judged by its application to normal circumstances and not by two outliers with shorter initial periods.\textsuperscript{30} Kagan responded that the amicus brief’s focus on the companies with short initial periods was the “right

\textsuperscript{24}Id. at 26.
\textsuperscript{25}Id. at 39.
\textsuperscript{26}Id. at 33-34, 38-39, and 43-44.
\textsuperscript{27}Brief of Anne Alstott et al. as Amici Curiae in Support of Respondent at 22, PPL, No. 12-43 (Jan. 18, 2013). The rate uniformity criterion was also advanced by Jacob Goldin, “Reconsidering Substance Over Form in PPL,” Tax Notes, Dec. 10, 2012, p. 1229.
\textsuperscript{28}Alstott brief, supra note 27, at 15-16. The effective tax rates on the 29 companies actually diverge slightly from 51.75 percent based on the exact number of days in their four financial years.
\textsuperscript{29}See transcript, supra note 20, at 5.
\textsuperscript{30}Id. at 12-24.
argument” and disagreed with Clement’s characterization of the two companies as outliers. She contended that the tax was formulated as it was precisely in order to reach those cases so that a uniform tax rate would apply to an estimate of value.\(^{31}\)

None of these criteria genuinely resolve the fundamental indeterminacy. The first two can be easily dismissed. One formulation of a tax does not become more real than an equivalent formulation merely because the tax is computed using that formulation or because the legislature uses that formulation to describe the tax. The rate uniformity criterion has more appeal than the other criteria because it refers to the actual operation of the tax. Retroactive taxes are hard to classify because we cannot observe how the tax would have been imposed under different possible outcomes of a specific investment’s payoff; the criterion skirts that problem by looking at cross-sectional variation across different investments. However, nothing in the regulations or the case law requires that a foreign income tax have uniform rates.

Moreover, all these criteria are irrelevant to any coherent U.S. tax policy goal. Should the U.S. tax treatment of a foreign tax really be 2.86 times more generous based on how the tax is computed or described or on how uniform its rates are across taxpayers?

The nine professors also advanced a few other arguments with some economic weight. Yet, those arguments also fail to fully resolve the indeterminacy.

The professors’ brief argued that income taxes must be prospective and that all retroactive taxes should be classified as non-creditable.\(^{32}\) The suggestion has some appeal because, as discussed above, the retroactivity of the U.K. tax is the feature that precludes a definitive determination of whether it is an income tax or an asset tax. Given the difficulty of classification, it may be reasonable to treat all retroactive taxes identically. If treating all retroactive levies as creditable is considered excessively generous, all retroactive levies should be treated as non-creditable. Nevertheless, the blanket denial of creditability to retroactive taxes appears to have little support in the regulations or the case law. Again, it is unclear why the timing of the tax should determine whether it receives the more generous treatment afforded by the credit.

The professors’ brief also argues that the U.K. windfall tax is economically similar to a hypothetical policy that would have charged a higher flotation price when the companies were privatized. The brief argues that because there would have been no credit for the payment of a higher flotation price, similarly there should be no credit for the windfall tax.\(^{33}\) The argument is valid on its own terms but only highlights the underlying ambiguity. The windfall tax is economically similar to many taxes and policies (including a higher flotation price and a conventional excess profits tax), all of which are therefore economically similar to each other. Some of those taxes and policies trigger a credit while others do not. In view of that incoherence, there is no way to identify any particular tax or policy as the appropriate benchmark to which the windfall tax should be compared.

At oral arguments, O’Connell also invoked a tiebreaker rule of statutory interpretation. A longstanding canon, which the Supreme Court has stated in several federal tax cases, holds that exemptions from taxation should be construed narrowly. O’Connell contended that the canon was especially applicable to a provision as generous as the FTC.\(^{34}\) Maybe so, but the canon surrenders to the indeterminacy rather than resolving it. Saying that cases close to the dividing line should be resolved in a particular way does not help determine where the dividing line is located.

The inconclusive nature of the arguments should prompt a more fundamental reexamination of the premises of the debate. To determine whether a specific tax should be creditable, it seems reasonable to identify the properties of a tax that make a credit appropriate and ascertain whether the specific tax has those properties. An examination of that question reveals, however, that there is little case for creditability of any foreign taxes. The absence of an underlying rationale for the credit explains why current law has been driven to embrace arbitrary distinctions in identifying the taxes that receive a credit.

**Incentive to Pay Foreign Income Taxes**

As Shaviro has emphasized, the FTC gives U.S. taxpayers an artificial incentive to pay foreign income taxes rather than incur other taxes or nontax costs. That incentive makes no sense from the standpoint of U.S. national well-being, because there is no meaningful distinction between foreign income taxes and other foreign costs. I defer consideration of other countries’ well being until the next section.

Consider a U.S. taxpayer that must choose between two foreign investment projects. The first

\(^{31}\text{Id. at 36-38.}\)

\(^{32}\text{Alstott brief, supra note 27, at 24-26.}\)

\(^{33}\text{Id. at 34-35.}\)

\(^{34}\text{See transcript, supra note 20, at 39.}\)
Empirical evidence recently presented by Kimberly Clausing and Shaviro confirms that a country’s provision of an FTC prompts its investors to direct their overseas investments toward high-tax countries. Clausing and Shaviro found that OECD countries with credits placed a larger share of their foreign direct investment in high-tax countries (statutory corporate tax rate above 30 percent) and a smaller share in low-tax countries (statutory rate below 15 percent) than the OECD countries that exempt overseas income or have a hybrid credit/exemption system. The difference persisted in a statistical analysis that controlled for countries’ GDP levels, geographical distance, and other relevant variables.35

Economists have long observed that the tax system should provide favorable treatment for projects that have spillover benefits for third parties. For example, if doing one project rather than another provides environmental benefits for Americans and more favorable tax treatment causes it to be chosen, Americans can benefit as a result of the environmental gains. The FTC’s favorable treatment of the French project would have a similar justification if that project provided similar spillover benefits to the American people. But the project’s only distinctive feature is that it results in higher foreign income taxes, which offer little or no benefit to the American people.

The FTC also gives U.S. taxpayers an artificial incentive to make other decisions that substitute foreign income taxes for other costs or for income reductions. For example, suppose that the U.S. taxpayer, after choosing the French project, discovers a strategy that would lower its French tax liability from $60 to $55 but would diminish the project’s pretax payoff from $200 to $196. (The strategy might require business changes that lower income or increase expenses, or it might require that legal fees be incurred to contest a tax assessment.) The taxpayer’s use of the strategy would serve the American national interest because it would increase the project’s net-of-French-tax payoff from $140 to $141. Under an FTC, however, the taxpayer will forgo using the strategy because its use would increase U.S. tax liability by $3.60, which would more than offset the $1 increase in the net-of-French-tax payoff. In contrast, the taxpayer will use the strategy if the U.S. tax system allows a deduction for foreign income taxes.


36Before-credit U.S. tax liability would fall by $1.40 (35 percent of the $4 reduction in pretax payoffs), but the FTC would fall by $5.
reduction in its U.S. taxes.\textsuperscript{37} Of course, nobody taxpayer would receive a fully offsetting $1 billion foreign income tax liability because the credit for a subsidiary’s foreign income tax payments is deferred until the subsidiary’s earnings are repatriated to the United States; blunts the incentive to incur foreign income taxes. The section 904 limitation also places an upper bound on the extent to which taxpayers can incur foreign income taxes at the expense of the U.S. treasury, although the incentive to incur foreign income taxes remains intact until the limitation is reached.

Congress and the IRS have adopted additional restrictions to deter U.S. taxpayers from incurring easily avoidable foreign income taxes. That goal can be achieved either by making the avoidance costs creditable or by making the avoidable income taxes non-creditable. Section 903 uses the first strategy, allowing credit to be claimed for foreign taxes that are paid in lieu of income taxes. Several provisions use the second strategy. Reg. section 1.901-2(e)(5)(i) denies the credit if the taxpayer makes payments in excess of the liability determined under a reasonable interpretation of foreign law or fails to use all effective and practical administrative and judicial remedies to reduce tax. Reg. section 1.901-2(c) denies credit for “soak-up taxes” that make the taxpayer’s liability dependent on the availability of the FTC; the rule prevents foreign governments from imposing income taxes on U.S. taxpayers right up to the point at which the section 904 limitation is reached. Section 901(i) denies credit for taxes that are used to pay subsidies that are linked to the amount of tax payments and reg. section 1.901-2A denies credit for foreign income taxes that are deemed to be payments for specific economic benefits to the taxpayer.

In addition to creating an incentive for U.S. taxpayers to incur foreign income taxes that would otherwise not have been incurred, the credit also creates an incentive for transactions that shift foreign income taxes toward U.S. taxpayers and away from parties that cannot claim a similar credit. To see this point, modify the above example to consider a mutually beneficial transaction that allowed the U.S. taxpayer to pay $5 of French income tax that would otherwise have been paid by another party while giving the U.S. taxpayer $4 of income that would otherwise have gone to the other party.

Various rules seek to prevent reallocation of foreign income taxes to U.S. taxpayers. Reg. section 1.704-1(b)(4)(viii) restricts the allocation of a partnership’s foreign income tax credits among the partners. Section 901(k) and 901(l) deny credit for income taxes paid on assets that are held for only brief periods, in an effort to prevent U.S. taxpayers from buying assets right before the tax is imposed purely for the purpose of incurring a creditable liability. Section 901(m) prevents the use of asset acquisitions to direct foreign taxes toward U.S. taxpayers.

The rules are so extensive and intricate precisely because they are trying to negate the basic incentives built into the credit. Yet, they can address only the most extreme cases. As long as the credit exists, no rules can motivate U.S. taxpayers to zealously reduce their foreign income taxes. Reg. section 1.901-2(e)(5)(i) recognizes this reality by stating that a “taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax.” Yet, American national well-being would be advanced if the taxpayer altered those things whenever the foreign tax savings exceed the nontax costs of the alteration. It is peculiar that the FTC dilutes incentives to minimize taxes paid to other governments, even as our tax system allows or even invites taxpayers (subject to the economic substance doctrine codified at section 7701(o) and related doctrines) to minimize taxes paid to our government.\textsuperscript{38}

The credit also distorts the incentives facing foreign governments. Governments that are interested in attracting U.S. investment have an artificial incentive to use income taxes that satisfy the criteria set forth in reg. section 1.901-2. Reuven S. Avi-Yonah has argued that the definition of creditable taxes has “significantly hampered the ability of foreign countries to adopt tax reforms,” a point echoed by George R. Zodrow and Charles E. McLure Jr. They note that the Bolivian government adopted a corporate income tax rather than a cash flow tax in 1994 after learning that U.S. companies would not be allowed to claim credit for cash flow tax payments.\textsuperscript{39}

\textsuperscript{38}In Judge Learned Hand’s famous words, “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes,” Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), aff’d, 293 U.S. 465 (1935).


\textsuperscript{37}Shaviro, “The Case,” supra note 2, at 69.

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propose to solve this problem by broadening the definition of creditable taxes. That step would narrow or eliminate the distortions of foreign governments’ tax reform decisions and might also simplify cases like PPL, but it would not address the credit’s other problems. Indeed, U.S. taxpayers’ artificial incentive to incur foreign tax liabilities would actually apply to a broader set of taxes.

Under this section’s focus on U.S. well-being, no reasonable case can be made for the provision of an FTC. Some observers object that the removal of the FTC would lead to a dramatic, and potentially undesirable, increase in the U.S. tax burden on U.S. taxpayers’ foreign-source income. As Shaviro emphasizes, however, the appropriate size of that tax burden is a separate question from the degree of relief for foreign income taxes. If taxing foreign income at ordinary rates without a credit is deemed to result in too high of a U.S. tax burden on that income, the solution is to lower the tax rate applicable to the income. Rate reduction provides relief impartially to income that has been heavily taxed abroad and income that has been lightly taxed abroad, avoiding the credit’s bias in favor of the heavily taxed income. As explained above, that bias is the source of the credit’s flaws.

Assume that the U.S. tax rate on foreigners’ foreign income must equal zero because the United States does not have the legal or practical power to tax that income. Then, for any fixed U.S. tax rate on Americans’ domestic income, what U.S. tax rates on Americans’ foreign income and on foreigners’ domestic income maximize national well-being? The problem is complex because the answer depends on how domestic and cross-border incomes respond to all the tax rates. The problem becomes simpler, however, if some items are close substitutes to each other. Close substitutes should always be taxed at similar rates because any divergence in tax rates allows taxpayers to substitute away from the tax. That simple principle offers useful guidance for cross-border taxation if a few reasonably plausible approximations are assumed to hold.

Suppose that foreign and domestic portfolio assets are perfect substitutes for each other. Then, American individuals’ income from foreign portfolio assets should be subject to the fixed tax rate that is assumed to apply to their income from domestic portfolio assets. Also, foreign individuals’ income from domestic portfolio assets should be subject to the zero tax rate that necessarily applies to their income from foreign portfolio assets. In other words, individual taxes on portfolio income should be imposed exclusively on a residence basis, with no source-based taxation.

Also, suppose that domestic-chartered and foreign-chartered corporations are perfect substitutes for each other. Foreign-chartered corporations’ income from domestic operations should then be subject to the fixed tax rate that is assumed to apply to domestic-chartered corporations’ income from domestic operations. Also, domestic-chartered corporations’ income from foreign operations should be subject to the zero tax rate that necessarily applies to foreign-chartered corporations’ income from foreign operations. In other words, corporate income taxes should be imposed exclusively on a territorial basis, with no charter-based taxation.

In the above analysis, the sharp divergence in the appropriate designs of the two taxes arises from the sharp divergence in the simple assumptions made about which margins of choice are perfect substitutes. Of course, the validity of the conclusions depends on the validity of those assumptions. For bonds with little or no risk, domestic and foreign assets should be almost perfectly substitutable for each other. For riskier bonds and stocks, risk differences may prevent domestic and foreign assets from being perfect substitutes for each other, although a high degree of substitutability may still exist. One would expect domestic and foreign charters to be almost perfect substitutes if the choice of corporate charter is nothing more than a decision about which piece of paper to obtain, but various institutional factors may make the chartering choice more than a paper decision. Or, at least, those factors may have been influential in the past. Shaviro argues that chartering decisions are becoming more elective over time, causing domestic and foreign charters to become closer substitutes.

Identifying the exactly optimal tax system may be impossible. Also, even if the theoretically optimal tax system could be identified, administrative factors would require that it be simplified before implementation. On the whole, however, it appears that American well-being would be promoted by the imposition of individual portfolio income taxes on a residence basis and (at least in the long run) the imposition of any corporate income taxes on a territorial basis. An extension of the above analysis suggests that the appropriate corporate income


41The proper taxation of individuals’ labor income and active business income is less clear because there may not be perfect substitutability along any margin of choice. A mix of residence-based and source-based taxation may therefore be warranted.
tax rate may be close to zero because source-based investment taxation prompts the relocation of investment abroad and transfer pricing schemes. In short, the best way to tax investment income is likely to be at the individual level on a residence basis, an approach that avoids both the capital flight triggered by source-based taxation and the migration away from domestic corporate charters triggered by charter-based taxation.

The above analysis considers only the well-being of Americans and also ignores any possible retaliation by foreign governments. I now consider generalizations of the analysis along those dimensions.

Global Well-Being and Global Cooperation

Some commentators challenge the logic described above. They call for the narrow focus on Americans’ well-being to be abandoned in favor of concern for the well-being of all the world’s inhabitants.

The global well-being framework provides a superficial case for the use of an FTC. In the above example, the credit causes the U.S. taxpayer to choose the French project, which appears to be the better choice for the world as a whole. Although the French project provides only a $140 payoff for the U.S. taxpayer and the U.S. treasury, it also generates $60 of revenue for the French treasury and therefore has a $200 value from a global perspective. The Irish project provides a more attractive $160 payoff for the U.S. taxpayer and the U.S. treasury but generates only $20 of revenue for the Irish treasury and therefore has a global value of only $180. Although the credit-inspired selection of the French project requires a $20 sacrifice by Americans and also inflicts a $20 loss on the Irish treasury, it confers a more-than-offsetting $60 gain on the French treasury. Although foreign income tax payments may confer no spillover benefits on Americans, they confer spillover benefits on foreign treasuries and therefore warrant favorable U.S. tax treatment under the global well-being framework.

As Shaviro and Michael J. Graetz emphasize, however, the global well-being framework is a flawed foundation for U.S. tax policy. Although Americans and foreigners have equal moral worth as human beings, global well-being is not a valid policy criterion for the U.S. government, whose primary purpose is to serve the American people. According to its preamble, the U.S. Constitution was established by “We, the People of the United States” in order to “form a more perfect Union . . . insure domestic Tranquility . . . and secure the Blessings of Liberty to ourselves and our Posterity” (emphasis added). Of course, that logic applies symmetrically to other countries, entitling them to serve their citizens to the exclusion of other people, including Americans. International law expressly recognizes the right of each country to distinguish between citizens and noncitizens.

From a practical perspective, it makes little sense to base U.S. tax treatment of cross-border income on a criterion that is completely ignored in setting other U.S. policies. To cite the most obvious example, we do not make the massive transfers to poorer foreign countries that would be called for by the global well-being framework. Although the United States probably should do more to combat poverty and human rights abuses around the world, its primary focus will and should remain the well-being of the American people. That focus is incompatible with the global well-being framework’s earnest solicitude for the treasuries of our investment partners.

Despite its prominence in the literature on taxation of cross-border income, the focus on global well-being has received little support from American policymakers, who recognize that their primary role is to serve the American people. For example, the Obama administration recently stated, “Business tax reform should be a foundation to maximize investment, growth, and jobs in the United States.”

A somewhat more appealing argument defends the credit as part of a cooperative international arrangement that avoids excessive taxation of cross-border investments. The argument runs as follows. While each country may gain in isolation from taxing both inbound and outbound investment, the resulting outcome harms all countries by

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43Article 1.2 of the United Nations Convention on the Elimination of All Forms of Racial Discrimination stipulates that the convention’s ban on discrimination “shall not apply to distinctions, exclusions, restrictions or preferences made by a State Party to this Convention between citizens and noncitizens.”

44A recent study estimates that maximization of global well-being would have called for the transfer of $16,000 per American to the rest of the world in 1999 and that the actual foreign aid budget of $33 per American could be rationalized under the assumption that U.S. policy assigned the well-being of a foreigner 2,000 times less weight than the well-being of an American. Wojciech Kopczuk et al., “The Limitations of Decentralized World Redistribution: An Optimal Taxation Approach,” 49 Eur. Econ. Rev. 1051 (2005).


46The argument is often phrased in terms of avoiding double taxation of cross-border investment, but Shaviro, “The Case,” supra note 2, at 87-88, explains that there is no logical basis for (Footnote continued on next page.)
discouraging mutually beneficial cross-border investments, which are subject to taxation by both the host and source countries. All countries therefore gain from a cooperative arrangement that averts that outcome. The United States should participate in such an arrangement, not to advance foreign well-being at the expense of American well-being, but to achieve a cooperative outcome that benefits Americans and foreigners alike.

Stated differently, the United States should adopt a farsighted policy that promotes American well-being through cooperation with other nations rather than a shortsighted and counterproductive policy that tries to promote American well-being at the expense of other nations and thereby provokes harmful retaliation. As Shaviro, Graetz, and others note, the tax policy commentators who say that U.S. tax policy should be based on global well-being may actually mean that it should be based on the promotion of American well-being through global cooperation.47

Under some circumstances, the cooperative argument would offer support for the FTC. If most other countries had settled on FTCs as their preferred way to avoid excessive taxation of cross-border investment, the best course might be for the United States to do the same. Even then, it might be desirable to require reciprocity by denying credit for taxes paid to any outlier countries that refused to provide a credit. Also, that outcome would be highly imperfect because the international community would have settled on an arrangement that gives each country an incentive to use income taxes in place of other taxes. Moreover, if each country adopted a limitation similar to section 904, cross-border investment would always be subject to the higher of the host-country and source-country tax rates, presumably causing cross-border investments, on average, to still face heavier tax burdens than within-country investments.

In any event, those circumstances do not exist in the world today. Although the international community has adopted cooperative arrangements that avoid excessive taxation of cross-border investment, an FTC is no longer the most common policy instrument. For corporate-level taxes on business income, most countries have moved to systems that are largely territorial. Moreover, corporate income taxes are gradually being reduced throughout the world. In contrast, portfolio income is generally taxed by the country of the individual investor’s residence and (except for dividend withholding taxes, which may also be diminishing over time) not by the source country.48

It is no accident that the international community has adopted those policies; the previous analysis suggested that those policies are the ones that promote each country’s individual interests. In the end, countries have limited incentives to deviate from cooperative outcomes.

The United States should promote this emerging international consensus. The eventual goal should be a regime that scraps corporate-level taxes and dividend withholding taxes, so that each country taxes investment income only at the individual level and only on a residence basis. There is no reason for the United States to retain a flawed FTC that does not actually undergird a cooperative international arrangement.

The United States already taxes the worldwide portfolio income of its citizens and residents, in accord with the principles set forth above. Congress and the IRS have recently adopted measures to better enforce that tax regime by preventing and punishing criminal tax evasion through offshore bank accounts. The credit currently provided for foreign taxes on that income should be replaced with a deduction, as Graetz and Itai Grinberg have recommended.49 The change would have little effect on holders of foreign bonds, who are unlikely to face foreign taxes on their interest income. As discussed above, holders of foreign stocks already receive only a deduction for foreign income taxes imposed at the corporate level, so the primary impact of the change would be the removal of the credit for foreign dividend withholding taxes, which could increase pressure on other countries to abandon those taxes.

The United States already exempts foreigners’ portfolio interest income from U.S. income tax under sections 871(h) and 1441(c)(9), in accord with the principles set forth above. Section 1441 imposes a 30 percent withholding tax on dividends received by foreigners from the United States, but bilateral tax treaties often reduce the tax rate to 15 percent or less. The United States should seek to reduce those taxes to zero in future treaty negotiations, although the reductions should continue to be done only on a bilateral basis.

The most significant policy change remaining for the United States to make is to move the corporate

48Graetz and Grinberg, supra note 8, at 541-542, discuss trends in portfolio taxation as of 2003.
49Id.
income tax toward territoriality or repeal. At present, the FTC and deferral serve as backdoor steps toward the exemption of foreign-source income. As discussed in this article and as illustrated by PPL, however, the FTC is a flawed way to achieve that goal, with pernicious incentives and needless complexity. It is widely recognized that similar criticisms apply to deferral. The extent to which foreign-source income is exempt should not depend on how heavily it was taxed by other countries or on whether it has been repatriated.

Conclusion

Because of the arbitrariness of the distinctions drawn by current law, the Supreme Court does not face an easy task in deciding PPL. Of course, the Court must make a decision that is faithful to current law, however flawed that law may be. Perhaps the rate uniformity criterion emphasized by the nine professors, in conjunction with the canon calling for narrow exemptions of tax deductions, should lead to a decision for the government. My concern, however, is not with the resolution of the case, but with the underlying flaws of the FTC highlighted by the case.

PPL has sparked renewed controversy about the definition of creditable foreign income taxes. Its most valuable lesson, however, is that no satisfactory definition can be found because the FTC lacks an underlying rationale. The United States should move toward a system that provides tax relief for foreign-source income, when it is warranted, through exemption or rate reduction rather than through a credit for foreign income taxes.