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THE FOREIGN TAX CREDIT AT NINETY-FIVE BIONIC CENTENARIAN

I. Introduction

Among the topics discussed at the 100th Anniversary symposium, international aspects of the U.S. system, perhaps surprisingly, may be the narrowest. The others--inequality, the type and scope of business taxes imposed, and politics--are important first-order inquiries of wide dimension. Uncertainty about whether and how to tax foreign income earned by U.S. taxpayers--the major international issue--generates as much chatter but is a more technical debate. Even among proponents of a U.S. tax exemption for foreign business income, there is a shared concern, genuine or obligatory, over "base erosion," which fundamentally is assignment of income to countries where it is not earned in any economically realistic sense.¹ If base erosion were dealt with (no small undertaking), there would not be much left to debate other than whether the United States should exempt or impose residual tax (current or deferred) on income legitimately earned abroad, which, in light of relatively low, converging corporate tax rates, probably would not be that important an issue. In sum, at least outside the professional and business precincts of those who benefit from the status quo, the question is more how to, rather than should we, curtail base erosion.

Along with anti-deferral rules (mainly subpart F) and transfer pricing, the foreign tax credit (FTC) is one of three main supports of the U.S. international tax system. The other two have major problems. Subpart F lacks essential anti-arbitrage protection and, of late, in clear nods to complaints that the U.S. system harms the competitive position of U.S. multinationals,² the government has relaxed the foreign *546 base company sales definition of "manufacturing" and adopted a permissive outlook toward services provided by foreign affiliates,³ all of which, alone or in conjunction with a porous transfer pricing regime, facilitates excessive foreign base erosion and U.S. tax deferral. The central problems with transfer pricing are uncertainty over the scope of intellectual property and failure of accepted pricing methodologies to properly de-emphasize where legal ownership of intellectual property is placed.⁴

The FTC, in contrast, is doing its job of relieving double taxation with, at long last, admirable imperviousness to abuse, although in a very complicated fashion. How it coordinates with the rest of the system depends, of course, on what the rest of the system is. Will income taxes be replaced with consumption taxes? Will corporate tax be integrated? Will the worldwide/credit system give way to territorial taxation? Will deferral survive? Will the system treat portfolio and direct investment differently? Will tax on intellectual property be reduced (for example, patent box)? The answers to these questions would have obvious implications for the need for and design of an FTC. But rather than wallow in what the credit might look like or make sweeping pronouncements about the need for a credit in various reform scenarios,⁵ I focus on how it has and will continue to operate within the current system. In any event, it is unlikely that any feasible reform would do away entirely with the need for an FTC or that historical issues would not resurface.⁶

In light of base erosion and deferral accommodated by subpart F and transfer pricing, the FTC has become the branch of international taxation least in need of attention. Even a properly constrained credit cannot modify the behavioral and consequent revenue effects of undue deferral of income inside controlled foreign subsidiaries, much less the tendency to engage in corporate expatriation with the aim of permanently avoiding U.S. tax on foreign operations.

An important data point is that FTCs are primarily an issue of corporate taxation. The vast majority of credits are claimed by U.S. corporations, *547 and the vast majority of those are indirect credits for taxes paid by foreign subsidiaries.⁷

How did we get here? Most of the issues and much of the history of the FTC can be organized along three parallel yet somewhat overlapping and counterbalancing tracks: the types of taxes that are creditable; the limitation placed on credits (how much U.S. tax they can offset); and, more recently, the efforts to deal with otherwise permissible credits that, after all is said and done, arise in transactions that so violently offend the underlying statutory purpose that they should be denied. The resulting corpus is extremely complicated, even by U.S. standards, the result of endless thrusts and parries by taxpayers, the U.S. government, and in some cases foreign governments that began eighty years ago and built to a crescendo over the last thirty-five years. Before launching these tracks, a very skeletal primer may be helpful.

A FTC lies only for income taxes (or certain taxes “in lieu of” income taxes) imposed by foreign countries.⁸ Taxes such as value-added, property, or wealth taxes are not creditable, although they are deductible.⁹ To be creditable, the tax in question must be compulsory, cannot be a payment in return for a specific economic benefit provided by the tax-collecting country, and, similarly, cannot be returned to the taxpayer in the form of a direct or indirect subsidy.¹⁰

For the most part, credits may be claimed only by U.S. taxpayers--U.S. corporations and U.S. citizens and resident individuals.¹¹ Credits are available for both direct and, in the case of U.S. corporations, indirect foreign income taxes.¹² Direct credits are those for taxes paid by the U.S. taxpayer itself or by a fiscally transparent entity (typically a partnership or disregarded entity) through which the taxpayer engages in foreign activity giving rise to the tax. Indirect credits are those for taxes paid by a foreign corporation in which the U.S. taxpayer owns directly or indirectly at least 10% of the voting stock.¹³ In light of the classical U.S. corporate tax system, only corporate shareholders qualify for an indirect credit; individual shareholders effectively only deduct corporate taxes. Indirect credits become available when the foreign corporation whose tax is at issue pays dividends to a U.S. corporate shareholder (or the foreign corporation's income is taxable *548 to U.S. corporate shareholders under subpart F).¹⁴ The indirect credit equals that percentage of cumulative taxes incurred by the foreign corporation that the dividend (or subpart F inclusion) bears to the corporation's cumulative after-tax earnings. The U.S. shareholder's income is increased (“grossed up”) by the foreign tax that the dividend carries.¹⁵

To qualify for a credit, the U.S. taxpayer (or the foreign corporation in the case of indirect credits) generally must be liable for the tax under relevant foreign law--the “technical taxpayer” rule. There is generally no requirement that the taxpayer must bear the economic burden of the foreign tax, only that he be liable to pay it under foreign law and eventually remits.¹⁶

Credits are limited to that portion of the U.S. taxpayer's tentative tax on worldwide income that foreign source income bears to worldwide income, effectively limiting the credit to the tax that the United States would impose on the foreign source earnings bearing the foreign tax.¹⁷ The limitation is intended to keep the FTC from offsetting U.S. tax on U.S. source income and, secondarily, to preserve U.S. residual tax on income taxed abroad at rates less than the U.S. rate. Various types of limitations have been in effect over the years (overall, per country, baskets, look-through rules, loss recapture rules, and capital gains effects), resulting in astonishing levels of complexity.¹⁸

Also, the limitation is based on foreign source net income, thus requiring rules allocating expenses between U.S. and foreign source gross income.¹⁹ The most significant issues in this regard arise under the interest allocation rules, which allocate interest expense in proportion to the basis (or value) of U.S. and foreign assets.²⁰ The particular problem with these rules is that they treat stock of foreign subsidiaries as foreign assets but do not include interest expense incurred by the subsidiary as allocable expense (“water’s edge”), which tends to overstate foreign-allocated interest expense and, concomitantly, to understate foreign source net income, ultimately restricting creditability to an unprincipled degree and, as a result, motivating objectionable attempts to capture foreign source income. The law was changed in *549 2004 to remedy this flaw, but revenue concerns have postponed the effective date far into the future.²¹

Hundreds of articles have been written about the foreign tax credit; there is no point in regurgitating much of the content here, at least not in technical detail, and particularly the ancient history.²² The thrust of this Article is that recent developments have brought the FTC to a place where it fairly, if not perfectly, relieves double taxation without being vulnerable to serious abuse, which is all that can be practically expected of it. Other weaknesses in the international tax rules are more deserving of attention.

II. Creditable Taxes

Congress gave birth to the FTC in 1918.²³ Before then foreign taxes were deductible.²⁴ Rising tax rates necessitated by the cost of World War I and the resulting increased magnitude of double taxation made the case for creditability. If U.S. and foreign rates were each 50%, an onshore investment returning 10% before tax would yield 5% after tax, while an equally profitable offshore investment would yield only 2.5% if foreign tax were deductible, but the same 5% as the onshore investment if foreign tax were creditable. Modern reflexive familiarity with FTCs may obscure the profundity of what Congress did: For the first time it put taxes of other sovereigns on a par with U.S. tax for purposes of exacting revenue from worldwide activity. What seems blasé today was a huge step then.

The 1918 legislation granted an unlimited credit for income tax imposed by a country on income sourced to that particular country.²⁵ Concerned with the potential for unlimited credits from high-tax countries to encroach on the U.S. tax base, Congress introduced a limitation in 1921.²⁶ At first it was a simple overall limitation, not tied to income earned in a particular country, but eventually it underwent *550 numerous oscillations and refinements.²⁷ Of relevance here, however, is the contention that, once the U.S. tax base was protected by a limitation, apart from the belief (of debatable accuracy and moment in the first place) that only income taxes could not be economically passed on to other parties, there was no ongoing reason to confine creditability to income taxes. Much of the creditability history synopsis below could have been avoided.²⁸

Until adoption of regulations in 1983,²⁹ which have largely settled matters, the IRS and the courts moved back and forth, often without much clarity, on the contours of creditable taxes.³⁰ Biddle, decided by the Supreme Court in 1938, planted the seeds of considerable confusion having little to do with the makeup of creditable taxes (as opposed to who paid them) by stating, in support of denying a credit to U.S. individual shareholders for integrated corporate tax paid by a British corporation, that questions of creditability rest on U.S. tax principles, as opposed to foreign law principles.³¹ Most of the ensuing creditability disputes centered on three issues. First, did the base of the levy in question reasonably conform to the salient features of an income tax in the U.S. sense: Was there a realization requirement; did the base begin with gross receipts; and was there reasonable allowance for cost recovery. Many of the cases involved taxes on mineral extraction, some of which measured the tax base by reference to unrealized mineral value at the place of extraction, or denied deductions for important expenses.³² Deglazing these requirements, the case law and eventually the regulations asked whether the levy, based on its predominant character, was likely to reach net gain in the normal circumstances in

which it applied.³³ In addition, in recognition that many taxes (including in the United States) imposed on nonresidents were based on gross income for legitimate administrability reasons, in 1942 Congress permitted a credit for taxes imposed in lieu of a generally imposed creditable income tax.³⁴ The second issue, again mainly in the context of extraction taxes, was whether part of the “tax” really was a disguised royalty (paid for the privilege of extraction). The *551 third was whether the “tax” directly or indirectly subsidized the taxpayer.

Since the 1983 regulations were adopted, until very recently there had been only a handful of cases resolving whether a levy was a creditable income tax.³⁵ Just in the last year, however, the Supreme Court put creditability back in the spotlight in a unanimous decision awarding a credit for a now-defunct U.K. windfall tax imposed on privatized utility companies previously owned by the U.K. government.³⁶ But the issue is highly technical, and despite claims to the contrary, is not likely to have important precedential reverberations. The one-time tax was imposed at a 23% rate on a base equal to the excess of nine times average annual earnings over a four-year period following privatization over the market capitalization value (“flotation value”) at which the company was sold to investors in the privatization transaction.³⁷ Algebraically, the tax was equivalent to a 52% tax on profits earned during the four years in excess of a fraction (44%) of flotation value, which in substance exposed the tax functionally as a fairly typical excess profits tax.

Regardless of quiescence in the field, it continues to be true that foreign countries must craft their taxes in conformance with U.S. income tax principles in order to be sure to attract U.S. investors. Indeed, an important treaty role has been to salvage creditability for taxes that otherwise would fall short.³⁸

III. Limitation on Credits

Limitation issues fall into two broad categories: scope and technical design. Scope relates to the range of the limitation across various subsets of foreign source income: all of it in a single calculation (“overall”); a separate calculation for each country to which taxes are paid (“per country”); or a separate calculation for each type of income, wherever earned, on which taxes are paid (“baskets”). Generally speaking, taxpayers seek a limitation with the widest boundaries, which maximizes foreign source income and results in the maximum limitation. Subdividing the calculation, either by country or basket, *552 can only serve to reduce the limitation where some foreign income is taxed below the U.S. rate and some above. Thus, an overall limitation is the most permissive; per country or basket limitations prevent some degree of averaging high and low foreign taxes that the overall method would accommodate. Present law limits credits under a two-basket system (passive income and other (“general limitation”) income).³⁹

Design issues are refinements of the general limitation formula (regardless of whether overall, per country, or baskets) necessary to handle losses and tax-favored income. The general formula in § 904(a) multiplies tentative U.S. tax on worldwide income by the percentage (not in excess of 100%) that foreign source income bears to worldwide income.⁴⁰ The calculation is annual and, focusing as it does only on where income is sourced, does not take special account of loss disallowance rules or tax-favored income. If losses in early years (foreign or U.S.) are recovered by profits in subsequent years, the limitation malfunctions. Similarly, if U.S. source capital losses, which are supposed to offset only capital gains, effectively offset U.S. ordinary income instead of foreign source capital gain, the limitation malfunctions. Finally, if foreign source capital gain is not rate-effected to account for the low U.S. rate of tax imposed on it (to individual taxpayers), the limitation malfunctions. As discussed below, § 904 corrects for all of these design flaws.

There can also be a dependency between scope and design issues. For example, as mentioned below, Congress adopted an overall method in 1976, abandoning the per country method, which better prevented averaging high rates in one country with low rates in another, because it was more concerned with recapturing foreign losses.⁴¹

A. Scope

An overall limitation was in effect from 1921 through 1932. Between 1932 and 1954, the smaller of an overall or per country limitation applied. From 1954 to 1960, a per country limitation was in effect. From 1960 to 1975, taxpayers could elect either an overall or per country limitation. In 1976, concerned with the distortive effects of foreign losses and motivated by a desire to recapture them as fast as *553 possible, Congress made the overall method mandatory once again.⁴² In the Tax Reform Act of 1986, at the time more concerned with averaging high and low foreign taxes on foreign profits in the wake of reduced U.S. tax rates, Congress switched to a basket system consisting of nine categories (most taxpayers faced two or three baskets at most) while, as mentioned below, preserving the overall (that is, unbasketed) method for foreign losses.⁴³ In the (don't laugh) American Jobs Creation Act of 2004, Congress reduced the baskets to two (passive and general), effective in 2007, on the disputed ground that the multi-basket system put U.S. multinationals at a competitive disadvantage.⁴⁴ These Acts also created look-through rules for dividends (and subpart F income) from foreign subsidiaries, which are generally designed to basket income and taxes in the same manner as if earned and incurred directly.⁴⁵

B. Design Issues

Congress refined the limitation to handle capital gains and losses in the Tax Reform Act of 1976.⁴⁶ The rules make sure that U.S. source capital losses offset foreign source capital gain, rather than U.S. source ordinary income, and they rate-effect net foreign source capital gain to remove the exempt portion from the limitation calculation.

The same legislation addressed overall foreign losses.⁴⁷ The problem was that foreign losses shrunk a U.S. taxpayer's worldwide income (and U.S. tax) in the year the loss was suffered and delivered a duplicate benefit in later years when foreign profits were earned and provided limitation ("capacity") to absorb credits for foreign taxes imposed either on the recovering activity (because the foreign country did not provide a loss carryforward) or on other foreign profits. The effect, if not corrected, was to permanently exempt U.S. profits sheltered in the loss year from taxation anywhere. Section 904(f) provided the correction by recapturing foreign source income as U.S. income to the extent of prior foreign losses and, when the basket system was adopted ten years later, foreign losses continued to be handled *554 on an overall basis even though foreign tax imposed on foreign profits was basketed.⁴⁸ The interest allocation rules can easily put a U.S. taxpayer in an overall foreign loss position by allocating interest expense incurred by a U.S. group against its holdings in foreign subsidiaries in years when the subsidiaries do not pay dividends to the U.S. group (or generate subpart F income).

U.S. ("domestic") losses created the opposite problem, working in the government's favor. Domestic losses offset foreign profits in the calculation of U.S. tentative tax to be offset by foreign tax, thus preventing the foreign tax from reducing U.S. tax, and, when subsequent domestic profits are earned, there is no limitation (capacity) to absorb the foreign tax incurred in the prior years. The effect was to subject foreign income earned in the loss years to double taxation. Section 904(g), enacted in 2004 and effective in 2007,⁴⁹ ended the distortion by recapturing domestic profits as foreign source income, thus generating the capacity to absorb credits for foreign tax incurred in prior years.

Although the rules now effectively eliminate the obvious distortions, combined they can be very complicated, requiring mind-numbing coordination rules to ascertain the sequence in which the many allocation and recapture rules apply.⁵⁰

C. Extra Limitations on Mineral Activities

In addition to the foregoing rules, oil and gas companies face incremental obstacles in crediting foreign tax. As mentioned above regarding creditability, "dual capacity taxpayers," those who receive specific benefits from the host country (for

example, the right to explore for and drill for oil on government land), must establish how much of the “tax” they pay is indeed a tax, as opposed to a royalty. Also, in an effort to prevent high taxes on oil (and other mineral) extraction from offsetting U.S. residual tax on other low-taxed income, special rules, first enacted in 1975, limit creditable taxes on mineral activities to the U.S. tax rate before subjecting the taxes to the normal limitation rules of § 904.⁵¹

*555 IV. Imaginative (Abusive?) Foreign Tax Credit Strategies and Prophylactic Responses

In 1986, when Congress reduced corporate tax rates from 46% to 35%,⁵² it foresaw U.S. taxpayers incurring foreign tax in excess of U.S. rates and, consequently, shored up the FTC limitation with a basket system making it difficult to average high- and low-tax foreign activities.⁵³ Subsequent developments, notably rate reductions in other countries and tax planning to shunt foreign income to low-tax jurisdictions, put many U.S. companies in an excess limitation posture. It made no sense for these companies to incur high foreign tax just to absorb excess capacity to claim credits; that would merely replace one tax liability (to the U.S.) with another (to a foreign country). The trick was to generate credits for tax (1) on income not yet taxed by the United States, which would temporarily monetize excess capacity at the expense of the fisc, or (2) more controversially, that was not economically borne by the U.S. taxpayer by virtue of transactions in which the bulk of the tax either was not incurred in a systemic sense or substituted for tax that a foreign counterparty would have paid in any event and, accordingly, was happy to bear a great portion of. These developments, and what Congress, Treasury, and courts have done to rebuff them, are discussed below.

A. Separation Techniques (“Splitters”)

Almost twenty-five years ago, in resolving whether U.S. or foreign principles should control measurement of a foreign corporation's earnings pool for purposes of calculating indirect credits accompanying dividends paid to a U.S. parent company, the Supreme Court decided in favor of U.S. principles, largely because the opposite conclusion would have facilitated credits for taxes imposed on income that had not yet been included in the parent's income.⁵⁴ The point seems to have been lost on taxpayers and the government. “Splitter” strategies were devised and, unlike many slide deck extravaganzas perpetually on ice in major accounting firms, actually implemented. Treasury was aware of the problem at least as early as 1985.⁵⁵

The most widely talked about involved “foreign reverse hybrids”--foreign entities classified as fiscally transparent for foreign law purposes but as corporations for U.S. tax purposes. Under the U.S. rule that credits belong to the “technical taxpayer”--the party liable for *556 the tax under foreign law⁵⁶--the owners of the entity (either a U.S. taxpayer or a foreign corporation from which it draws indirect credits) were the taxpayers entitled to a credit even though the income on which the foreign tax was imposed was insulated from U.S. tax as long as it remained inside (was not distributed by) the reverse hybrid entity. A similar separation of income and taxes could be achieved if foreign tax consolidation rules treated a foreign parent company as the taxpayer on group income earned by lower-tier subsidiaries where the foreign parent was a U.S.-owned hybrid entity (corporation for foreign law purposes but fiscally transparent for U.S. tax purposes) or foreign corporation delivering indirect credits.⁵⁷ Proposed regulations issued in 2006 would have amended the technical taxpayer rule to deny credits in these cases, but they languished until 2012.⁵⁸

Congress intervened in 2010 with new § 909,⁵⁹ which defers credits in splitter transactions until the underlying income has been included by the U.S. taxpayer (or foreign corporation from which it draws indirect credits). To keep § 909 from hurtling to unintended places (and tax professionals to chronic worry mode), administrative guidance has limited it to reverse hybrids and other specific splitter arrangements, including use of hybrid instruments that move income but not tax or vice versa.⁶⁰ To take a simple example, if a second-tier foreign subsidiary issues hybrid debt (debt for foreign purposes but equity for U.S. purposes) to a first-tier foreign subsidiary of a U.S. parent company, payments on the

security move foreign tax up the chain to the first tier, while, for U.S. purposes, the underlying income remains in the second tier. Foreign consolidation splitters are checked in newly finalized technical taxpayer regulations, not under § 909.⁶¹

An earlier form of separation technique, promoted and presumably implemented despite vulnerability from the start under then-existing § 704(b) regulations, involved allocation of foreign tax incurred by a hybrid partnership (foreign entity treated as a corporation under foreign law but as a partnership for U.S. tax purposes) to one partner but the underlying income to another. Many of these partnerships involved affiliated partners, and the design was to allocate tax but not income (other than income equal to the tax-- effective 100% tax rate) *557 to a partner who could use the tax to absorb excess capacity under § 904. Treasury effectively stopped this practice with regulations finalized in 2006 that require proportionate allocations of tax and income.⁶²

B. Permanent Base Differences--“Covered Asset Acquisitions”

U.S. and foreign tax systems define income differently in innumerable details. Sometimes the difference is permanent (for example, income exempt in one country but taxable in the other) and sometimes temporary (for example, different depreciation schedules). Section 904 deals with base differences in calculation of the FTC limitation; permanent differences due to income taxed abroad that is exempt under U.S. law raise the question which basket the associated foreign tax should be placed in. For years, first by regulation, then by statute, the tax has been assigned to the general limitation basket.⁶³

A threshold question arises whether foreign tax imposed on income exempt from U.S. tax should be creditable at all. A particular application is where a U.S. taxpayer purchases stock of a foreign entity with appreciated assets and eliminates the unrealized appreciation by marking the asset basis to market for U.S. purposes without subjecting the appreciation to U.S. taxation. This happens where a U.S. corporation purchases the stock of a foreign corporation and makes a § 338(g) election, purchases an interest in a partnership and makes a § 743(b) election, or purchases the stock of an entity disregarded for U.S. tax purposes. Should foreign tax imposed on the base difference be creditable? If not, should the issue be handled mechanically under § 904 or by denying the credit itself?

Section 904(b), in effect since 1976,⁶⁴ has handled the parallel question regarding foreign tax imposed on preferential-rate capital gains by removing the exempt portion of gain from foreign source income in the FTC limitation. Similarly, since 1988, § 338(h)(16), in the context of a § 338(g) election, has ignored unrealized appreciation as a source of foreign source income to the seller. These approaches, in technically different ways, prevent exempt foreign income from inappropriately inflating the FTC limitation, removing ability to absorb credits from unrelated activity.

*558 Section 901(m), enacted in 2010,⁶⁵ goes right to the heart of the matter by denying a credit (but allowing a deduction) for foreign tax imposed on the exempt income in the stock purchases described above (“covered asset acquisitions”). Adopted with minimal legislative history, it raises numerous technical and conceptual questions⁶⁶ and represents a novel approach to double taxation. It neither adjusts the § 904 limitation nor gives voice to traditional objections to creditability (subsidy, disguised royalty, and so on). It simply states as a first principle that income exempt in the United States cannot bear double taxation and therefore should not give rise to credits. Although the principle is hard to criticize, of all the prophylactic initiatives described here, it was probably the least necessary.

C. “Foreign Tax Generators”--Foreign Tax Borne by a Counterparty

Even the name sounds bad. “Foreign tax generators” come in many varieties and are, intentionally, exceedingly complicated.⁶⁷ Though this summary is far from universal, at bottom, most generators are duplicate-benefit transactions

in which a U.S. corporation, usually a financial institution (acting either as borrower or lender), holds a security issued by a foreign special purpose entity (“SPV”) through which the loan proceeds pass and which incurs foreign tax on profits from investment of the loan proceeds (usually the profits are interest on a loan to an affiliate of the disguised borrower). Securities issued by the SPV are also owned by a foreign counterparty to the deal, and, with the help of inconsistent classification or ownership of the securities by the United States and the counterparty's home country, the tax incurred by the SPV is effectively reversed (where the counterparty is the borrower) or is a substitute for tax that the counterparty would have incurred in a straightforward loan (where it is the lender). That being the case, the counterparty is willing to bear, through the pricing of the securities and various associated deals (for example, interest rate and currency swaps), most of the tax incurred by the SPV. In addition, the associated deals often compensate for overpricing the SPV's income (via above-market interest), adding even more creditable tax to the mix. The U.S. corporation obtains a credit for easily *559 avoidable tax economically borne by the counterparty. In these transactions, it can be demonstrated, by comparison to a straightforward loan, how the U.S. corporation and foreign counterparty (and usually the counterparty's home country) all benefit at the expense of the U.S. treasury. In result, foreign tax generators are like any tax shelter in the sense that two parties trade disparate tax positions for their mutual after-tax benefit at the expense of the fisc with virtually no risk. Generators have originated in several other countries as well, where the mirror-image issue is whether a taxpayer from that country can claim a credit for U.S. tax economically borne by a U.S. counterparty.⁶⁸

The core problem with generators is that the regulations have long made clear that the technical taxpayer is entitled to a credit, regardless of whether it bears the burden of the tax or passes it along to someone else.⁶⁹ In addition, a U.S. taxpayer, as part of its obligation to take reasonable steps to minimize foreign tax, is not required to alter the form of a business transaction.⁷⁰ If it wants to borrow or lend through an SPV that happens to incur enforceable but easily avoidable tax, according to the regulations it is not the province of the U.S. government to tell the taxpayer to structure the transaction as a straightforward loan. So, if credits for taxes incurred in generators should be denied, the question is on what basis.

The government's first challenge to generators came in [Notice 98-5](#),⁷¹ where it fashioned the theory that if credits were significantly disproportionate in amount to the cash (net of foreign tax) generated by the transaction, the credits would be denied under forthcoming regulations. Although the Notice did not literally rest on the economic substance doctrine, there was no mistaking its economic substance tone. Two subsequent cases involved credits for withholding tax claimed by U.S. taxpayers who, within minutes, purchased stock of a publicly traded foreign corporation, received dividends (on which the withholding tax was imposed), and sold the stock.⁷² The transactions lost money before tax but more than made up for it through a credit for foreign tax legally imposed on the U.S. buyer but economically *560 paid by the seller through the sale pricing. The courts held for the taxpayers, rejecting the government's economic substance argument, and eventually the government withdrew [Notice 98-5](#) while maintaining that it would be back to fight another day.⁷³

The deals continued and the government responded with temporary regulations in 2008⁷⁴ (finalized in 2011) to the effect that transactions fitting a carefully circumscribed set of conditions (including duplicate benefits and inconsistent classification) would be denied credits on the ground that the taxes were not compulsory payments.⁷⁵ These regulations, which provoked howls of unfairness from the generator industry,⁷⁶ effectively shut it down. The government raised the ante by challenging deals predating the regulations in court on several grounds, including economic substance. Several cases have been decided, all but one in favor of the government.⁷⁷ These cases, by the time they go through appeals, are likely to be important contributors to the scope of the economic substance doctrine.

D. Complexity

There is no denying that the initiatives described above, while doubtless effective in achieving the goal of denying inappropriate FTCs, are complicated, both internally and in pinball-like interaction with each other. The first initiative against splitters was later discovered to facilitate generators, prompting a hold on proposed changes to the technical taxpayer rules. Covered asset acquisitions, it turned out, could also be splitters, causing the government to say in the preamble to the splitter regulations that that was not intended, except in the case of § 338, on which it would have more to say in future.⁷⁸ Partnership interbranch payments, which after much deliberation were permitted in 2006 as a narrow exception to the rule against separating *561 income and credits via partnership allocations,⁷⁹ were subsequently declared villainous when the splitter regulations came out in 2012.⁸⁰ Complicated transition rules cede and switch jurisdiction among the initiatives on the basis of when they were first rolled out. The Obama administration has repeatedly asked for a pooled approach to indirect credits, meaning essentially that all foreign subsidiaries would be treated as one for purposes of determining the amount of indirect credits accompanying a dividend, regardless of which particular company (high-tax or low-tax) paid the dividend.⁸¹ On and on.

IV. Conclusion

Although it was not always so, the law governing FTCs is mature and sound, albeit overly complicated. The contours of creditable taxes have been well established for thirty years. The limitation has recently completed a decades-long overhaul necessary to prevent most undue averaging of high and low taxes while adequately accounting for various types of losses and tax-favored income. And, most important, abusive FTC strategies have been effectively stymied over the last decade. Much of the help has come from Congress, which I would surmise does not hear much lobbying against FTC reform given the desire of U.S. multinationals to keep profits offshore, at least until repatriation amnesty is re-enacted or an exemption system is adopted. Strapped together strong by these developments, the FTC enters its second century well prepared for its task.

Anti-base erosion measures are an entirely different story. Transfer pricing and subpart F will be the main battlegrounds in the years ahead.

Footnotes

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¹ H. Comm. on Ways & Means, 112th Cong., Ways and Means Discussion Draft, Participation Exemption (Territorial) System (Comm. Print 2011) [[hereinafter Camp Draft] (draft released by Chairman Dave Camp providing options for combatting base erosion); OECD, Addressing Base Erosion and Profit Shifting (2013), available at <http://www.oecd.org/tax/beps.htm>.

² See, e.g., Nat'l Foreign Trade Council, Comments to the President's Advisory Panel on Federal Tax Reform: The U.S. International Tax System and the Competitiveness of American Companies (2005), available at <http://www.nftc.org/default/tax/TaxReformPanelSubmission2005.pdf>.

³ See Reg. §§ 1.954-3(a)(4)(iv); Notice 2007-13, 2007-1 CB. 410.

⁴ See OECD, Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions (Discussion Draft 2012), available at <http://www.oecd.org/tax/transfer-pricing/50526258.pdf>.

⁵ The Camp territorial proposal claimed significant simplification of the FTC system. Camp Draft, note 1, at 27-30.

⁶ For the argument that replacing a credit with a deduction may be optimal in combatting FTC planning, see Daniel N. Shaviro, Rethinking Foreign Tax Creditability, 63 Nat'l Tax J. 709 (2010).

- 7 See Scott Hollenbeck & Maureen Keenan Kahr, *Individual Foreign-Earned Income and Foreign Tax Credit*, 2006, IRS Stat. Income Bull., Spring 2009, at 54; see also Melissa Costa, *Corporate Foreign Tax Credit*, 2008, IRS Stat. Income Bull., Summer 2012, at 128.
- 8 [IRC §§ 901\(b\)\(1\), 903](#); Reg. §§ 1.901-2(a)(1), -2(a)(3), 1.903-1. Credits for taxes paid to U.S. possessions are ignored in this Article.
- 9 [IRC § 164](#).
- 10 [IRC § 901\(i\)](#); Reg. §§ 1.901-2(a)(2), -2(e)(3), -2(e)(5).
- 11 See [IRC §§ 901\(b\), 906](#).
- 12 [IRC §§ 901\(a\), 902](#).
- 13 [IRC § 902\(a\)](#).
- 14 [IRC §§ 902, 960](#); see [United States v. Goodyear Tire & Rubber Co.](#), 493 U.S. 132 (1989).
- 15 [IRC § 78](#); see [Am. Chicle Co. v. United States](#), 316 U.S. 450 (1942).
- 16 Reg. § 1.901-2(f).
- 17 [IRC § 904](#).
- 18 See Melissa Redmiles & Jason Wenrich, *A History of Controlled Foreign Corporations and the Foreign Tax Credit*, IRS Stat. Income Bull., Summer 2007, at 130-31.
- 19 See [IRC §§ 861\(b\), 862\(b\), 863\(a\)](#).
- 20 Reg. § 1.861-9T et seq.
- 21 [IRC § 864\(f\)](#); American Jobs Creation Act of 2004, [Pub. L. No. 108-357, § 401\(a\)](#), 118 Stat. 1418, 1488.
- 22 The FTC has provoked prodigious quantities of literature addressing everything from first principles to hyper-technical issues. Some of the more important work analyzing broad principles and providing historical sweep are Elisabeth A. Owens, *The Foreign Tax Credit: A Study of the Credit for Foreign Taxes Under United States Income Tax Law* (1961); Michael J. Graetz & Michael M. O'Hear, [The 'Original Intent' of U.S. International Taxation](#), 46 *Duke L.J.* 1021 (1997); Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 *Tax L. Rev.* 227 (1984); Charles I. Kingson, [The Foreign Tax Credit and Its Critics](#), 9 *Am. J. Tax Pol'y* 1 (1991).
- 23 Revenue Act of 1918, [Pub. L. No. 65-254, § 238](#), 40 Stat 1057, 1081.
- 24 Tariff Act of 1913, [Pub. L. No. 63-16, § II\(G\)\(b\)](#), 38 Stat. 114, 173.
- 25 1918 Act, note 23.
- 26 Revenue Act of 1921, [Pub. L. No. 67-98, § 238\(a\)](#), 42 Stat. 227, 258.
- 27 See Part III.
- 28 See Isenbergh, note 22; John P. Steines, Jr., [Whether, When, and How to Tax the Profits of Controlled Foreign Corporations](#), 26 *Brook. J. Int'l L.* 1595 (2001).
- 29 Reg. §§ 1.901-2, -2A.
- 30 These developments are presented in detail in Isenbergh, note 22.
- 31 [Biddle v. Commissioner](#), 302 U.S. 573, 578-79 (1938).

- 32 See, e.g., [Keasby & Mattison Co. v. Rothensies](#), 133 F.2d 894 (3d Cir. 1943); [Inland Steel Co. v. United States](#), 677 F.2d 72 (Ct. Cl. 1982).
- 33 See [Inland Steel](#), 677 F.2d at 80 (citing [Bank of America Nat'l Trust & Sav. Ass'n v. United States](#), 459 F.2d 513 (Ct. Cl. 1972)).
- 34 Revenue Act of 1942, Pub. L. No. 77-753, § 158(f), 56 Stat. 798, 858; [IRC § 903](#).
- 35 [Phillips Petroleum Co. v. Commissioner](#), 104 T.C. 256 (1995); [Texasgulf, Inc. v. Commissioner](#), 172 F.3d 209 (2d Cir. 1999); [Exxon Corp. v. Commissioner](#), 113 T.C. 338 (1999).
- 36 [PPL Corp. v. Commissioner](#), 665 F.3d 60 (3d Cir. 2011), rev'd, 133 S. Ct. 1897 (2013); [Entergy Corp. v. Commissioner](#), 683 F.3d 233 (5th Cir. 2012), cert. denied, 133 S. Ct. 2759 (2013). In the interest of full disclosure, I was on the legal team representing Entergy in the Tax Court, Fifth Circuit, and Supreme Court proceedings.
- 37 [PPL Corp.](#), 133 S. Ct. at 1900-02.
- 38 See [Rev. Rul. 73-106](#), 1973-1 C.B. 343; [Notice 2008-3](#), 2008-1 C.B. 253; Tax Convention, U.S.-It., Aug. 25, 1999, 4 Tax Treaties (CCH) P 4803; Pamela B. Gann, The Concept of an Independent Treaty Foreign Tax Credit, 38 Tax L. Rev. 1 (1982).
- 39 [IRC § 904\(d\)\(1\)](#).
- 40 [IRC § 904\(a\)](#).
- 41 Tax Reform Act of 1976, [Pub. L. No. 94-455](#), § 1031, 90 Stat. 1520, 1620-24; S. Rep. No. 94-938, at 236-37 (1976).
- 42 Staff of the Joint Comm. on Tax'n, 99th Cong., General Explanation of the Tax Reform Act of 1986, at 854-55 (Comm. Print 1987). Prior to 1986, there had been a special basket for passive interest income. *Id.* at 856-57.
- 43 Tax Reform Act of 1986, [Pub. L. No. 99-514](#), § 1201, 100 Stat. 2085, 2520-28; see Joint Comm., note 42, at 853, 861-68.
- 44 2004 Act, note 21, § 404, 118 Stat. 1494-97; see Staff of Joint Comm. on Tax'n, 108th Cong., General Explanation of Tax Legislation Enacted in the 108th Congress 271-75 (Comm. Print 2005).
- 45 [IRC § 904\(d\)\(3\)](#), (4).
- 46 See [IRC § 904\(b\)](#); 1976 Act, note 41, § 1034, 90 Stat. 1629-30.
- 47 1976 Act, note 41, § 1032, 90 Stat. 1624-26.
- 48 [IRC § 904\(f\)\(5\)](#).
- 49 2004 Act, note 21, § 402, 118 Stat. 1491-92.
- 50 See Reg. § 1.904(g)-3.
- 51 [IRC § 907](#). The Obama administration would go further by denying credits (as opposed to restricting limitation) for taxes paid by dual capacity taxpayers in excess of generally prevailing rates in the source country. See Staff of the Joint Comm. on Tax'n, 111th Cong., Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal 317 (Comm. Print 2010).
- 52 1986 Act, note 43, § 601, 100 Stat. 2249.
- 53 *Id.* § 1201, 100 Stat. 2520-28.
- 54 [United States v. Goodyear Tire & Rubber Co.](#), 493 U.S. 132 (1989).
- 55 [Notice 98-5](#), 1998-1 C.B. 334.
- 56 Reg. § 1.901-2(f).

- 57 See former Reg. § 1.901-2(f)(3) (amended in 2012, see [T.D. 9576, 2012-1 C.B. 723](#)); [Guardian Indus. Corp. v. United States](#), 477 F.3d 1368, 1374-75 (Fed. Cir. 2007).
- 58 Prop. Reg. § 1.901-2(f), 71 Fed. Reg. 44240 (Aug. 4, 2006). The portion of these regulations addressing foreign consolidation systems was finalized in 2012, [T.D. 9576, 2012-1 C.B. 723](#), while the portion dealing with other splitters was left to regulations under § 909, [T.D. 9577, 2012-1 C.B. 730](#) (issuing temporary regulations under § 909).
- 59 Act of Aug. 10, 2010, Pub. L. No. 111-226, § 211, 124 Stat. 2389, 2394-96.
- 60 Notice 2010-92, 2010-2 C.B. 916.
- 61 See note 58.
- 62 [Treas. Reg. § 1.704-1\(b\)\(4\)\(viii\)](#). These regulations had permitted separation of taxes from certain inter-branch payments, which the regulations under § 909 issued in 2012 identified as a “splitter” and consequently cut back on. See [T.D. 9577, 2012-1 C.B. 730](#).
- 63 Reg. § 1.904-6(a)(1)(i); [IRC § 904\(d\)\(2\)\(H\)](#).
- 64 See note 41.
- 65 2010 Act, note 59, § 212, 124 Stat. 2397-98.
- 66 See Philip Wagman, NYSBA Tax Section Report No. 1231, [Section 901\(m\): Covered Asset Acquisitions \(2011\)](#), available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1231-Report.pdf>.
- 67 See Gregory May, Getting Realistic About International Tax Arbitrage, Taxes, Mar. 2007, at 37; Yaron Z. Reich, International Arbitrage Transactions Involving Creditable Taxes, Taxes, Mar. 2007, at 53.
- 68 4145356 Canada Ltd. v. The Queen, [2011] C.T.C. 220 (Can. Tax. Ct.); [Comm'r of Inland Revenue v. BNZ Inv. Ltd.](#) [2002] 1 NZLR 450 (CA); [Westpac Banking Corp. v Comm'r of Inland Revenue](#) [2009] 2 NZLR 99 (CA); [Swift v. HM Revenue and Customs](#), [2010] UKFTT 88 (TC); [Bayfine UK v. HM Revenue and Customs](#), [2011] EWCA (Civ) 304, [2011] S.T.C. 717 (Eng.); [Hill Samuel Invs. Ltd. v. HM Revenue and Customs](#), [2009] UKSPC, [2009] S.T.C. 315.
- 69 Reg. § 1.901-2(f).
- 70 Reg. § 1.901-2(e)(5)(i).
- 71 1998-1 C.B. 334.
- 72 [Compaq Computer Corp. v. Commissioner](#), 277 F.3d 778 (5th Cir. 2001); [IES Indus. v. United States](#), 253 F.3d 350 (8th Cir. 2001).
- 73 Notice 2004-19, 2004-1 C.B. 606.
- 74 [T.D. 9416, 2008-46 I.R.B. 1142](#).
- 75 Reg. § 1.901-2(e)(5)(iv).
- 76 See Kevin Dolan, Foreign Tax Credit Generator Regs: The Purple People Eater Returns, 115 Tax Notes 1155 (June 18, 2007).
- 77 [Pritired 1, LLC v. United States](#), 816 F. Supp. 2d 693 (S.D. Iowa 2011) (denying FTC on economic substance and partnership anti-abuse grounds); [Hewlett-Packard Co. v. Commissioner](#), 103 T.C.M. (CCH) 1736 (2012) (decided on debt-equity grounds, finding that HP's investment in Dutch SPV was debt, destroying its claim to indirect credits); [Bank of New York Mellon Corp. v. Commissioner](#), 140 T.C. No. 2 (2013) (denying FTC on economic substance grounds); [Salem Financial, Inc. v. United States](#), 112 Fed. Cl. 543 (2013) (denying FTC on economic substance grounds); [American Int'l Group, Inc. v. United States](#), 2013-1 USTC ¶ 50,255 (S.D. NY 2013) (rejected taxpayer's motion for summary judgment on economic substance grounds).

But see [Santander Holdings USA, Inc. v. United States](#), 2013-2 USTC P 50,564 (D. Mass. 2013) (granting taxpayer's motion for summary judgment on profit element of economic substance).

78 [T.D. 9577](#), 2012-1 C.B. 730.

79 See former Reg. § 1.704-1(b)(4)(viii)(d)(3).

80 [T.D. 9577](#), note 78.

81 See, e.g., Office of Mgmt. & Budget, Fiscal Year 2014: Analytical Perspectives: Budget of the U.S. Government 187 (2013), available at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/spec.pdf>.

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