Rewriting the Foreign Tax Credit Limitation (Again)

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… double taxation, under income tax law, can be avoided only by a series of practical compromises …. Theory cannot be satisfied. Ease and practicability of administration settle many disputes which might be protracted indefinitely on a theoretical basis.

— *Thomas S. Adams*

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Table of Contents

I. Introduction and Overview
II. History of the Foreign Tax Credit Limitation
  A. The Invention of the Foreign Tax Credit
  B. Protecting Residual U.S. Taxation: Rapid Replacement of Jurisdictional Rule with Foreign Tax Credit Limitation
  C. Flip-flopping Between Overall and Per Country Limitations
  D. Growth, Decline, and Re-growth of Other Separate Limitations
    1. Basketing by Character
    2. The Issue of Intercompany Payments - Using Look-Through to Preserve Character of Income and Avoid Disaggregating Returns from Active Business Operations
    3. Post-TCJA Basketing by Ownership Structure
III. Prolegomena to Any Future Foreign Tax Credit Metaphysics
  A. Introduction
  B. Congressional Purposes Reflected in the Foreign Tax Credit and Limitation
  C. Protecting U.S. Taxing Jurisdiction: the Cross-Crediting Issue and Per Country vs. Separate Basket Solutions

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D. Is Per Item the Platonic Ideal of a Foreign Tax Credit Limitation?
1. Introduction
2. The Simple Shiny Seductive Appeal of Per Item
3. Evaluating the Per Item Limitation
E. Moving On: So What About Per Country Instead?
F. The Changing Shape of the Playing Field
IV. A Modest Proposal
A. The Task at Hand
B. A Two-Basket System
C. Specific Design Considerations
1. Definition of Low-Tax Income
2. Expense Allocation
D. Comparison of the Two Basket Proposal to a Per Country Approach

I. Introduction and Overview

The design and operation of the foreign tax credit limitation have been frequently debated over the last hundred years, resulting in several major reversals of legislative direction and a constant flow of smaller-scale (but hardly trivial) modifications, not to mention an equally active florescence of regulatory activity (particularly after 1986). Yet despite all of the many changes that the limitation has seen over time, its conceptual and normative underpinnings have received limited attention since the enactment of the Tax Reform Act of 1986,[1] which established the architecture of current law. While there has been extensive legislative and regulatory activity since 1986, the focus of that activity has shifted to more technical issues arising from the operation of the credit. By contrast, the similarly complicated history of U.S. taxation of foreign subsidiaries of U.S. companies has developed against a background of ongoing and starkly-drawn policy debates sounding in macroeconomic policy—international competiveness and investment neutrality—as well as tax policy. But despite its importance, the foreign tax credit limitation has not enjoyed a comparable vogue of policy debate in recent decades, apparently crowded out by the frequent tumult and shouting over controlled foreign corporations (CFCs) and deferral.

Notwithstanding the absence of a robust foreign tax credit policy debate in recent years, however, the House of Representatives has recently passed a bill that would make the most important changes to the foreign tax credit limitation since 1976, and possibly since its inception.[2] And the Senate is considering very similar language advanced by the Senate Finance Committee.[3] In particular, both bills would adopt a per country approach to the operation of the foreign tax credit limitation, under which credits for income taxes paid to a particular foreign country would be permitted only in respect of the income that a taxpayer earns from that same country. Given that a per country approach to the foreign tax credit limitation was both adopted and repealed decades ago, we thought it would be useful to re-familiarize the reader with the policy bases for the design of the limitation as it has evolved over the past hundred years, to review how the current proposals compare with previous versions of such a limitation, and to consider an alternative approach that could potentially simplify the provisions that Congress is considering at this time.

We thus start in section II with a brief but always-edifying recap of the history of the credit and limitation since 1918. In section III we provide an introduction to the normative and policy considerations that have guided, are guiding, or perhaps should guide the design of the limitation, including an evaluation of a hypothetical per item limitation, frequently posited as the Platonic ideal of the foreign tax credit limitation, and equally frequently cited to support a per country limitation as the next best thing. While the fatal practical flaws of a per item approach have always been acknowledged, even by those who admire it in theory, we find that those practical flaws are matched by equally troubling normative concerns, and that many of those same practical and normative concerns affect the per country limitation, based in large measure on its inadministrable level of complexity. We will thus turn in section IV to a modest proposal that could potentially simplify the mind-numbing complexity of the per country legislative proposals that are under consideration as we write.

II. History of the Foreign Tax Credit Limitation

A. The Invention of the Foreign Tax Credit

At the height of the military and related fiscal demands of World War I, Treasury proposed and Congress enacted the

world's first full foreign tax credit for corporate taxpayers.[4] The United States thereby sought to resolve the problem of cross-border income being subject to the overlapping claims of taxing jurisdiction both by the taxpayer's country of residence and by the country in which the income was earned—the country of source.[5] While overlapping source and residence tax claims had long been recognized as a problem, relatively low pre-war tax rates had limited the impetus for a solution.[6] But the dramatic increase in tax rates required by unprecedented military spending during World War I brought the issue to a head.[7]

By granting its taxpayers a full, dollar-for-dollar credit for foreign taxes paid on foreign source income, the United States ceded primary taxing jurisdiction over such income to the country of source. Notably, however, this approach also retained secondary U.S. taxing jurisdiction over the income; that is, if the foreign taxes on the income, and therefore the foreign tax credits associated with the income, are less than the taxpayer's applicable U.S. tax rate, then residual U.S. tax will apply to top up the tax paid to the U.S. rate.

This preservation of residence-country taxing jurisdiction over foreign source income is the principal advantage of a credit-based approach for relieving cross-border double taxation. The primary alternative approach to avoiding double taxation is to simply exempt foreign-source income from residence country taxation (often referred to as territorial taxation), for example by providing a "participation exemption" for foreign-source dividends. While such an approach was historically popular around the world, the opportunities it provided for not only relieving double taxation but for creating double non-taxation were increasingly recognized as problematic.[8]

The competing concerns of avoiding double taxation while simultaneously preventing double non-taxation were at the heart of the early design and amendment of the U.S. foreign tax credit. As initially enacted, the foreign tax credit was not subject to a limitation as such; instead, the definition of a creditable foreign income tax was limited to an income tax that a foreign country imposed on income arising within its borders. That is, creditable foreign taxes were subject to a source-based jurisdictional nexus requirement, for example limiting the credit for taxes paid to the United Kingdom to UK taxes on UK-source income.

Treasury and Congress quickly recognized, however, that this system potentially ceded too much taxing jurisdiction to source countries, by allowing foreign taxes in excess of the U.S. tax rate to be fully credited against the taxpayer's U.S. tax liability—including its liability for tax on U.S.-source income. As that clearly went further than the intended relief of double taxation required, Congress acted swiftly to adopt a different approach in the Revenue Act of 1921, enacting—ta-dah!—the world's first foreign tax credit limitation, which in fundamental form was not all that different from the one we know and love today (but possibly not tomorrow).

B. Protecting Residual U.S. Taxation: Rapid Replacement of Jurisdictional Rule with Foreign Tax Credit Limitation

The foreign tax credit limitation enacted in 1921 took the form of a proviso that replaced the ineffective jurisdictional nexus rule enacted two years before.[9] A redline of the 1921 statutory language against the prior version highlights the new language and approach, which granted to domestic corporations a credit for

> the amount of any income, war-profits, and excess-profits taxes paid during the same taxable year to any foreign country, or to any possession of the United States: *Provided*, That the amount of credit taken under this subdivision shall in no event exceed the same proportion of the taxes, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits, and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to its entire net income (computed without such deduction) for the same taxable year.[10]

Several aspects of this initial enactment are notable. First, it deleted the 1918 Act's language that allowed credits only for taxes that a country imposed on income sourced in that country; thus, the credit applied to all foreign taxes paid by the taxpayer, without regard to the source of the income or the basis for a particular foreign country's assertion of taxing jurisdiction over the income.

Second, it fully protected a primary (and sole) U.S. claim to tax U.S. source income, while fully ceding primary taxing jurisdiction over all foreign source income (in the aggregate) to all foreign taxing jurisdictions (in the aggregate).

And third, the effectiveness of the provision was heavily dependent on the source rules that would effectively define the scope of primary vs. secondary U.S. taxing jurisdiction over particular streams of income. Thus, an important achievement of the 1921 legislation was to accompany the enactment of the limitation itself with the enactment of a full set of source rules addressing interest, dividends, rents and royalties from real, personal, and intangible property,

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income from personal services, gains from sales of real and personal property, and income from manufacturing and selling personal property.[11] The enactment of legislative source rules in 1921 apparently responded to some confusion over the administrative development of source rules under the prior legislation limiting creditable taxes to those imposed by the country of source.[12]

C. Flip-flopping Between Overall and Per Country Limitations

Early in the history of the limitation, Congress vacillated between an overall approach to the calculation of the credit and an alternative approach in which the credit is computed separately with respect to the income earned and taxes paid in each foreign country. The difference between the two of course lies in the extent to which cross-crediting is permitted—that is, the extent to which the U.S. tax on income that is subject to a relatively low rate of foreign tax may be offset by excess credits arising from income subject to foreign tax at a relatively high rate. The policy considerations pertinent to the question of blending vs. not blending high and low foreign tax rates are addressed in section III below; here we address only the historical progression between the two, which can be succinctly summarized in tabular form as shown in Table 1.

Table 1 suggests some observations. First, per country has been the primary limitation in 28 of the last 100 years, while the overall limitation has been the main rule in 72 years. Second, the per country limitation was repealed in 1976, giving the overall limitation an uninterrupted run now approaching fifty years (albeit subject to the incursions of the other types of separate limitations described in the next section). Indeed, as discussed in more detail below, a return to the per country approach was proposed by Treasury in 1984 and 1985, but was rejected by Congress in the Tax Reform Act of 1986.

While the past is not necessarily prologue, it often is; this history thus suggests that Congress ought to proceed with caution before reverting to a per-country approach, which has been enacted and repealed before. Further, for the reasons discussed in Section III, below, per country seems to us at best an imperfect solution—both over- and under-inclusive—to the cross-crediting concerns that have been articulated about the overall foreign tax credit limitation. And as also discussed below, it is more administratively burdensome than is necessary to achieve its goals.

D. Growth, Decline, and Re-growth of Other Separate Limitations

1. *Basketing by Character*

Although much focus during the early days of the foreign tax credit limitation was on the seesaw contest between overall and per country approaches, beginning in 1962 the

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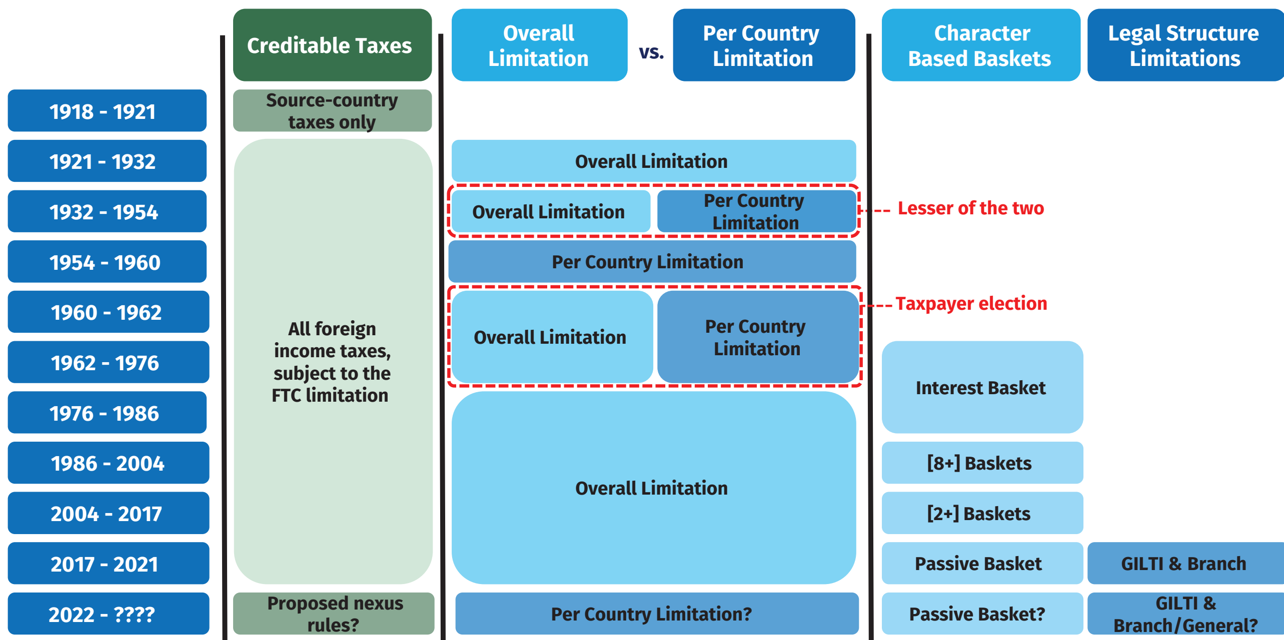


structure of the foreign tax credit limitation began to shift to a focus on separate limitations tracking the character of income. Initially limited to the interest basket enacted in 1962, the separate limitation concept was broadly expanded in the Tax Reform Act of 1986 by increasing the number of baskets to nine (plus).[13]

Although based on character, the foreign tax credit baskets prescribed by Code Sec. 904(d) were generally designed to limit certain cross-crediting between high-taxed and low-taxed income, as most clearly reflected in the conversion of the former interest basket into a broadly applicable passive basket. The primary purpose and effect of those rules was to remove the incentive for U.S. persons to shift passive income abroad when they otherwise have excess foreign tax credits.[14] Absent the passive basket, shifting passive income abroad would create additional foreign source income, and therefore increase the taxpayer's foreign tax credit limitation, and permit it to use excess credits from foreign taxes imposed on other income.[15] Even prior to the reduction in the number of baskets from nine to two by the American Jobs Creation Act of 2004,[16] the separate baskets other than passive largely served specific, narrow functions (for example, ensuring the taxable portion of income earned through the DISC and FSC tax regime was not offset by foreign tax credits). As a result, Code Sec. 904(d) as enacted in 1986 did not limit cross-crediting of income and taxes from active business operations in any significant manner as had been the case under the per country limitation of prior law.[17]

The 1986 shift of the limitation's focus to the character of income, generally as a surrogate for identifying highly mobile low-taxed income, presented two complications. The first was how to characterize nominally passive income such as dividends, interest, rents and royalties; although such amounts are generally passive income in the hands of most taxpayers, important exceptions apply. For example, interest income to a bank is almost never income from a passive investment. The tax rules confront this problem in a number of places, and often address it by simply providing an exception for such amounts earned by an active business.[18] Thus, beginning in 1962, the foreign tax credit basket for interest income had included an exception for interest that was "derived in the conduct of a banking, financing, or similar business."[19] When the 1986 Act expanded the interest basket to include a broader set of passive income defined by cross-reference to foreign personal holding company income under subpart F,[20] the exception for active interest was addressed by the financial services basket, which served as the general basket for these taxpayers, and included "income derived in the active conduct of a banking, financing, or similar business.[21]

The second complication presented by relying on the passive character of income to identify highly mobile low-taxed income relates to the payment of such amounts between affiliates. We thus turn next to the 1986 Act's use of look-through rules to preserve the character of income when paid between related parties.

2. The Issue of Intercompany Payments - Using Look-Through to Preserve Character of Income and Avoid Disaggregating Returns from Active Business Operations

a) Interest Income Basket under pre-1986 Act Rules. Although interest, dividends, rents, and royalties are generally viewed as passive forms of income for tax purposes, this view is frequently altered when such amounts are paid between affiliates. For example, dividends from a wholly owned subsidiary are generally not considered passive income to the parent corporation, and instead the subsidiary's operations are generally treated as part of the overall business operations of the group, as illustrated by the treatment of dividends within a consolidated group.[22] More broadly, the treatment of intercompany items under the consolidated return regulations is generally determined as if the members of the group were a single corporation.[23]

Before the 1962 enactment of the interest limitation began to apply separate limitations based on the character of income, unrestricted cross-crediting was permitted without regard to the character of income (subject of course to the per country limitation in some years). Thus, before 1962 there were no special rules providing look-thru treatment because none were needed: income earned directly from active foreign operations (manufacturing and sales income, services income, *etc.*) was combined with foreign source interest, dividends, rents and royalties going back to the genesis of the limitation in 1921. Under an overall limitation, all income was basketed together and thus full cross-crediting was permitted. And when a per country approach was applicable, the sourcing rules that were used to determine the appropriate country basket permitted cross-crediting of such amounts within each country.

But as soon as character-based basketing began to be adopted, starting in 1962, the problem of characterizing intercompany payments for purposes of the foreign tax credit rules was addressed through the simultaneous adoption of look-through rules. Specifically, from its inception the interest basket excluded any interest "received from a corporation in which the taxpayer owns at least 10 percent of the voting stock."[24] This rule could be viewed as a form

of quasi-consolidation, in that it operated to mitigate the general structure for taxing the income of foreign subsidiaries that treats them as separate entities. It did so by basketing the income not based on its character in the hands of the recipient, but instead based on the activities of the payor. Thus, the rule applied the foreign tax credit limitation as if the income of a foreign subsidiary had been earned directly by the taxpayer, preventing the intercompany payment from shifting the character of the income as earned by the group, and aggregating all of the returns from active business operations together for purposes of the foreign tax credit limitation.

b) Enactment of Code Sec. 904(d)(3) in 1986—Look-Through for Subpart F Inclusions, Dividends, Interest, Rents and Royalties from CFCs. As noted above, the 1986 Act expanded the number of foreign tax credits baskets to nine (plus). The legislation also reworked the look-through rules in several respects and established an approach that remains in the Code today. The expansion of the passive basket beyond interest income required a broader set of look-through rules, applicable under Code Sec. 904(d)(3) to dividends, subpart F inclusions, rents, and royalties, in addition to interest. The addition of several other separate foreign tax credit limitations also meant the characterization of look-through payments was not limited to active or passive, but also potentially any of the other baskets newly introduced in 1986.

One policy served by the look-through approach, in preserving the character of income paid between affiliates, was to reduce disparities between earning income directly (including through a branch) and indirectly through a foreign subsidiary. As explained by the 1986 Bluebook,

> Congress determined that dividends, interest, rents, and royalties from, and subpart F inclusions with respect to, controlled foreign corporations should be subject to the new separate limitations and to the overall limitation in accordance with look-through rules that take into account the income of the controlled foreign corporation itself. In Congress' view, a dividend received by a 10-percent shareholder of a controlled foreign corporation, for example, should not automatically be treated as 100-percent passive income. Look-through rules reduce disparities that might otherwise occur between the amount of income subject to a particular limitation when a taxpayer earns income abroad directly (as through a foreign branch), and the amount of income subject to a particular limitation when a taxpayer earns income abroad through a controlled foreign corporation.[25]

But the look-through approach also served an entirely separate goal, by enabling U.S. taxpayers to structure their returns on foreign investments as payments that would be deductible for local tax purposes:

> Congress decided to subject interest, rents, and royalties, in particular, to look-through rules because such payments often serve as alternatives to dividends as a means of removing earnings from a controlled foreign corporation or other related person. In addition, Congress believed that interest, rents, and royalties from controlled foreign corporations generally should be treated for look-through purposes like dividends from controlled foreign corporations so that payment of the former would not be discouraged. Interest, rents, and royalties generally are deductible in computing tax liability under foreign countries' tax laws while dividend payments generally are not; thus, in the aggregate, interest, rent, and royalty payments reduce foreign taxes of controlled foreign corporations more than dividend payments do. Under the foreign tax credit system, the payment of interest, rents, and royalties by controlled foreign corporations may, therefore, reserve for the United States more of the pre-credit U.S. tax on these corporations' foreign earnings than the payment of dividends.[26]

The final changes to the look-through rules were made in 2004 as part of the reduction in baskets from nine to two. Prior to the 2004 Act, section 904(d)(1) provided as follows:

> Except as otherwise provided in this paragraph, dividends, interest, rents, and royalties received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall not be treated as income in a separate category.[27]

Separate category at the time was defined as "any category of income described in subparagraphs (A) [(passive income)], (B) [(high withholding tax interest)], (C) [(financial services income)], and (D) [(shipping income)] of [section 904(d)(1)]."[28] The regulations expanded the definition of separate category to include all foreign tax credit baskets other than general.[29]

The reduction of baskets as part of the 2004 Act was accompanied by an amendment to section 904(d)(3)(A) to exclude look-through amounts from the passive basket, as the other limitation categories were no longer applicable. The full revised version is as follows:

Except as otherwise provided in this paragraph, dividends, interest, rents, and royalties received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall not be treated as passive category income.

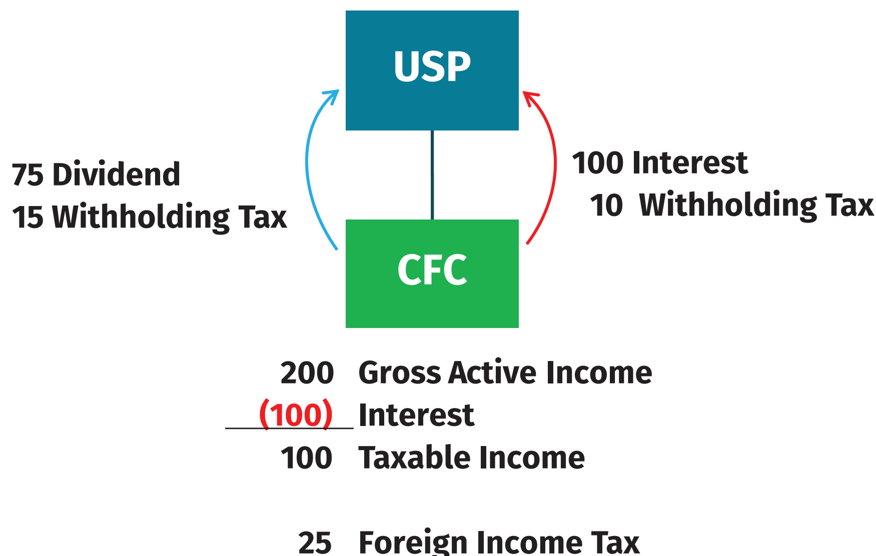
In other words, because there were only two baskets following the 2004 Act changes, the exclusion of income from the passive basket automatically placed it in general, and thus provided the same degree of look-through treatment as under pre-2004 law.

Thus, at all times prior to 2018, going back to the enactment of the credit a century ago, all income amounts related to active business operations were included together for foreign tax credit purposes. Figure 1, below, illustrates how section 904(d)(3) applied prior to the enactment of the TCJA. USP, a domestic corporation, owned 100 percent of the outstanding stock of CFC. CFC was a French corporation that operated an active manufacturing business. CFC had EUR200 of income before interest expense. CFC paid EUR100 of interest to USP entitling it to a EUR100 deduction. CFC thus had EUR100 net taxable income for both French and U.S. tax purposes. CFC was subject to French corporate income tax at a rate of 25 percent (EUR25). CFC also distributed to USP a dividend equal to its remaining profits, the 75 of earnings and profits remaining after payment of the French tax. This dividend was subject to an additional 20 percent withholding tax (EUR15).

USP received the dividend and included the gross amount (EUR75) in income. USP was entitled to a foreign tax credit under section 901 (and section 903) for the EUR15 withholding tax on the dividend. USP was also deemed to pay EUR25 of foreign taxes under former section 902 because it had distributed 100 percent of CFC's earnings. USP was required to "gross up" the dividend under Code Sec. 78 for the amount of the deemed paid foreign taxes such that the total income from the dividend was EUR100. USP had an additional 100 of income from its receipt of the interest from CFC, and as in the case of the dividend, was entitled to claim a foreign tax credit for the EUR10 withholding tax imposed on the interest payment.

Although USP was entitled to a total of EUR50 of foreign tax credits on its EUR200 of income, an issue remained as to whether those credits could be used in the current year given the foreign tax credit limitation of Code Sec. 904. Absent the look-through rules, Code Sec. 904(d)(1) would characterize both the dividend and interest income as passive income, however, because the dividend income would be high-taxed, it would be "kicked out" to the general basket and thus the excess credit on such amount would be available to cross-credit against the low taxed interest income. But Code Sec. 904(d)(3) applied and thus the character of the income in the hands of USP was not controlling. Instead, both the dividend and the interest income were subject to the look-through rules, and the dividend was thus treated as coming ratably from the CFC's baskets of earnings, which in this case was all general basket. The interest income was allocated based on the income of the payor that the interest deduction was allocated against. In this case, the expense was allocated against active (general basket) income and thus the

FIGURE 1.



interest income was placed in the general basket. Under former Treasury Regulation section 1.904-6(a)(i) (in force at the time), all of the foreign income taxes related to each amount also were allocated to the general basket and thus the foreign taxes on the high-taxed dividend income could be cross-credited against the residual U.S. tax on the low-taxed interest income. Rather than disaggregating the various returns from this single active business, the look-through rules placed them all in the general basket, allowing foreign taxes on the separate items to be cross-credited against one another.

c) Post TCJA Look-through—A Lurch Towards Per Item? The final step in the historical development of the look-through rules is one that Congress did not take. As noted above, notwithstanding all of the changes to the foreign tax credit limitation made by the TCJA, the look-through rules under Code Sec. 904(d)(3) were untouched. Instead, Treasury and the Service have stepped in to fill the breach by adopting rules for applying the look-through rules in the post-TCJA world that only apply look-through to treat income that otherwise is general basket income as passive basket income.[30] Thus, the failure to apply look-through to post-TCJA periods effectively separates the various income streams from an active foreign business into different baskets, in this case, the GILTI basket (for net operating income) and the general basket (for the related intercompany interest and royalties).

The formulation of the look-through rule in the regulation is directly at odds with the statute and the history of the look-through rules. The preamble to the proposed rule had stated that "[t]he proposed regulations provide that the look-through rules under Code Sec. 904(d)(3) provide look-through treatment solely for payments allocable to the passive category. Any other payments described in Code Sec. 904(d)(3) are assigned to a separate category other than the passive category based on the general rules in Reg. §1.904-4."[31] But providing look-through only to the extent that a look-through payment is attributable to passive income is the opposite of what the statute provides. Code Sec. 904(d)(3)(A) provides the general look-through rule, and notes that it applies to exclude income from the passive basket except as otherwise provided in Code Sec. 904(d)(3). Code Secs. 904(d)(3)(B), (C) and (D) then provide the exceptions to look-through treatment—or in other words, the instances where look-through does not apply—to the extent look-through amounts are attributable to passive income. Thus, while the statute may not provide where look-though amounts belong when the rule applies, it is clear that look-through does not apply to passive income. Accordingly, the application of look-through only to passive income in the proposed regulations is precisely the reverse of what the statute requires.

This interpretation is consistent with the broader context of the look-through rules and their historic operation. The point of look-through is to allocate income that otherwise is passive income in the hands of the recipient to another basket based on the underlying income of the payor. There is no need to apply the look-through rules to characterize passive income as passive income. Moreover, the approach of the regulations would create completely novel results. A look-through amount that is attributable to tested income is allocated to a basket neither based on the character of the income in the U.S. shareholder's hands, which would be passive, nor based on the underlying income of the payor, which would be GILTI. Instead, the income is allocated to a third category of income, the general basket, which has nothing to do with the income in the hands of either.

Some have argued that this result was compelled by the definition of the baskets in Code Secs. 904(d)(1) and (2), maintaining that the look-through rules cannot allocate an item of income to the GILTI basket because it is defined to only include income that is included under Code Sec. 951A(a).[32] But this is precisely what the look-through rules are intended to do. The scope of the various baskets as stated in Code Secs. 904(d)(1) and (2) are the rules that apply to characterize income in the hands of the taxpayer. But the look-through rules override this characterization in the case of a look-through amount, and instead provide that the income is not to be basketed based on its character in the hands of the recipient but based on the character of the income of the payor to which it is allocable. Neither satisfy the definition of each basket under Code Sec. 904(d)(1) and former section 904(d)(2)(F), but if they did, then there would be no need for the look-through rules to apply to achieve this result.[33]

3. Post-TCJA Basketing by Ownership Structure

The disaggregation of income from active business operations that would arise under the look-through regulations described above echoes the more foundational disaggregating effects of the TCJA's partition of the former general basket. The TCJA separated active earnings into three baskets based not so much on the character of income as on the legal structure in which it is earned. Specifically, the TCJA divided active income into: (1) the branch basket, (2) the GILTI basket, and (3) the general basket. The branch basket encompasses income earned from foreign activities conducted directly or through a flow-through entity. The precise policy objectives of separately basketing branch income have never been entirely clear,

and apparently evolved during the legislative process. The original explanation in the Senate Budget Committee report was "to prevent excess foreign taxes credits generated in high-tax branch countries to be used to reduce U.S. tax owed on income generated in a low-tax country."[34] It is unclear what was thought to be included as "income generated in a low-tax country" given that most of such income would already be (1) separately basketed in the GILTI or passive baskets, (2) would be branch income or (3) would no longer be foreign source income as a result of the change to the sales source rule (which would not have been viewed as income generated in the foreign country in any event). By the time the the Joint Committee on Taxation released its General Explanation, the focus had shifted to cross crediting involving low-taxed royalties, which in general is hard to squeeze into the category of income generated in a low-tax country as this income presumably was generated in the United States where the IP giving rise to the royalty was developed, or even if focused on where the IP was used, it generally would have been a high-taxed country even if the royalties themselves were low-taxed, for example, under an income tax treaty.[35] Moreover, this policy result for low-taxed royalties only arises (at least in the case of related party royalties) because look-thru treatment under Code Sec. 904(d)(3) does not apply.[36] While that consequence was clear when the TCJA Bluebook was issued, as it followed the issuance of proposed foreign tax credit regulations providing this approach, there is no indication that this was Congressionally considered or that foreign tax credit look-through was simply not considered at all as part of the TCJA. This seems most clear from the preamble to the proposed regulations quoted above, and in particular its explanation of the decision to adopt this approach.

Post-TCJA the new GILTI basket includes amounts included under Code Sec. 951A(a), which comprises the active (non-subpart F income) earned through a CFC. Finally, the general basket, though substantially reduced in scope, remains the residual basket for purposes of the foreign tax credit limitation and thus includes the principal remaining categories of active income. This includes income earned from "U.S. activities" (ownership of stock, debt, or IP and the resulting dividends, interest, or royalties earned thereon) as well as (and somewhat incongruously) subpart F income other than foreign personal holding company income. Thus, by separating different kinds of returns from active business operations that had historically always been aggregated for foreign tax credit purposes, the TCJA substantially reduced cross-crediting, and effectively took several steps down the path toward a per item limitation.

III. Prolegomena to Any Future Foreign Tax Credit Metaphysics

A. Introduction

In this modestly-titled section, we present an introduction to some of the normative, policy, and practical considerations that have guided, are guiding, or possibly should guide Congress and Treasury when considering the design of the foreign tax credit and its limitation. But sadly, a pompous title won't hide the actual modesty of this effort, which merely provides initial sketches of several topics that deserve more detailed analysis. These assorted topics are not presented in an entirely random order (really), but neither have we succeeded in integrating these topics into a coherent system of foreign tax credit metaphysics.[37] Instead, we have tried to focus more on practical considerations than metaphysics, consistent with the long history of the foreign tax credit's development.

We begin with a summary of the multiple purposes that Congress sought to achieve when it enacted the relevant statutory provisions, because, call us old-fashioned, we think that Congress' purpose in enacting a statute remains relevant even when the statute was enacted a century ago. We then turn to the issue of cross-crediting: Congress and Treasury have long been concerned about the revenue and incentive effects that flow from taxpayers' ability to use excess credits for foreign taxes paid on high-taxed foreign income to reduce the residual U.S. tax they would otherwise pay on low-taxed foreign income.

The issue of cross-crediting will then bring us to the theoretical appeal of a per item foreign tax credit limitation. Although such a limitation has never been enacted, and indeed has never been seriously proposed, it is nevertheless worth considering in some detail, because it lurks in the background of many discussions of the foreign tax credit limitation. A per item limitation is frequently put forward (often with little or no analysis) as the Platonic ideal of the foreign tax credit limitation, and this unexamined premise is then used to justify other design choices based on those other choices' similarity to the purported per item ideal—in particular, a per country limitation is often touted as a more user-friendly version of the per item approach. We thus think that some examination of the per item shibboleth is long overdue.

Having dispensed with the per item theory, we then turn to consider today's renewed enthusiasm for a per country limitation, but find that the current per country proposals, regardless of one's view of their theoretical merits, are wholly impractical. And finally, our last prolegomenon

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notes the changing shape of the international tax playing field in which the U.S. foreign tax credit operates.

We hope that these sketches will inspire further work by others, if nothing else to point out our many errors.

B. Congressional Purposes Reflected in the Foreign Tax Credit and Limitation

Any analysis of the normative considerations affecting the design of our foreign tax credit rules must begin by considering what motivated Congress when it first enacted the foreign tax credit in the Revenue Act of 1918, and when it added the foreign tax credit limitation to the statute in 1921. A review of the history will show that several factors motivated Congress' desire to eliminate the double taxation of cross-border income.[38] First, the early legislative history, and other contemporaneous materials, reflect Congressional concerns that international double taxation could adversely affect the competitive position of U.S.-owned businesses operating in international markets.[39]

Second, the early history also reflects a strong normative concern about preserving horizontal equity between U.S. taxpayers with purely domestic income and those with income from foreign sources. In more recent decades people have tended to speak in terms of economic efficiency, neutrality, or the various incentive effects created if cross-border income is taxed more heavily or more lightly than domestic income; but in 1918 Congress was motivated by a more straightforward sense that two taxpayers with similar amounts of income should bear a similar tax burden.[40]

Finally, the third significant factor affecting the design of the credit system was Congressional interest in preserving residual U.S. taxing jurisdiction over foreign source income, rather than adopting an exemption system that would have yielded U.S. taxing claims over such income altogether.[41]

In the century since the original enactment of the foreign tax credit, Congress has sometimes returned to a focus on the first and third of these factors. In particular, debates about subsequent changes to the foreign tax credit have often considered the question of the credit's impact on the competitive position of U.S.-based international businesses, and have likewise focused on the protection of residual U.S. taxation of foreign income, particularly in light of concerns about the incentive effects created when an overall limitation permits excess credits to shelter low-taxed foreign income from residual U.S. tax.

On the other hand, Congress has not found occasion to explicitly revisit the second factor, the normative consideration of horizontal equity between taxpayers with and without foreign income subject to foreign taxes. But while Congress has not seen a need to alter the operation of the credit based on that underlying normative principle, this does not suggest that this principle or purpose has somehow been superseded, forgotten, or otherwise lost in the mists of time. To the contrary, one of the single biggest changes to the foreign tax credit scheme was the enactment of Code Sec. 903 in 1942, expanding the creditability of foreign taxes to certain non-income taxes; the enactment of Code Sec. 903 thus suggests that Congress continued to be concerned about the impact of unrelieved double taxation on U.S. taxpayers operating in foreign markets.[42] Rather than acquiescing in the double taxation of such taxpayers on the basis of the IRS' technical argument that certain foreign taxes were noncreditable because they were not income taxes in the U.S. sense, Congress instead loosened the definition of a creditable foreign tax to provide additional relief from double taxation in the face of an evolving international landscape that had seen the introduction of several novel foreign taxes. Accordingly, in evaluating a normatively "correct" foreign tax credit limitation, we think it is important to bear in mind the principle of horizontal equity that in part motivated the credit's initial enactment.

The principle of horizontal equity, because it sounds in equity, has important implications for the operation of the foreign tax credit, implications that are reflected both in the judicial interpretation of the credit and in post-enactment Congressional revisions to the foreign tax credit statute. In particular, the equitable origins of the credit strongly suggests that it should be read and applied with a clear view to its practical real-world effects, rather than adopting an aridly formalistic analysis and implementation of the statute. This can be seen, for example, in foreign tax credit decisions in which courts have insisted that the substance of a foreign tax must be evaluated to determine whether it is a creditable income tax, rather than using the formalistic analysis that the IRS had sought to impose.[43] As noted, this was likewise seen in the enactment of Code Sec. 903, and in Congress' 1986 rejection of a proposed per country limitation, discussed below.

C. Protecting U.S. Taxing Jurisdiction: the Cross-Crediting Issue and Per Country vs. Separate Basket Solutions

When it was first enacted in 1921 the foreign tax credit limitation was intended to protect U.S. taxing jurisdiction over U.S. source income. That is, the credit as enacted in the 1918 Act contained no mechanism to prevent excess foreign tax credits from being used to offset U.S. tax on

U.S. income, potentially ceding taxing jurisdiction over U.S. income to foreign sovereigns. As discussed above (and needless to say), Congress and Treasury acted quickly to address that problem by enacting the foreign tax credit limitation. Thus, as initially conceived, the limitation served to ensure that the United States collected its full statutory tax in respect of all U.S. source income of U.S. taxpayers.

However, the foreign tax credit limitation as it has evolved seeks to do more than that, because it seeks to protect not only original U.S. taxing jurisdiction over U.S. income, but also to protect residual U.S. taxing jurisdiction over foreign source income, by limiting the extent to which excess foreign tax credits on high-taxed foreign income can be used to offset residual U.S. tax on lower-taxed foreign income. Concerns about such cross-crediting between high- and low-taxed foreign income led to the initial enactment of the per country limitation in 1932.[44] Moreover, as discussed above, Congressional and Treasury concerns about cross-crediting (or "averaging" foreign tax rates) have extended beyond its direct revenue effects to include also the potential economic inefficiency that could result if investment decisions are driven by credit-maximizing considerations rather than being strictly based on pre-tax ROI.

In 1984 and 1985 Treasury addressed in detail the Reagan administration's concerns about the incentive effects of cross-crediting, and proposed a return to the per country limitation (last repealed in 1976) to address those concerns. But Congress responded in 1986 by adopting a narrower and more practical solution to the issue than the per country solution that Treasury had urged, in part based on a practical view of the effects of a U.S.-based MNC's "integration" of its operations across multiple foreign jurisdictions. In light of the Biden Administration's 2021 proposal of a per country approach to the foreign tax credit, and the extension of that proposal in legislation that has passed the House, the history of Congress' rejection of the Reagan Administration's similar per-country proposal is particularly relevant.

To begin with, the concerns expressed by the Reagan Treasury closely echo the concerns stated in 2021 as the basis for changing to a per country system. In its initial tax reform proposals issued in 1984, Treasury stated that an overall limitation

> distorts investment decisions. A taxpayer has an incentive to generate low-taxed foreign income to utilize excess foreign tax credits. As a consequence, investments may be shifted from the United States to low tax countries. The U.S. tax base is eroded and capital may be allocated to less productive uses for tax reasons.[45]

And when Treasury returned to the subject with its second round of tax reform proposals in 1985, it addressed the same concerns in even more detail, starting with the observation that passive interest income could not be averaged with other income under the existing interest basket, but noting that foreign taxes on other types of passive income could be averaged with taxes on active business income. Treasury then summarized two distinct objections to such averaging, arguing first that

> … the averaging permitted by an overall limitation gives taxpayers with operations in a high tax country an incentive to invest in low tax countries. For a taxpayer with excess foreign tax credits, low tax country investments may be more attractive than investment in the United States that generate a higher pre-tax economic return simply because of the possibility of using the excess credits to offset a portion of the U.S. tax otherwise due …. The overall limitation under current law thus causes economic decisions to be distorted purely for tax advantage.[46]

Treasury's second objection to the overall limitation was that it "permits some foreign countries to maintain high tax rates without reducing their ability to attract U.S. investment," given the ability of U.S. taxpayers to average high-tax foreign income against other foreign income earned in lower-tax jurisdictions, and concluding that

> The overall limitation inappropriately requires the U.S. Treasury to bear the cost of high foreign tax rates on U.S. businesses to the extent of its claim to a residual tax on low tax foreign income.[47]

As a response to these concerns, Treasury in 1984 and the Reagan administration in 1985 both proposed the return of the per country limitation that had been repealed in 1976.[48] When Congress evaluated these concerns in connection with the enactment of the Tax Reform Act of 1986, it took them seriously enough to enact significant changes to the foreign tax credit limitation, but it stopped well short of the per country solution that Treasury had urged. Congress did not find the averaging of high and low taxed income to be generally inappropriate, as stated in the 1986 Bluebook:

> In general, Congress believed that the overall limitation was consistent with the integrated nature of U.S.

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multinational operations abroad. Congress believed that the averaging of foreign tax rates generally should continue to be allowed.[49]

Congress instead sought to distinguish between appropriate cross-crediting—that involving the operations of an active foreign business—and inappropriate cross-crediting:

> … cross-crediting should not be permitted when it would distort the purpose of the foreign tax credit limitation. Congress believed that, in some cases, the ability of U.S. persons to average foreign tax rates for foreign tax credit limitation purposes, and thereby reduce or eliminate the residual U.S. tax on their foreign income had undesirable consequences. U.S. taxpayers with excess foreign tax credits have an incentive at the margin to place new investments abroad rather than in the United States when the income that those investments will generate will be taxed abroad at below the U.S. rate and the excess credits will be available to reduce or eliminate the U.S. tax on the income.[50]

Further, Congress concluded that this incentive was particularly problematic "in the case of investments that can quickly and easily be made in foreign countries rather than at home, for example, portfolio investments in stock in publicly traded companies."[51] Thus, the solution that Congress adopted in 1986 was not per country, but rather a separate-limitation approach that generally sought to prevent low-taxed passive income from mixing with higher-taxed business income. We will return below to the topic of the '86 Act's separate limitations and their later evolution, but as a bit of foreshadowing we will note here our conviction that the idea of separating high and low taxed income was sound, and can potentially be addressed more directly, rather than being pursued indirectly through surrogate tests that are either character-based (as in 1986) or country-based (as in the BBBA).

Before we can set forth our modest proposal, however, we must first dispense with a false idol, which is the entirely hypothetical notion of a per *item* limitation.

D. Is Per Item the Platonic Ideal of a Foreign Tax Credit Limitation?

1. Introduction

Although Treasury's per country proposals were not enacted in the 1980s, Treasury sought to justify those proposals on a basis that deserves further discussion because it continues to resonate in foreign tax credit policy debates. In fact, despite its purely hypothetical tenor, this may well be the most important prolegomenon on our list.

The President's 1985 tax reform proposals suggested that a per item (or transactional) limitation would be normatively correct:

> The purpose of the foreign tax credit is to relieve international double taxation of foreign income. Double taxation would be fully relieved if income derived from each separate transaction were treated separately for credit purposes and the U.S. tax were offset by a credit for the foreign tax paid with respect to that income. Any departure from a transactional approach to crediting foreign tax will permit some averaging of foreign taxes and will therefore involve some surrender of the residual tax imposed by the United States on foreign income that is taxed by foreign countries at rates below the U.S. rate.[52]

Treasury acknowledged, however, that "[i]t is impossible as a practical matter to eliminate all tax rate averaging by calculating the foreign tax credit on a transactional basis," in part because "the technical complexity of such a system would make it unworkable." Treasury thus moved on to state the question as being "how much tax rate averaging to permit in the system and at what cost in terms of the complexities of compliance and enforcement," and answered that question by proposing a per country approach as a more administrable version of the unattainable transactional ideal it had posited.

This view of per country as a more user-friendly version of the normatively correct per item limitation continues to percolate in tax policy discussions.[53] But it seemed to us that the normative correctness of per item was often assumed without discussion (it does have a seductively simple appeal), so we thought it would be worthwhile to consider in more detail whether per item really is normatively correct. We thus start with why it sounds right, and then move on to some reasons why it really isn't.

2. The Simple Shiny Seductive Appeal of Per Item

Because the foreign tax credit is purely and simply intended to "prevent double taxation," there is an inherent plausibility to Treasury's 1985 claim that the credit's purpose would be fully served by a per item limitation. That is, if a particular item of income is taxed by a foreign government at a rate of, say, 10 percent, then the only thing required to avoid double taxation of that item would seemingly be to provide a credit for the 10 percent tax, leaving the United States free to collect its residual

tax in respect of that item. Thus by granting a credit for the ten percent foreign tax and collecting an additional 11 percent of residual U.S. tax on the income, the United States would both avoid double taxation and protect its residual taxing jurisdiction over the foreign income of U.S. taxpayers. And to the extent that one or more foreign governments taxed an income item at a rate in excess of the U.S. rate, discarding the resulting excess credits would again protect the residual U.S. taxation of other, lower-taxed, foreign income, and would put the burden of the higher foreign taxes squarely where it belongs—on the taxpayers that operate in countries that impose such high-rate taxes.

The traditional objections to this view have been limited to more or less regretful acknowledgments that alas such a per item system would present too many practical difficulties to implement, and must therefore yield to a more practical alternative approach. But the view that a per item system would be the normatively correct way to administer a foreign tax credit limitation (if it could be administered) is worth further examination, because the choice among more-administrable alternative systems is likely to be influenced by how closely they may be seen as approaching the per item Platonic ideal, if that is in fact accepted as the ideal. Indeed, the current enthusiasm for a per country system seems to be very much driven by the view that it is a reasonable facsimile of the tempting-but-unattainable per item ideal.

We thus think it is useful, whether for this year's legislation or for the next time the wheel of change turns, to examine more closely the glib appeal of per item as the normatively correct limitation. It certainly presents a straightforward logical appeal to say that once the foreign tax on a given item has been credited, there is really no more work the foreign tax credit system needs to do. Further, a per item approach would of course eliminate the ability of taxpayers to cross-credit taxes imposed by higher-rate countries against lower-taxed foreign income that would otherwise bear residual U.S. tax, and would thereby eliminate the incentive effects that may arise under an overall limitation to generate low-taxed foreign earnings that can be blended with, and sheltered by, the excess credits from high-taxed foreign earnings.

While the double taxation of cross-border income is certainly the problem that Congress acted more than a century ago to address, from the historical standpoint of what Congress actually sought to achieve, and more importantly from the forward-looking standpoint of what the U.S. foreign tax credit regime needs to achieve in the future, the elimination-of-double-taxation mantra is an incomplete and inadequate expression of what the goals of our foreign tax credit system have been and should be. That is, the phrase is merely descriptive of the phenomenon that Congress sought to address, and does not articulate the reasons for addressing it. And the latter reasons, we submit, must inform how we define double taxation. Moreover, stating that a per item system would prevent double taxation assumes that per item double taxation can in the first place be defined and discerned, or at least approximated. We evaluate these and other aspects of the per item theory below.

3. Evaluating the Per Item Limitation

a) Can an Unworkable System be Normatively Correct?

Turning now to evaluate whether a per item limitation is genuinely the normatively correct implementation of the foreign tax credit limitation, we believe that a number of considerations suggest that it is not, and that some degree of averaging or blending is more consistent with the underlying (and critical) purposes of the statute. Moreover, we believe that these considerations, together with the additional considerations summarized below, also suggest that a per country limitation is neither a necessary nor even a viable alternative to a per item approach.

There are two fundamental conceptual issues with a per item principle. The first is that an "item" of income is an undefined and inescapably inchoate concept; and the second is that subdividing income into individual items, even if it could be done, is unnecessary to achieve the objectives of the foreign tax credit limitation.

The first issue is not simply a matter of there being no readily-available definition—a definition could, after all, be drafted. Rather, the problem is more basic than that, because no definition could reasonably answer all the questions that would inevitably arise, a problem readily illustrated by considering a simple fact pattern. If a taxpayer sells two t-shirts, should it be viewed as earning one item of income, or two? It seems like the answer should be easy, yet it could conceivably depend on any number of considerations, with no clear normative basis for deciding which considerations should govern. Should the answer depend on whether the shirts were sold to one customer or two? Or if both shirts were sold to a single customer, would it make a difference if that customer walked into the shop two times and bought the two shirts in two separate transactions? After all, Treasury suggested in the 1980s that a per item limitation would operate on a transactional basis.[54] But a transaction-based definition would simply reformulate the question as how to define a "transaction," and thus trades the question we started with for a differently worded but essentially similar one—when someone sells two shirts, it is equally unclear whether that should

be viewed as giving rise to one or two transactions, or one or two items of income.

Further, a myriad of other considerations could conceivably influence our view on whether our two shirt sales are one item of income (or one transaction) or two. For example, should it make any difference to the analysis whether the two shirts are identical? What if they differ in color, pattern, size, or design? Or should it make any difference if the income from the sale of the two shirts is taxed at the same local tax rate, or instead one shirt was produced in a plant that receives an enterprise zone tax reduction, while the other bears full local tax? Or what if the United States thinks the sale of a shirt is a single item of revenue from the sale of goods while the foreign jurisdiction subdivides this into the sale of a good and a return on the relevant intellectual property (which could itself be subdivided between trademark value, proprietary design, manufacturing IP, etc.—all items of income that potentially have differing tax treatment under the U.S. tax rules).

Moving beyond our comfy t-shirt example, similar item-izing questions would arise in every other business context, presenting myriad imponderable questions of one item vs. two vs. many, and with no ready normative basis for answering them. To take an increasingly important example, what if a foreign country taxes activities with a reduced carbon footprint at a lower rate than it taxes other activities? If a U.S.-owned business produces electricity using both coal-fired and wind-powered facilities, it will only have income from selling electricity, but it will be taxed at two different rates. Should the design of foreign environmental policies require us to subdivide the taxpayer's income into multiple items for U.S. foreign tax credit purposes, and in this case effectively double tax the income from renewable resources? Or should it matter if the differentially-taxed streams of income are operationally related, for example by using carbon-based generation to complement natural variances in the sources of renewables-based power (based on varying wind speeds, day lengths, river flows, etc.)? Finally, what in the world would any of these potentially item-defining considerations have to do with the proper application of the U.S. foreign tax credit?

This last point brings us to the second issue, which luckily for us actually resolves the first, by showing that there is in fact no need, given the purpose of the foreign tax credit limitation, to attempt to eff the ineffable by separately defining individual items of income. In the realm of the purely theoretical, we could go so far as to atomize income items into the smallest possible units of measure, cents in the U.S. system. But to what end? The question is how small a unit of measure is actually needed to serve the purposes of the foreign tax credit limitation; and the answer is assuredly not a breakdown to the level of pennies; and we submit that it is equally unnecessary to seek a breakdown to the level of individual items (however defined). Instead, determining the relevant unit of measure must be keyed to the policy goals of the limitation, and no policy goal is served by a per item breakdown. Yes, a per item breakdown, if it were possible to define and administer, would in principle eliminate cross-crediting. But a per item breakdown is unnecessary to prevent (or limit) cross crediting. We discuss in more detail below an alternative two-basket approach that could be used to either limit or eliminate cross crediting, without the need for any of the conceptual infirmities and practical impossibilities of a per item system.

Both of these considerations are aptly illustrated by the regulatory implementation of other Code rules that refer to "items" of income. For example, the subpart F high tax exception under Code Sec. 954(b)(4) applies to "any item of income received by a controlled foreign corporation" that is subject to an effective rate of foreign tax greater than 90 percent of the U.S. corporate tax rate. But in implementing that rule Treasury and the IRS rejected any effort to actually define individual items of income, or to administer the rule on an item-by-item basis. Instead, they implemented the rule by defining items as categories of income that may include the income from hundreds or thousands of separate transactions.[55] The preamble to T.D. 8618, in finalizing that implementation of the rule, readily acknowledged that "amounts attributable to separate transactions may be included in the same item of income," and stated that a transaction-by-transaction approach would add complexity (no kidding) and be inconsistent with related foreign tax credit rules.[56]

In sum, attempting to define individual items of income is not necessary, which is fortunate because it is also impossible as a practical matter. Instead, even under a nominally per item system, some grouping of transactions must presumably be contemplated as the unit of measure defining an item of income. But again this simply restates the question in a way designed to improve its practical operation while still failing to identify a normative basis for how or why the relevant categories should be defined in a particular way. And even if we pull the camera further back, and define the relevant items of income as the income of particular business operations, the results would be problematic as can be seen from another simple example.

Assume a U.S. taxpayer has business operations in Country A that generate $200 in foreign source income. If Country A income tax of $42 is imposed on that business

income, one might readily conclude that the taxpayer will be double-taxed unless the United States provides a $42 credit for the foreign taxes, and thus refrains from collecting any residual U.S. tax on the $200 of Country A income.

But now let us suppose that what we see as $200 of foreign source business income is characterized and taxed differently under Country A's tax law, based on particular aspects of the activities generating the income.[57] Suppose that under foreign law $100 of the income is subject to $42 of tax, while the other $100 of income is exempt (*e.g.*, due to a tax holiday). It now makes a huge difference whether we have one item of income, or two, because if we have one item the result is unchanged, but if we have two items the results will be very different under a per item rule; the high-taxed amount will bear no residual U.S. tax, but will produce $21 in excess credits, while the low-taxed item will be subject to a full residual U.S. tax of $21.

Given a general policy focus on limiting cross-crediting between high- and low-taxed income, it could readily be argued that income subject to differential foreign tax rates should be viewed as separate items of income. But under that view, when the taxpayer's Country A business pays $42 in Country A tax on $200 of Country A income, and the United States imposes an additional tax of $21, claiming that the taxpayer has suffered no double taxation depends on a somewhat arid view that the taxpayer's resulting effective tax rate of 31.5 percent is not the result of U.S. double taxation but rather of the foreign country's bad judgment (from the perspective of the U.S. foreign tax credit system) in adopting two different tax rates for business operations: a high-rate tax (which is only partially creditable for U.S. purposes) and a zero-rate tax (which results in full residual taxation by the United States). In other words, claiming that we have eliminated double taxation in such a case would depend entirely on believing that we should have, normatively speaking, two distinct items of income based on the applicability of differential tax rates under foreign law, even though we would otherwise see a single stream of business income for U.S. tax purposes. But should we really pay no attention to the taxpayer behind the curtain who the U.S. tax system would otherwise simply see as earning business profits of $200 on which it paid $42 of foreign taxes, but who instead must pay a total of $63 in taxes? This result mostly seems to penalize the taxpayer for doing business in a country that fails to impose a uniform rate of tax on all income (something that the United States itself does not do), while advantaging taxpayers with operations in jurisdictions that do follow a homogenized approach. It is far from clear to us that such tax system design choices under foreign law should determine the results under the U.S. foreign tax credit in this manner.

An additional question worth considering is whether the U.S. view of differentially-taxed income streams should be affected by the foreign jurisdiction's reasons for adopting a two rate approach. If, as discussed above, a foreign country's tax rates vary based on a business' carbon footprint, should the design of such foreign environmental incentives require us to subdivide the taxpayer's income into multiple items for U.S. foreign tax credit purposes, potentially requiring effective double taxation of lower-taxed income from renewable resources? Or what if the foreign jurisdiction's policy goals are less lofty than addressing climate change, but are simply administrative in nature, like taxing insurance activities more heavily with premiums-based taxes in lieu of income taxes, or relying on gross-basis withholding taxes more heavily to reduce the exposure to transfer pricing concerns? Or what if the distinctions drawn under foreign law simply reflect the political influence of particular market participants? And again, what purpose of the foreign tax credit would be advanced by following any such foreign-law categories, regardless of their policy basis, when none of these foreign-law distinctions bear any relation to the concerns that animate the current policy efforts to rewrite the foreign tax credit limitation?

It is thus far from clear to us why as a normative matter the shifting characterizations and categorizations that myriad foreign tax laws may impose should determine U.S. tax results under a per item system. Moreover, we will show below that declining to give U.S. tax effect to shifting foreign law distinctions does not mean abandoning the effort to limit cross-crediting. Policy concerns about blending high-taxed manufacturing income with low-taxed passive income are legitimate, but have been successfully addressed by the passive basket for the past 35 years, and could be addressed in the future under a similar two-basket approach.

Accordingly, in the absence of any even theoretical (much less practical) ability to define an item of income coherently, and thereby make a per item system work, we do not understand how per item can even as a hypothetical matter be a normatively correct solution to the problem of cross-border double taxation, such that other designs should then be judged on the basis of how closely they approach this unworkable system. This would be like saying that a perfect solution to the problem of air pollution is that people should simply stop breathing; and because we know that of course people can't do that, we won't try to enforce that solution, but we will judge all other solutions by how closely they approach the very

elegant stop-breathing solution. In other words, once the fundamental unworkability of a per item system is acknowledged, it seems (to us) unhelpful to continue pointing to it as normatively correct and a basis for judging other systems.

In the next section we consider a separate concern that would arise even if it were possible to define an item of income in a normatively coherent and administratively practicable manner. If it were actually possible to implement such a per item system, it would produce highly random distinctions between similarly-situated U.S. taxpayers that cannot be justified by any policy objective of the foreign tax credit.

b) The Randomness of Per Item. The randomness of a per item approach is best introduced with a comparative example. Table 2 compares two U.S. corporations, each of which has a single CFC.

Each U.S. parent receives a $100 interest payment from its CFC, each CFC otherwise has $100 of subpart F income, and a total of $42 in foreign tax is imposed on the $200 of income in each case. On that basis you might think that the foreign tax credit results should be the same in both cases, given the identical amounts of foreign income and tax. But under a per item system you'd be wrong, if one of the two countries has the bad taste to impose taxes at rates that differ from the applicable U.S. tax rate. In our example Country B imposes withholding tax at a 10 percent rate, while taxing the underlying subpart F income at a 32 percent rate; while Country A more helpfully (though unfortunately less realistically) taxes both amounts at a 21 percent rate. Assuming that a per item system would treat each U.S. parent as having two items of income—a $100 interest payment received directly from the CFC plus a $100 subpart F inclusion—the Country A taxes paid (or deemed paid) by US Parent 1 will be fully creditable, because each item was subject to foreign tax at a rate matching the U.S. rate. But sadly Country B's differential tax rates will stick US Parent 2 with a much worse result, since the interest income that was taxed at only a 10 percent Country B rate will be subject to $11 of residual U.S. tax; while the higher-taxed subpart F income will leave the parent with $11 of excess foreign tax credits.

What this example illustrates is that basing the foreign tax credit limitation on the tax imposed on individual "items" of income would give undue weight in the U.S. tax system to the random ways in which a taxpayer's legal and capital structures interact with a myriad of decisions made by each country in structuring its tax system, producing unpredictably anomalous results that serve no normative goal or policy purpose of the foreign tax credit. If a country relies more on withholding taxes and less on corporate income taxes, its taxes will show up as taxes on the income items of the recipient of a payment, and may vary depending on the nature of the payment (dividend,

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TABLE 2. THE RANDOMNESS OF PER ITEM

Item	Taxable Income	Tentative US Tax	Foreign Tax	Foreign Tax Credit	Residual US Tax, Per Item
Interest from Country A CFC	100	21	21	21	0
Sub F from Country A CFC	100	21	21	21	0
Totals	200	42	42	42	0 Total tax: 42

US Parent 1 — Country A CFC — Sub F income: 100

$100 interest payment – Country A withholding tax applies at 21% rate

Item	Taxable Income	Tentative US Tax	Foreign Tax	Foreign Tax Credit	Residual US Tax, Per Item
Interest from Country B CFC	100	21	10	10	11
Sub F from Country B CFC	100	21	32	21	0
Totals	200	42	42	31 11 Excess FTC	11 Total tax: 53

US Parent 2 — Country B CFC — Sub F income: 100

$100 interest payment - Country B withholding tax applies at 10% rate

interest, *etc.*), as well as on that country's treaty policies and the resulting terms of its tax treaty with the United Sates. Conversely, if a country relies more on corporate taxes, its taxes will show up as taxes on the payor company's income, not as a withholding tax on the recipient of a payment. Unless the country happens to impose both types of taxes at uniform rates (which would be unusual), the resulting differences in tax rates on individual items could product the type of anomalous excess credit/excess limit results illustrated by the example, even when the total foreign tax burden is less than or equal to the applicable U.S. tax rate.

These vagaries of legal, capital, and income tax structures, by unpredictably affecting the amount of foreign tax associated with any particular item of income, could easily result in the per item approach producing different U.S. tax results for identical operations subject to identical levels of total foreign tax, depending simply on the manner in which a foreign country designs its tax system. Many countries rely on withholding taxes because net income taxes are harder to enforce, and they may find it politically challenging to budget government funds for enhanced income tax enforcement functions (imagine that). Developing countries in particular may find withholding taxes appealing for reasons of administrability,[58] and also based on the potential for such taxes to target profits earned by foreign investors. A country's decisions to make particular tax system design choices should not produce radically different U.S. foreign tax credit results when the levels of total foreign taxation are the same. In sum, the randomness of the results flowing from a per item analysis suggest that such an analysis would provide an unreliable measure of the foreign tax burden actually borne by a U.S. company's international operations.

c) Inconsistency of Per Item with Legislative Purposes of Code Sec. 901. The per item approach is in tension with the underlying purposes of the foreign tax credit and limitation, which as noted above included protecting the competitive position of U.S. businesses operating abroad, as well as seeking equitable tax burdens between those with and without foreign source income.

From a competiveness standpoint, it seems reasonably self-evident that unrelieved double taxation would impinge on the competitive position of a U.S.-based multinational, *vis-à-vis* a foreign-based multinational not bearing such double taxation. Advocates of a per item approach tend to define the issue away as not reflecting actual double taxation of any income item, but an example illustrates the aridity of that claim. Table 3 considers the sad case of our US Parent 2 from the example provided in Table 2, which has the misfortune to operate in Country B, with its differential withholding tax and corporate income tax rates. The effective tax rate imposed on US Parent 2's Country B operations amounts to 26.5 percent. But if

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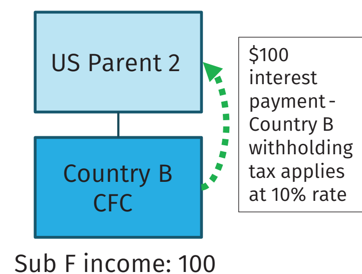
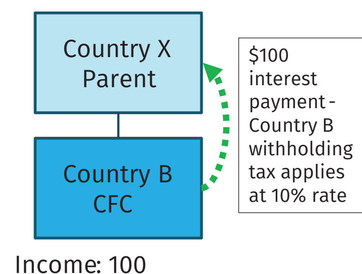
TABLE 3.

Item	Taxable Income	Tentative US Tax	Foreign Tax	Foreign Tax Credit	Residual US Tax, Per Item
Interest from Country B CFC	100	21	10	10	11
Sub F from Country B CFC	100	21	32	21	0
Totals	200	42	42	31 11 Excess FTC	11 Total tax: 53



Item	Taxable Income	Tentative Foreign Tax	Country B Tax	Country X Foreign Tax Credit	Residual Country X Tax
Interest from Country B CFC	100	21	10	-	-
Income from Country B CFC	100	21	32	-	-
Totals	200	42	42	42	0



we assume a non-U.S. competitor that benefits from an overall foreign tax credit limitation (or for that matter an exemption system), the effective tax rate borne by the Country B operations will be 21 percent. The competitive advantage conferred by that tax rate differential is unlikely to be eliminated by providing US Parent 2 with the bland assurance that it is not "actually" suffering double taxation, even though its country B operations pay Country B tax at a rate equivalent to the full U.S. rate, plus an additional residual U.S. tax.

More broadly, by prohibiting all averaging between higher and lower taxed operations in multiple countries, a per item limitation runs contrary to the integrated nature of international businesses in the twenty-first century. Prohibiting all averaging effectively presumes that all averaging is the result of tax planning that artificially and distortively generates low-taxed income to soak up excess credits. But as Congress recognized during its consideration of the 1986 Act, the reality is that cross crediting often arises based on the taxpayer finding it necessary as a business matter to operate both in relatively high-tax countries such as Germany, and in relatively low-tax countries, such as Ireland. To be sure, an additional factor in the picture may be the taxpayer's natural tendency to reduce foreign tax burdens where it is possible to do so, a tendency that was for many decades explicitly encouraged by the United States.[59]

But whether a low foreign tax rate in a particular country arises from deliberate tax planning or mere happenstance, to the extent the low-taxed foreign operations and income are an integral part of the business that also operates in higher-tax countries, Congress in 1986 saw no need to prohibit cross-crediting, and instead focused its concerns on the artificiality of cross-crediting using passive or otherwise moveable income. We acknowledge that in principle the ability to cross-credit between high and low tax operations could at the margin cause a taxpayer to invest in new operations in a low-tax foreign jurisdiction rather than the United States. But we are not aware of substantial evidence—either statistical or anecdotal—to suggest that this has actually been happening. To the contrary, in our experience the tax tail only rarely has enough strength to wag the investment dog, especially when it comes to the complexities of locating manufacturing plants and other facilities to serve foreign markets, and this seems likely to continue as corporate income tax rates across the globe are converging.[60] Accordingly, in our view the double taxation of integrated cross border business items that would arise under a per item limitation as a practical matter (even if not as a theoretical matter), puts the per item approach at cross purposes with the foreign tax credit's legislative goal of protecting the competitive position of U.S.-based multinationals.

Similarly, a per item limitation would be in tension with the Congressional purpose of achieving horizontal equity between taxpayers with and without foreign source income. As noted above, Dr. Thomas S. Adams was Treasury's international tax expert and the principal architect of the foreign tax credit rules enacted in the Revenue Acts of 1918 and 1921. His writings in the years following the enactment of the credit make clear that it was motivated in large measure by the normative view that cross border double taxation would violate horizontal equity because radically different tax burdens would apply depending on the source of taxpayers' income.[61] And ultimately double taxation is not just bad tax policy, but an injustice:

> Equity in taxation is not always clear and plain. I see my own equities through a telescope, but the other fellow's equities through a microscope. This is true of me and you as well as the legislator. But the worst forms of double taxation are clearly and plainly inequitable.[62]

Further, Dr. Adams' writings suggest that this equitable consideration motivated not only his own proposal of the foreign tax credit mechanism,[63] but that it is also what persuaded Congress to surprise him by adopting it immediately, despite the revenue pressures of the war:

> I had no notion, ladies and gentlemen, when I proposed it, that it would ever receive serious consideration. I expected it to be turned down with the reply which I have received so often from legislative committees: "Oh, yes, Doctor, that is pretty good, but the finances won't permit it." But to my surprise, the credit for foreign taxes was accepted and approved, because it touched the equitable chord or sense, and because double taxation under the heavy war rates might not only cause injustice but the actual bankruptcy of the taxpayer.[64]

Dr. Adams thus attributed the enactment of the foreign tax credit to its resonance with Congress' "equitable chord or sense."

Further, Congress appears to have doubled down on this equitable focus when it decided in 1942 to provide credits for certain foreign taxes that did not qualify as income taxes, suggesting that Congress was more concerned about the impact of unrelieved double taxation on the international operations of U.S. taxpayers than it was about the niceties of the technical operation of the

credit.[65] Accordingly, in considering whether a per item limitation would operate in a normatively "correct" manner, we think the principle of horizontal equity that in part motivated the credit's initial enactment argues against an approach that would as a practical matter result in unrelieved double taxation and a higher effective tax rate on foreign operations than on similar operations conducted solely in the United States.

We do not of course go so far as to argue for no limitation at all, which would effectively cede taxing jurisdiction over U.S. income to foreign sovereigns. Instead our point is a narrower one, that in determining whether double taxation has occurred within the intendment of what Congress sought to relieve, or what Congress today should decide to address, a per item limitation would artificially deny the existence of double taxation when a practical viewpoint—such as that evinced by Congress in enacting Code Sec. 903—would tell us that in the examples posited above double taxation of the taxpayer's foreign operations is in fact occurring, a reality that is not contradicted by a clever technical definition of the concept.[66]

In sum, to fulfill the competitive and equitable goals that Congress sought to achieve in enacting the credit, goals that in today's global economy seem even more important than when Dr. Adams persuaded Congress to adopt the credit a century ago, a taxpayer's integrated foreign business operations should be subject to U.S. residual tax only to the extent that foreign tax is paid at a rate less than the applicable U.S. tax rate; because a per item approach would fail to achieve such a result, its inconsistency with the purposes of the statute is yet another reason to conclude that such a system is not the normatively correct implementation of the statute.

E. Moving On: So What About Per Country Instead?

We suspect that some readers may feel that our analysis of per item has spent way too much time beating an imaginary horse. Maybe so, but we felt that it would be useful to take more seriously the common claim that per country is a great system because it is a junior varsity version of per item, which is the normatively correct rule. Having found that per item actually suffers from substantial normative and practical weaknesses, we now turn to consider per country; when deprived of meaningful support from per item, does per country necessarily collapse as well?

Well, um, no. In terms of the basic concern about cross-crediting, there is much to recommend a per country system. But per country will suffer from many of the same administrability concerns that made per item the stop-breathing solution that we mocked above. Further, the current per country proposals cannot sensibly be compared to the previous per country regime that was repealed in 1976, because a number of aspects of the proposed system would be fundamentally different from the prior one. To begin with, the proposed per country regime would be applied with a multiple-basket overlay, whereas historically only a limited-scope interest basket existed. Thus, rather than creating a number of foreign tax credit limitation baskets equal to the number of countries in the world, as the old system did, the new system will multiply that number by (at least) three.[67]

Further, rather than assigning income and taxes to particular countries based on longstanding source principles, the BBBA proposal would instead determine income's country of origin on a taxable presence basis.[68] To that end the proposals would build on taxable unit/tested unit rules in recent regulations that test the limits of human comprehension.[69] And even for the handful of people in the world who do understand those rules, a gargantuan compliance challenge would be presented by the need to allocate and apportion income, expenses, and taxes among hundreds (or thousands) of separate taxable units.

The compliance challenge of allocating and tracking income, expenses, and taxes across many tested units would be further complicated by the numerous statutory provisions that have been added to the operation of U.S. foreign tax credit since 1976, as well as the complexity of U.S. multinational groups as they have increased their geographic footprint and corporate organization charts in the intervening 45 years.

One example of these daunting new complexities would be the need to overlay the new per country system with the overall foreign loss (OFL) and separate limitation loss (SLL) rules, which did not exist in the world of the pre-1976 per country system. A taxpayer would potentially be required to track per country OFL recapture accounts equal to the number of countries in which it operates multiplied by the number of baskets that can go negative, which under the BBBA seems likely to be two.[70] Thus, an MNC operating in 75 countries could have 150 OFL accounts. The math gets even more interesting in the case of separate limitation losses, as a taxpayer would have per country SLL accounts equal to the number of its loss baskets multiplied by the number of its income baskets. As a theoretical matter, a taxpayer could have over 100,000 SLL accounts for a single year of operation.[71] While it is extremely unlikely for any taxpayer to achieve such a result, the number of SLL accounts even in much more likely fact patterns suggests a crushing level of complexity. For example, for a taxpayer operating in 75 countries, with income or losses in an average of say two baskets per

country (or 150 total), that in a given year has losses in 15 of those baskets, it would have 2,025 SLL accounts (135 × 15).

The many differences between the current proposals and the pre-1976 per country regime strongly suggest that the historical operation of the per country system provides virtually no relevant guidance concerning the administrability of the current proposals. But given the layers of complexities sketched above—multiple baskets, taxable units, look-through rules, and OFL/SLL recaptures, etc.—it appears to us that a per country rule as currently proposed would essentially be compliance-proof.[72] Yes, in theory it would do much to address cross-crediting, but even in that regard it seems likely to be simultaneously too narrow and too broad. Too narrow because it would not address cross-crediting opportunities within a single foreign country; in the case of any country that has both high-taxed and low-taxed categories of income, taxpayers will still have the incentive to generate low-taxed income whenever their business operations are otherwise subject to tax at a rate in excess of the U.S. rate. And too broad for the same reasons discussed above in relation to a per item limitation; by prohibiting all averaging between higher and lower tax countries, a per country limitation would ignore the integrated nature of international businesses in the twenty-first century.

As discussed above, prohibiting all averaging effectively presumes that all averaging is the result of taxpayers responding to the incentive to artificially and distortively generate low-taxed income to soak up excess credits; but the reality is that much averaging is simply the function of where taxpayers need to do business in global markets, combined with the natural tendency to reduce foreign tax burdens where it is possible to do so. Indeed, as noted above the latter tendency was for many decades explicitly encouraged by the United States, since obviously reducing foreign tax burdens reduces the amount of foreign tax credits that the United States is obligated to grant, and does so in a manner that is considerably less painful for U.S.-based businesses than doing so by imposing unrelieved double taxation.

F. The Changing Shape of the Playing Field

Historically, of course, the United States has granted its taxpayers a foreign tax credit under purely domestic law, subject at times to relatively minor adjustments under bilateral tax treaties, which mostly served to confirm the availability of the credit provided under domestic law. The operation of the credit has thus been almost purely a matter of U.S. law.[73]

All of that may change in the near future, however, as the ongoing Pillar 2 work at the OECD envisions a global minimum tax rate of 15 percent computed on a per country basis, implemented *via* a "top-up" (*i.e.* residual) tax generally imposed at the parent-company level.[74] While the United States already has its own form of global minimum tax in its GILTI rules, the existing GILTI regime uses a very different model than that envisioned by the OECD. Salient differences include the fact that GILTI currently applies on an aggregated basis to all CFCs (not on a per country basis), and provides for a (reduced) foreign tax credit; the OECD mechanics, by contrast, envision a per country top-up tax based on the effective tax rate borne by foreign income, without technically using a foreign tax credit mechanism at all.[75]

Many observers speculate that the U.S. GILTI rules will benefit from some form of transition relief, but greater conformity with the OECD approach seems likely to be necessary at some point. Assuming that the United States is permitted to retain a credit mechanism (which as a formal though not substantive matter differs from the OECD's mechanics), it would presumably be required to operate on a per country basis to conform to the OECD's per country ETR approach, even if a per country system is not otherwise enacted in accordance with the proposals currently pending in Congress.

IV. A Modest Proposal

A. The Task at Hand

There seems little value in attempting to build a perfect foreign tax credit system from scratch, as revolutionary changes seem unlikely to be enacted given the practical realities of the U.S. legislative environment. Instead, we narrow our focus here to the task that Treasury and Congress have set for themselves in the current proposed round of changes to the foreign tax credit limitation. The main policy concern is the cross-crediting issue discussed above—the adverse revenue and incentive effects created when taxpayers can use excess credits from high-taxed foreign income to offset the residual U.S. tax on low-taxed foreign income. Further, while the subject of concern relates to low-taxed income generally, policymakers seem to have focused in particular on the ability of multinationals to generate such income by adroitly structuring the tax ownership of intangible property into low-tax jurisdictions. Thus, neither Treasury nor Congress has shown any enthusiasm for a wholesale redesign of the U.S. foreign tax credit system; instead, as has so often been the case in the past 100 years, an

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incremental solution is being sought to address a specific area of concern.

Further, the room for legislative maneuver seems to have been further cabined, in the last few years, by an emerging international consensus about issues of global profit shifting through the use of intangibles. After a decades-long global evolution toward a territorial approach to international taxation, that evolution has been halted and indeed reversed by a growing global consensus pushing for global minimum taxation of cross-border profits. The United States was perhaps the last country to adopt a territorial taxation policy, when the TCJA enacted a participation exemption for cross-border dividends of the type that other countries had applied for decades. But at the same time that it joined the territorial party, the United States also effectively phoned in a complaint to the police, by enacting a GILTI regime that subjected most global profits of U.S.-owned groups to current U.S. taxation. Now, less than four years later, a new global consensus, developed through extensive work on base erosion and profit shifting (BEPS) issues at the OECD and other multilateral fora, has shifted decisively away from territorial taxation and instead embraces worldwide taxation without deferral (although, much like the U.S. GILTI regime, preserving a territorial component for modest returns from tangible assets).[76]

With the recent emergence of a worldwide taxation approach, both in the United States under the TCJA and now globally under Pillar II, relief from double taxation must necessarily be provided by a foreign tax credit mechanism, as the alternative territorial method for relieving cross-border double taxation is practically defunct. Thus, the relatively narrow question presented at this inflection point in U.S. international taxation is how to best address the issues presented by low-taxed intangibles income in the context of the GILTI rules. The emerging legislative solution, similar to the approach under Pillar II, is to adopt a per country tax system to prevent taxpayers from cross-crediting between high-taxed foreign income and low-taxed income from intangible assets.

All of these developments, then, have permitted us to focus on a relatively narrow, incremental proposal that we believe could simplify and improve what Congress is currently drafting. A per country foreign tax credit limitation, as discussed above, is both over and under inclusive, and is heavily reliant on claims that it is a rough justice surrogate for a per item foreign tax credit limitation—but as we saw above, that notion too is deeply flawed. Moreover, the magnitude of the complexities introduced by a per country system with basket overlays would make it deeply inefficient to implement, both for taxpayers and the government. Fortunately, however, what the per country approach seeks to achieve can be accomplished with far less pain, and far more gain, under the modest proposal sketched below.

B. A Two-Basket System

The policy objectives of a per country system can be achieved by adopting a two-basket system, with one basket for low-tax income and one for all other income. Such a system would have the following salient features:

- A separate foreign tax credit limitation would apply to low-tax foreign income, while the general basket would encompass all other income. Passive income would continue to require special focus, as discussed below.
- Low-tax income for this purpose could be defined at a rate that forecloses all cross-crediting, but for several reasons we think it makes more sense to set the rate at a level that permits limited cross-crediting; in particular, we suggest defining low-taxed income as income subject to a foreign rate of tax that is less than 80 percent of the U.S. tax rate for GILTI (or 12 percent assuming that the current legislation is enacted adopting a 15 percent rate for GILTI).
- The determination of the tax rate would take into account the allocation of expenses, to the extent that remains part of U.S. law following the proposed legislation; alternatively, a surrogate for expense allocation could instead be provided by lowering the rate threshold defining low-tax income.
- However, expense allocation would be used for purposes of determining the actual foreign tax credit limitation to ensure that the limitation protects U.S. taxation of U.S. source income.[77]

We emphasize two threshold points about the proposed two-basket approach. The first is that this approach relies on the essential insight that eliminating cross-crediting does not require a multiplicity of baskets. Instead, as a matter of principle, all cross-crediting can be completely eliminated with a two basket approach, and thus there is no need for a system with over six hundred baskets. If low-tax income is placed into a separate basket that isolates it from high-tax income, with low-tax income being defined by reference to the U.S. taxpayer's effective U.S. tax rate, then excess credits will be separated from excess limitation, just as much so as if a per item limitation were applied. Thus, preventing cross-crediting is simply a matter of applying the ETR test to separate items of income into two categories.

We acknowledge that separating all income into individual items (or groupings of items), and allocating

expenses and foreign taxes to those items, will be administratively burdensome. But such a burden is unavoidable under any approach that seeks to limit cross-crediting between categories of income, regardless of the number of categories involved. Put another way, as long as we seek to limit the creditability of foreign taxes to some subset of net income (*e.g.*, branch income, French income, *etc.*), we will need to isolate the foreign taxes, gross income and relevant deductions to associate them with the chosen income category. For example, when we had two baskets, passive and general, between 2006 and 2017, we were required to identify all income items as either passive or general income, and then allocate expenses and foreign taxes to those two categories. And if the approach now is to be per country, then we must identify and separate all income into separate country baskets, and then allocate expenses and foreign taxes to each country's income. But while the burden of separating income, expenses and taxes into categories is unavoidable, once that separation has been done then two baskets are all that is necessary to limit cross-crediting. And limiting the number of baskets to two will greatly simplify the operation of the system, for example in relation to ODL and SLL rules (as discussed below).

The second threshold point is that this approach is not novel, and instead has been an embedded feature of the foreign tax credit system going back to the enactment of the interest basket in 1962. Given that history, the credit for this proposal rightly belongs to the tax policymakers of earlier generations, doubtless including Stanley Surrey and Elizabeth Owens.[78] Thus, far from being condemned to repeat an unremembered past, we instead propose to build upon the foreign tax credit's well-remembered history, and offer a corollary adage to Santayana's: "Those who learn from history are best able to repeat it."[79]

As discussed above, the interest income basket, and its more sizable offspring the passive basket that replaced it under the 1986 Act, both addressed a similar concern of taxpayers being able to generate low-taxed foreign income by shifting the location of ownership of easily moveable assets, thereby creating additional capacity to absorb excess credits from high-taxed income. This purpose is most clearly captured by the high-tax kick-out, which moves any high-taxed passive income with excess credits into the general basket. Put another way, the passive basket is not about preventing cross-crediting of general income and taxes with passive income writ large, just low-taxed passive income.[80] (High-taxed passive income is presumably earned from foreign sources for business reasons, as subpart F and the passive basket have eliminated any reason shift such income offshore for tax purposes.)

Thus, the two-basket proposal simply adopts a similar approach to address the intangibles problem as was successfully achieved with the passive basket. Indeed, we propose to merge this low-taxed basket into the current passive basket and thereby eliminate another basket. This follows from the point noted above, that only two baskets are needed to limit cross-crediting, and again is not a novel one. The 2004 Act reduced the number of baskets in section 904(d)(1) from 9 to 2, and did so in part by combining the low-taxed income from the DISC and FSC regimes in the passive basket.

C. Specific Design Considerations

1. Definition of Low-Tax Income

a) Tax rate indicating low-tax income. We suggest that low-tax income for purposes of the two basket proposal be defined as income subject to a tax rate that is below 80 percent of the top marginal corporate tax rate for GILTI. The precise percentage chosen determines the degree of cross-crediting permitted by the system between higher-taxed and somewhat-lower-taxed income. As long as the chosen number is some significant percentage of the U.S. tax rate, however, cross crediting will not be allowed in respect of the genuinely low-tax income that should be the primary focus of concern.[81]

Conversely, it is important that the rate is not set to 100 percent of the U.S. rate because, as discussed above, that would prohibit all cross-crediting and effectively result in a per item system. For the reasons discussed above, the goal of this proposal is not to replicate a per item system. Instead, by setting the rate at 80 percent it allows the blending of amounts that are taxed at rates above and slightly below the U.S. rate, presumably from various jurisdictions, and thus the system would address the integrated global business operations that are so prevalent today, while still addressing the low-taxed intangibles problem.

Using a rate materially below the U.S. rate also mitigates the common differences between the U.S. and foreign tax systems, such as timing differences due to accounting methods, etc. While this categorization may not perfectly identify every case in which income belongs in the low-tax basket, its goal is simply to avoid inappropriate cross-crediting in the great majority of cases, as no system will operate perfectly given the various differences that can exist when applied to the tax systems of roughly 200 jurisdictions.

b) Items of Income. The proposed system would build on the per country approach recently proposed by others to test the high or low tax status of income. That is, the rate-tested "unit" or item of income would be the income

earned from each jurisdiction. This approach capitalizes on the relative accessibility of accounting information at the country level, as such information is presumably needed for local tax compliance purposes in all events. Moreover, it recognizes the logic of recent per country proposals which posited that income earned in a single jurisdiction will generally be subject to the same level of taxation. As noted above, this oversimplifies the tax systems of many countries, which often impose different tax rates for different types of income, generally to either incentivize or disincentivize various forms of economic activity. (The United States is no different in this regard, imposing different tax rates for various categories of income such as FDII, GILTI, capital gains, as well as income that is exempt and therefore subject to a zero rate of tax such as interest on state and local bonds.) Nevertheless, the two-basket approach does not require a faux precision to achieve its goals, as we believe the imprecision of measuring tax rates on a country basis will not lead to materially inappropriate cross-crediting. Unlike a per country approach, however, once country-level income amounts are determined to be either high-tax or low-tax, it would not be necessary to further track the income on a per country basis—for example, OFL and SSL recapture accounts would be maintained on a two-basket basis.

The proposal would deviate from recent per country proposals by not attempting to separate out income by taxable unit or tested unit. Instead, the proposal would take a traditional source based approach that would include royalties and interest in the same "category" as other income, and thus allow cross-crediting of the return from an investment in a given country without regard to the characterization of that return, or the underlying tax system of the foreign jurisdiction. This would allow the U.S. foreign tax credit system to treat investments in different taxing jurisdictions in a manner that is consistent, and thus not interfere with the structural decisions of any specific jurisdiction regarding how best to implement its overall tax system. This also would effectively achieve results consistent with the look-thru approach under pre-TCJA law (as interpreted in the regulations). And perhaps most importantly, this approach would be vastly more administrable than a taxable unit system, whose complexity is both daunting and unnecessary (and therefore inefficient).

2. Expense Allocation

The expense allocation issues addressed here relate to the treatment of expenses of a multinational group that are not incurred directly by its foreign subsidiaries but that support the activities of the subsidiaries in some way. The primary expenses at issue are interest, research & experimentation, and stewardship. Such expenses incurred by U.S. members of a multinational group are typically allocated in part to the group's foreign source income. Because these expenses arise for different reasons, their allocation is based on different allocation keys, for example, on the basis of assets in the case of interest expense.[82]

The allocation of group expenses raises two distinct issues of interest here. The first issue is whether and how expense allocation should apply for purposes of determining whether income is high-tax or low-tax. For example, if a CFC earns of $100 of subpart F income that is subject to foreign tax of $10, it would not appear to constitute high-tax income; but if U.S. expenses of say $40 were allocable to that income, then suddenly it would be high-tax. While this issue arises under the current foreign tax credit limitation only in the context of the high-tax kick-out from the passive basket, the two-basket proposal would make such a tax rate test applicable to all foreign income. It would thus seem natural for expense allocation to apply for purposes of running the tax-rate test; but this would not necessarily be a requirement for the test to operate appropriately, depending on the policy considerations surrounding what is intended to be treated as low-tax income.

Our proposed tax rate test based on 80 percent of the U.S. tax rate is not received wisdom—the test could alternatively be pegged higher or lower, within some reasonable range. U.S.-level expenses are rarely permitted as a local deduction to a CFC; for example, France does not permit an interest deduction for a portion of the interest expense incurred by the CFC's parent and other U.S. members of its group even though the U.S. expense allocation rules will allocate a portion of such interest to this income for purposes of computing the foreign tax credit limitation. The effect of not allocating expenses to foreign income is to decrease the foreign ETR on such income. Thus, the system could approximate an 80 percent threshold with expense apportionment by simply using a lower threshold rate without expense allocation, if it were considered beneficial to avoid expense allocation in connection with classifying income as high-tax or low-tax.[83]

However, the second issue that arises in relation to the allocation of group expenses will always require such expenses to be allocated, and thus there would seem to be little real benefit to skipping expense allocation at the rate-test stage. The second purpose for allocating expenses is the same in all foreign tax credit systems; such an allocation is necessary to ensure that foreign tax credits do not offset U.S. taxation of U.S. source income. This fundamental principle was the basis for enacting the foreign tax credit limitation in 1921 and remains unchanged today. The U.S.

income that must be taken into account for this purpose is the income that is subject to U.S. tax, *i.e.* ***net*** U.S. source income. To determine what constitutes net U.S. income (and net foreign source income) requires an allocation of expenses to gross amounts of U.S. and foreign source income. Absent properly allocating such expenses one of the two fundamental principles of the foreign tax credit system will be violated. If too little expense is allocated to foreign source income, the credit for foreign taxes will be permitted to offset U.S. tax on U.S. source income. Conversely, if too much expense is allocated to foreign source income, the original purpose of the foreign tax credit—to eliminate the double taxation of foreign source income—will be violated as too few foreign tax credits will be permitted. This second consideration is a real one given that the current system structurally over-allocates interest expense to foreign source income under a water's edge approach, and thus there is already some degree of double taxation under current law from this misallocation.

Accordingly, while it will be necessary to allocate group expenses to foreign source income for limitation purposes under the proposed two basket system, the detailed aspects of such a requirement are beyond the scope of our analysis here. As with many aspects of the tax law, there may be non-tax policies that influence the outcome, such as in the case of charitable deductions, which are always allocated exclusively against U.S. income. The policy for this approach is largely to provide favorable tax treatment for charitable contributions, which is not a policy limited to allocation of expenses for foreign tax credit purposes. Similar arguments may thus apply to other expenses, such as research & experimentation, which also receive generally favorable tax treatment for U.S. income tax purposes. But while these questions are ripe for further analysis, they are as noted beyond the scope of this article, and thus the present proposal does not include modifications to the general expense allocation rules.

D. Comparison of the Two Basket Proposal to a Per Country Basket Approach

The largest advantage of the two basket proposal as compared with a per country approach is to significantly simplify the operation of the U.S. foreign tax credit system. Before turning to that advantage, however, we acknowledge there is one significant burden that the proposal will not eliminate: the undoubtedly burdensome requirement to identify and separate income into separate items, and then allocate expenses and foreign taxes thereto. But this burden exists under either proposal, and indeed, exists to some degree under virtually any foreign tax credit system as noted above. This burden grows or shrinks depending on the degree of disaggregation the system employs, which is why a theoretically pure per item system (in operation) is not a practically achievable one. And while per country attempts to approximate by relying on the assumption that countries generally tax all income in a similar fashion, that system or any system will invariably need to separate out gross income, and to allocate expenses and foreign taxes.

The two basket proposal accepts this level of administrative burden because it is part of the current legislative proposals. And while there are ways to soften this burden, they generally entail the usual tradeoffs between administrative simplification vs. more precise adherence to an underlying tax policy goal, and thus are not focused on here, in part because those same simplifications (or at least similar ones) could also be adopted in a per country system to achieve roughly similar benefits.[84]

The principal benefit of the two basket proposal is to simplify the operation of the foreign tax credit system once income, deductions and taxes have been subdivided. Although that classification is a significant part of the overall burden of the system, this second component of burden is also significant, especially given the complexity of the foreign tax credit rules already in the Code today. The SLL and OFL rules are one important example. As noted above, a taxpayer could have tens and potentially over a hundred OFL account adjustments in a single year, with a theoretical maximum exceeding 400 (assuming 200+ foreign jurisdictions).[85] In a two basket system there could only be two. In the per country system, SLL account adjustments in a single year could easily be in excess of a thousand for a given multinational company, with a theoretical maximum over 100,000. In a two basket system there could only be one. A further simplification would be achieved in the proposed two basket system by looking to traditional source rules to determine the country in which income was earned, for purposes of testing its high or low tax status, rather than requiring the unnecessary (and potentially imaginary) precision envisioned by the taxable unit approach.

One potential complication arising from a foreign tax credit system that relies on the foreign ETR to categorize income is the timing difference created by the anti-deferral rules of subpart F/GILTI and the subsequent taxation of the related earnings when they are distributed as dividends in later years. Current law already addresses this problem with two modifications. First, Code Sec. 960(b) permits a foreign tax credit for foreign taxes imposed on distributions of PTEP (both withholding taxes on the distributions of PTEP and income taxes imposed on the recipient of such

distributions, for example, where a CFC is held through other CFCs), including by preserving the deemed paid credit mechanism of now repealed Code Sec. 902. The limitation part of the system is managed by Code Sec. 960(c), which allows a taxpayer to preserve any excess limitation arising at the time of the subpart F or GILTI inclusion to permit capacity to credit such PTEP taxes in a future year.

The foreign tax credit regulations provide a solution to this problem as well, again in the context of the high-tax kick-out from the passive basket. PTEP taxes on income that was high-taxed are simply placed in the high-tax basket and thus cannot be cross-credited against low-taxed income, just like the original deemed paid credits on such income. PTEP taxes on low-taxed income are more complicated, but can be addressed by allocating the portion of such taxes to the low-taxed basket up to the point the combined rate on such income is the 12 percent threshold for high-taxed income, with the remaining portion of such taxes placed in the high-taxed basket. This approach will require tracking PTEP by year (which is already required under current law, and has been since 1962), and tracking PTEP by country (which will be required under the current legislative proposals). The approach will also require tracking the foreign ETR associated with PTEP for such year and country, which seems a modest increase in the burden otherwise imposed by a broader per country approach.

* * *

For the reader (if any) who has struggled through to this point in the narrative, we hope that the ideas sketched above will have provided enough food for thought to have made the journey worthwhile. We also hope that our efforts may provide some sustenance as the United States embarks, yet again, on a rewrite of its foreign tax credit limitation rules.

ENDNOTES

[*] This article is based on a panel presentation by Rob Culbertson at the 74th Annual University of Chicago Federal Tax Conference on November 5, 2021.

[1] P.L. 99–514, 100 Stat. 2085 (1986) (the "1986 Act").

[2] *See* H.R. 5376, sec. 138124, H.R. Rep. 117-130 at 2137 (the budget reconciliation bill passed by the House on November 19, 2021, frequently referred to as the Build Back Better Act; the bill does not formally bear that short title due to the constraints of the reconciliation process, but for convenience we use that term here, abbreviated as "BBBA").

[3] On December 11, 2021, the Senate Finance Committee released the "updated text of the Finance Committee's title of the Build Back Better Act." Available at *www.finance.senate.gov/chairmans-news/finance-committee-releases-updated-build-back-better-text*. The language of the Finance Committee's per country proposal closely tracks the language of the House bill, appearing in section 128124 of the Finance Committee document, at p. 809.

[4] Revenue Act of 1918, Section 238, Pub. L. 65-254, 40 Stat. 1057, 1080–81 (1919). A similar credit was provided to individual taxpayers under section 222 of the same Act. 40 Stat. 1057, 1073–74. Note that while the Revenue Act of 1918 was not actually enacted until February of 1919, it is frequently referred to as 1918 legislation, consistent with its short title as well as its gestation period and effective dates. The historical discussion that follows is deeply indebted to the magisterial article by Michael Graetz and Michael O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 Duke L.J. 1021 (1997).

[5] In this article we generally use the terms "source" and "residence" in a commonsense way to refer, respectively, to the country in which income is earned and the country in which the ultimate owner is subject to tax as a resident. We recognize that many technical and policy issues lurk beneath the surface of residence, sourcing, and related expense allocation rules, but those issues are regrettably beyond the scope of this article—we had to draw the line somewhere.

[6] *See, e.g.,* Culbertson, "Sense and Sensibility and Creditability: Redefining an Income Tax 'in the U.S. Sense,'" 173 Tax Notes Federal No. 2 (2021), at notes 19-20 and accompanying text (providing a brief summary of the early history of efforts to address cross-border double taxation, and citations to more learned works). Although some might view it as bad form to cite oneself as authority for one's argument, our defenses are threefold. First, only half of us wrote the cited article. Second, citing the previously-published work allows for more compact and efficient citations. And third, the cited article is completely correct.

[7] The corporate tax rate was one percent from 1909–1915, then doubled to two percent for 1916, tripled to six percent for 1917, and doubled again to 12 percent in 1918. SOI Tax Stats—Historical Table 24 (1909–2010) available at *www.irs.gov/statistics/soi-tax-stats-historical-table-24*. The top marginal corporate tax rate then hovered in the teens until right before World War II when the rates went up to forty percent (including a higher bracket at 53 percent for income between $25,000 and $50,000 for the period from 1942–1945).

[8] The United States arrived very late to the exemption-system party, and when it finally showed up it came in with a whimper and not a bang, enacting a nominal "participation exemption" for foreign dividends only in 2017, while simultaneously making the exemption largely meaningless by providing for immediate U.S. taxation of most foreign subsidiary earnings under a putative tax on global intangible low-taxed income (with its regrettable acronym GILTI). Section IV.A, below, discusses the world's recent evolution from territorial to worldwide models of taxation based on growing concerns about the territorial approach's facilitation of double non-taxation.

[9] Revenue Act of 1921, section 238, Pub. L. 67-98, 42 Stat. 258–59 (1921).

[10] Redline prepared by the authors between Revenue Act of 1918, Section 238, Pub. L. 65-254, 40 Stat. 1057, 1080–81 (1919) and Revenue Act of 1921, section 238, Pub. L. 67-98, 42 Stat. 258–59 (1921). *See also* Culbertson, *supra* note 6, at text accompanying notes 40–47.

[11] Graetz & O'Hear, *supra* note 4, at 1057–1059.

[12] *Id.*

[13] Tax Reform Act of 1986, P.L. 99-514, §1201(a). Our parenthetical "plus" qualifier reflects the fact that there could be multiple iterations of some baskets, including 10-50 and treaty baskets.

[14] Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1986, at 863 (May 1987) (the "1986 Bluebook"). The 1986 Bluebook explains in the "Reasons for Change" section discussing the Act's amendments to 904:

> Also, many forms of passive income are manipulable as to source. The incentive at the margin to place new investments abroad rather than at home, if the taxpayer has excess foreign tax credits that can be used to shelter additional foreign income from U.S. tax, is of particular concern in the case of passive investments, which often can quickly or easily be made in low or no tax foreign countries.

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Id. at 863. Also, fair warning: we plan to throw caution to the winds, and will recklessly and profligately refer to the 1986 Bluebook as "legislative history" throughout this article. We are aware of, and respect, the traditional view that the post-hoc comments of unelected staffers should not be considered real legislative history. On the other hand, since the same unelected staffers write the committee reports that unquestionably are real legislative history, the distinction seems to us a rather pedantic one. Plus we ran out of time to track down citations to the underlying committee reports (which in any event track the Bluebook language remarkably closely, generally speaking).

[15] There is no incentive to shift passive income abroad if it will be subject to tax at a level at or above the U.S. marginal tax rate.

[16] P.L. 108-357, §404.

[17] The "per country" foreign tax credit limitation was enacted in 1932. Revenue Act of 1932, §131(b)(1). As highlighted by the chart above, the per country limitation had a complex history in its coordination with the overall limitation until it ultimately was removed in 1976. For a brief summary of this interaction over the intervening years, *see* West and Varma, The Past and Future of The Foreign Tax Credit, 91 Taxes No. 3, 27, 29 (March 2012).

[18] *See, e.g.,* Code Sec. 954(h) (providing an exception from foreign personal holding company income for certain "active financing income" of a controlled foreign corporation).

[19] Former section 904(f)(2)(B) (1962).

[20] Code Secs. 904(d)(2), 954(c).

[21] Former section 904(d)(1)(C), (d)(2)(C) (1986).

[22] *See* Reg. §1.1502-13(f)(2).

[23] *See* Reg. §1.1502-13(b)(2).

[24] Former section 904(d)(2)(C) (1962). Although limited to interest income, the look-through rules in 1962 applied to an expanded scope of amounts as compared to current law and included interest "received on obligations acquired … as a result of the disposition of stock or obligations of a corporation in which the taxpayer owned at least 10 percent of the voting stock." Former section 904(d)(2)(D) (1962). The original statutory interest basket thus incorporated the predecessor of the modern day foreign tax credit look-through rules:

(f) APPLICATION OF SECTION IN CASE OF CERTAIN INTEREST INCOME.-

(1) IN GENERAL.—The provisions of subsections (a), (c), (d), and (e) of this section shall be applied separately with respect to-

(A) the interest income described in paragraph (2), and

(B) income other than the interest income described in paragraph (2).

(2) INTEREST INCOME TO WHICH APPLICABLE.—For purposes of this subsection, the interest income described in this paragraph is interest other than interest-

(A) derived from any transaction which is directly related to the active conduct of a trade or business in a foreign country or a possession of the United States,

(B) derived in the conduct of a banking, financing, or similar business,

(C) received from a corporation in which the taxpayer owns at least 10 percent of the voting stock, or

(D) received on obligations acquired as a result of the disposition of a trade or business actively conducted by the taxpayer in a foreign country or possession of the United States or as a result of the disposition of stock or obligations of a corporation in which the taxpayer owned at least 10 percent of the voting stock.

[25] 1986 Bluebook, at 866.

[26] *Id.*

[27] Former section 904(d)(3)(A) (2004).

[28] Former section 904(d)(3)(F)(I) (2004).

[29] Reg. §1.904-5(a)(1).

[30] Reg. §1.904-5.

[31] The full discussion in the preamble to the proposed version of this regulation was as follows:

> Before amendments made by the American Jobs Creation Act of 2004 (AJCA), section 904(d)(3) generally provided that dividends, interest, rents, and royalties ("look-through payments") received or accrued by a taxpayer from a CFC in which the taxpayer is a United States shareholder were treated as income in the separate category to which the payment was allocable. Section 904(d)(4) provided similar look-through rules for dividends from noncontrolled section 902 corporations. The AJCA reduced the number of separate categories from nine to two, and revised section 904(d)(3). Under section 904(d)(3)(A) as amended by the AJCA, except as otherwise provided by section 904(d)(3), dividends, interest, rents, and royalties received or accrued by a taxpayer from a CFC in which the taxpayer is a United States shareholder are not treated as passive category income. Exceptions are provided, generally, when the payment is allocable to passive category income. However, the existing regulations under §1.904-5 were largely unchanged after the AJCA amendments and retained the pre-AJCA approach to assigning dividends, interest, rents, and royalties based on the separate category of the income to which the payment was allocable, rather than excluding the income from the passive category to the extent not allocable to the passive category. In practice, because there were generally only two separate categories after the AJCA and because the general category was a residual category, the approach under the existing regulations of assigning payments to a separate category based on the separate category to which they were allocable resulted in payments that were not allocable to passive category income being assigned to the general category.
>
> The Act added two new separate categories to section 904(d)(1) but made no changes to the look-through rules in section 904(d)(3) and (4). In addition, the legislative history does not provide any indication of how the look-through rules were intended to operate with the addition of the new separate categories.
>
> The proposed regulations provide that the look-through rules under section 904(d)(3) provide look-through treatment solely for payments allocable to the passive category. Any other payments described in section 904(d)(3) are assigned to a separate category other than the passive category based on the general rules in §1.904-4. Therefore, proposed §1.904-5 revises the various look-through rules to reflect the application of look-through rules solely with respect to payments allocable to passive category income. Dividends, interest, rents, or royalties paid from a CFC to a United States shareholder thus are not assigned to a separate category (other than the passive category) under the look-through rules, but are assigned to the foreign branch category, a specified separate category described in proposed §1.904-4(m), or the general category under the rules of proposed §1.904-4(d).

[32] Code Sec. 904(d)(1)(A).

[33] Although the regulatory implementation of the look-through rules is not a focus of this article, the above discussion suggests to us that the government could appropriately revisit the decision reflected in the regulations and permit the application of the look-through rules to allocate look-through amounts to the GILTI basket to the extent that they are allocable to tested income of the payor CFC. The statute has a gap in light of the changes made to the foreign tax credit limitation by the TCJA, and thus Treasury and the Service have the authority to fill that gap via regulations.

[34] *See* p. 388 of the Senate Finance Committee explanation of the TCJA legislation, made available by the Senate Budget Committee at *https://www.budget.senate.gov/imo/media/doc/SFC%20Explanation%20of%20the%20Bill.pdf*.

[35] Joint Comm. on Tax'n, General Explanation of Public Law 115-97, JCS-1-18 (2017) (TCJA Bluebook)

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at 395–396. The TCJA Bluebook included the following example of the concerns to be addressed by the branch basket.

> For an example of a restriction created by the provision, assume that a U.S. taxpayer receives foreign-source royalty income that has been subject to little or no foreign tax and that is in the general limitation category. Assume the U.S. taxpayer also has manufacturing sales income in one or more foreign branches that has been subject to foreign tax at a rate higher than the applicable U.S. tax rate. If the U.S. taxpayer has foreign tax credits related to foreign tax paid on its foreign branch manufacturing sales income in excess of the separate foreign branch limitation amount, the taxpayer is not permitted to use those excess foreign tax credits to offset residual U.S. tax on the foreign-source royalty income in the general limitation category. If, by contrast, the royalty income were instead derived by another foreign branch (''Foreign Branch 2'') subject to little foreign tax, the taxpayer would be permitted to take into account foreign tax attributable to, and foreign income derived by, the high-tax foreign branch in the same foreign tax credit limitation computation as foreign tax attributable to, and foreign income derived by, Foreign Branch 2.

Id.

[36] This arguably disfavored treatment of royalties presents an interesting contrast to historical approaches to royalties for foreign tax credit purposes, whether under the look-through rules of Code Secs. 904(d)(3) and (4), or former section 902(d), which permitted taxpayers to claim an indirect foreign tax credit upon the receipt of a royalty (instead of a dividend) from certain wholly owned foreign subsidiaries. Former Code Sec. 902(d) (1954).

[37] We're not saying that we Kant, just that we didn't …

[38] For a thorough summary of the genesis of the foreign tax credit and limitation, *see* Owens, The Foreign Tax Credit 4/1, 198–202, as well as the extensive discussion in Graetz & O'Hear, *supra* note 4. The latter work draws heavily on the published works and personal papers of Dr. Thomas S. Adams, who was Treasury's primary international tax expert, and the principal architect of the foreign tax credit provisions in 1918 and 1921.

[39] Culbertson, *supra* note 6, at text accompanying notes 29–33.

[40] Culbertson, *supra* note 6, at text accompanying notes 19–40. Never fear, we will discuss the fascinating equitable origins of the foreign tax credit in more detail below.

[41] Culbertson, *supra* note 6, at text accompanying notes 41–48.

[42] Culbertson, *supra* note 6, at text accompanying notes 51–53.

[43] *See, e.g.,* PPL Corp. et al, 569 US 329 (2013), *rev'g* 665 F.3d 60 (3d Cir. 2011), *rev'g* 135 TC 304 (2010) (finding that the IRS' "rigid construction" of section 901 was "unwarranted," and "cannot be squared with the black-letter principle that 'tax law deals in economic realities, not legal abstractions.'" (569 US at 340, citation omitted)).

[44] *See* Owens, The Foreign Tax Credit (1961), at 198–199 (citing H.R. Rep. No. 708, 72d Cong., 1st Sess., 11–12, 23–24 (1932)).

[45] U.S. Department of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth (1984), at 143.

[46] The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, General Explanation (1985), at 387. Although styled as a presidential rather than Treasury document, the President's Tax Proposals were of course drafted by the tax policy staff at Treasury; we thus refer to it as a Treasury document notwithstanding its lack of a formal Treasury attribution.

[47] *Id.* at 387–388. The concerns expressed by the Reagan administration in the 1980s were echoed in 2021 by the Biden administration, which for example stated in the Greenbook that existing law " incentivizes U.S. companies with operations in high-tax jurisdictions to invest in lower-tax jurisdictions, to take advantage of the automatic global averaging" under the GILTI and foreign tax credit rules. U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (2021), at 6.

[48] At the time of its repeal, taxpayers were permitted to choose between overall and per country limitations, so naturally per country was used only by taxpayers that found it advantageous. The main benefit of the pre-1976 per country regime was that it permitted foreign losses to be ring-fenced and not reduce a taxpayer's foreign tax credit limitation in profit-making countries, but instead reduce the taxpayer's U.S. income. By contrast, under an overall limitation, a taxpayer's foreign losses will first reduce its foreign income, and thus its foreign tax credit limitation, before reducing any U.S. income. Thus per country's main customers at that time were a limited group of taxpayers that experienced a combination of losses in some countries and taxable income in other countries (a profile particularly common among oil companies). Congress described as an inappropriate "double benefit" taxpayers' ability to utilize per country losses against U.S. source income, and then later claim foreign tax credits when operations in the loss-making country became profitable. *See*, Joint Comm. on Tax'n, General Explanation of the Tax Reform Act of 1976, at 233–236.

[49] 1986 Bluebook, at 862.

[50] *Id.*

[51] *Id.*

[52] The President's Tax Proposals to the Congress, *supra* note 46, at 386–387.

[53] For example, this view was discussed during the foreign tax credit panel at the University of Chicago Law School 74th Annual Federal Tax Conference in November 2021 (at which a preliminary version of this paper was presented in PowerPoint form).

[54] The President's Tax Proposals to the Congress, *supra* note 46, at 386–387.

[55] Reg. §1.954-1(c)(1)(iii) (defining an item of income for purposes of computing net foreign base company income).

[56] Similarly, Reg. §1.904-4(c) uses grouping rules to identify an item of income for purposes of applying the high tax kick-out from the passive income basket.

[57] It should go without saying (but here we go anyway) that countries seeking to encourage or discourage particular economic activities frequently adopt tax rules that result in different foreign tax rates applying to income that the United States taxes at a uniform rate. It also should go without saying the United States itself has a long history of doing the same, for example, the reduced rates of taxation for capital gains and certain dividends, foreign derived intangible income from transactions with foreign customers under section 250, shipping income under section 1352, the former manufacturing deduction under section 199, etc.

[58] *See, e.g.,* Avi-Yonah and Margalioth, "Taxation in Developing Countries: Some Recent Support and Challenges to the Conventional View," 27 Va. Tax Rev. no. 1 (2007), at 9 (noting academic literature recommending greater reliance on withholding taxes).

[59] *See* text accompanying note 26, above. Reducing foreign tax burdens on foreign income obviously reduces the amount of foreign tax credits that the United States is obliged to grant, and does so in a manner that is considerably less problematic for U.S.-based businesses than doing so by imposing unrelieved double taxation.

[60] Admittedly it is much simpler to generate low-taxed foreign income by relocating intangibles than manufacturing plants, and indeed such relocations have been a staple of international tax planning for decades, whether through the use of cost sharing arrangements or otherwise. But that issue could be addressed through more targeted means than changes to the foreign tax credit that effectively result in unrelieved double taxation—including through the alternative foreign tax credit regime sketched in section IV, below.

[61] "If each state utilized its full powers, multiple taxation would be rampant among those who derived any income from sources without the jurisdiction in which they were domiciled, whereas those whose income was derived within the jurisdiction in which they lived would be subject to but one tax." Adams, "Interstate and International Double Taxation," in Lectures on Taxation: Columbia University Symposium (Roswell Magill ed., 1932), at 120. The discussion that follows summarizes Dr. Adams' views on double taxation, based in large measure on his own writings; Graetz & O'Hear, *supra* note 4, and Culbertson, *supra* note 6, provide fuller discussions of this topic.

[62] Adams, "International and Interstate Aspects of Double Taxation," remarks to the National Tax Association, September 10, 1929, reported in 22 Nat'l Tax Ass'n Proc. 193 (1930), at 198.

[63] "In the midst of the war, when the financial burden upon the United States was greater than

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it had ever been, I proposed to the Congress that we should recognize the equities which I have just noted, by including in the federal income tax the so-called credit for foreign taxes paid …" *Id*.

[64] *Id*.

[65] For further detail on the enactment of Code Sec. 903, *see* Culbertson, *supra* note 6, at text accompanying notes 51–53.

[66] As noted by Dr. Adams in the passage we chose as the epigram for this article, double taxation "can be avoided only by a series of practical compromises …. Theory cannot be satisfied." Adams, *supra* note 61, at 119.

[67] Not to mention there being way more countries in the world today than there used to be. For example, while just 51 countries founded the United Nations in 1945, its membership has grown steadily, exceeding 100 members by 1961 and reaching 143 members by the time per country was repealed in 1976. *en.wikipedia.org/wiki/Enlargement_of_the_United_Nations#Summary*. As of 2021 there are now 193 member countries, *id*., and that is before sub-national separate taxing jurisdictions are counted, such as UK Overseas Territories, the U.S. possessions, etc., so with three separate foreign tax credit limitations we would potentially be looking at 600 per country/per limitation baskets or more. NB: By using UN membership as a rough proxy for the number of countries in the world, we do not intend to express any views regarding the sovereignty (or lack thereof) of any disputed territory. We are willing to express the view, however, that a set of per country baskets seems unlikely to be required for the Principality of Sealand, which is an interesting story but would not appear to be a "foreign country" within the meaning of section 901. *See en.wikipedia.org/wiki/Principality_of_Sealand*.

[68] Under the BBBA income and taxes would be attributed to "exactly one taxable unit of the taxpayer," with the term taxable unit defined to include (i) each CFC; (ii) each pass-through entity owned by taxpayer or CFC if resident in a different country; (iii) each branch of the taxpayer or CFC that has a taxable presence in a different country; and (iv) the US taxpayer itself, as the general or residual taxable unit. *See* H.R. 5376, sec. 138124, H.R. Rep. 117-130 at 2138–2139. Although the current legislative language would leave to regulations the treatment of overlapping taxable presences (such as branches), the legislative history indicates that income and taxes will be attributed to the "lowest tier" unit. [House Budget Committee Report on W&M Provisions of BBBA, at 251.] If a Country A CFC has a Country B branch, it is to be hoped that the concept of attributing taxes to the lowest tier means that Country A taxes imposed on the Country B Branch income of the CFC would be treated as Country B taxes; otherwise the Country A taxes would be separated from the Branch B income and remain Country A taxes but with no limitation in Country A, and therefore non-creditable.

[69] *See, e.g.,* Proposed Reg. §1.861-20(d)(2) and (3), 85 FR 72078 (12 November 2020).

[70] This assumes that a taxpayer can never have a loss in the GILTI basket. Given that losses remain offshore under the GILTI rules, and the proposed BBBA legislation turns off most if not all expense allocation to the GILTI basket, an OFL arising from any of the per country GILTI baskets seems unlikely to be an issue.

[71] This computation is based on an assumption that there could in theory be as many as 220 relevant taxing jurisdictions. In such a case, and assuming income from each country in each of the three possible baskets (GILTI, general and passive), and an equal number of baskets with income and loss (thus maximizing the number of SLL accounts), you get to 108,900, or (330 × 330).

[72] But maybe that's okay, because it would also, and for the same reasons, be virtually audit-proof.

[73] *See, e.g.,* M.D. Biddle, SCt, 38-1 USTC ¶9040, 302 US 573, 58 SCt 379 (1938); Goodyear Tire and Rubber Co., SCt, 89-2 USTC ¶9658, 493 US 132, 110 SCt 462 (1989).

[74] *See, e.g.,* Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy (October 8, 2021) (reflecting discussions at the OECD/G20 Inclusive Framework on BEPS) (October Statement); Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two) (December 20, 2022). For top-up tax not collected at the parent-company level, the model rules currently propose that remaining tax amounts be collected via a formulary apportionment mechanism that would allocate taxing rights to jurisdictions in which a multinational group has tangible assets and/or employees.

[75] Other current differences include the lower tax rate under the GILTI rules, and the absence of any carryovers of credits or losses.

[76] *See, e.g.,* October Statement, *supra* note 75.

[77] Expense allocation would need to be modified to account for any other changes in the proposed legislation, for example, interest expense allocation would need be turned off if Code Sec. 163(n) is enacted, or at least coordinated with that provision by allocating interest expense prior to its application and then stacking disallowed interest against foreign source income.

[78] Stanley Surrey served as the Assistant Secretary of the Treasury for tax policy during the Kennedy and Johnson administrations, and he recruited to Treasury his Harvard Law School colleague, Elizabeth Owens. Kay, Herma Hill, "In Memoriam: Elizabeth Owens," 112 Harvard Law Review No. 7 (1999). As the author and co-author of the most comprehensive treatises on foreign tax credit issues ever written (now sadly out of date), Professor Owens seems likely to have played a part in the development of the interest basket enacted in 1962, during her tenure at Treasury working with Surrey.

[79] *Cf.* Santayana, George, *The Life of Reason, Vol. 1: Reason in Common Sense* (Kindle E-book ed.). While Santayana of course gave us the familiar aphorism that "[t]hose who cannot remember the past are condemned to repeat it," he also warned against "a vain, because unpractical, repetition of the past." *Id.* We do not think our looking to foreign tax credit precedent amounts to a vain and unpractical repetition of the past; far less do we accept the applicability of Santayana's related observation that "old age is as forgetful as youth, and more incorrigible …" Forgetful maybe, but not incorrigible ….

[80] The high withholding tax basket presents the mirror image of the passive basket, separating out interest income that is subject to high withholding taxes. The purpose behind this rule is different, however, and stems from a concerns about taxpayers not bearing the costs of such withholding taxes. While it is not clear that this is true, given the various sources of capital besides U.S. banks that were available to foreign borrowers, it is clear that this is one instance where the adage that all press is good press may not have been correct. The high withholding tax basket was enacted to address concerns that U.S. financial institutions had lobbied to prevent a reduction of Mexican withholding taxes on interest paid to U.S. lenders, as reported in a newspaper article which then was cited in the legislative history of the 1986 Act. 1986 Bluebook at 865.

[81] For example, assume that a U.S. taxpayer has $200 of foreign source income. It pays $25 of foreign tax on $100 of such income, and $15 of foreign tax on the other $100. Because the tax rate on the latter income exceeds 80 percent of the U.S. GILTI rate, it is not classified as low-tax income, and both amounts can be averaged (or cross-credited) in the general basket. On the other hand, if the second $100 of income were subject to foreign tax of only $10, it would be low-tax income, and separating it into the low-tax basket would prevent the excess credits on the other foreign income from offsetting the residual U.S. tax owed on that amount.

[82] *See* Reg. §1.861-9.

[83] For example, assume that a CFC has 100 of net income that is subject to foreign tax at a rate of 10 percent, for a total foreign tax liability of 10. Assume further that the US parent of the CFC incurs expenses allocable to that income (interest, research & experimentation and stewardship expenses) of 20. If those expenses were included in determining the foreign ETR, the resulting net income would be subject to a tax rate of 12.5%. If expense allocation were not included as part of determining the foreign ETR, then the net income would be subject to a rate of 10%. Thus, one can provide roughly equivalent results with and without expense allocation by approximating some level of expenses in setting the ETR for high-taxed income. However, determining high-tax status without expense allocation will be rough justice, as between different companies (as no two multinational groups will have the same level of allocable expenses), and also as between income from

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different jurisdictions of the same multinational as its income from different jurisdiction may have different levels of allocable expenses. Given that the U.S. tax system already has well developed expenses allocation rules, the recommendation for the proposal is to make full use of this precision and avoid the rough justice of a system without expense allocation.

[84] *See supra* discussion at notes 68–70.

[85] For the reasons noted above, this assumes that a taxpayer can never have a loss in the GILTI basket.

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