

U.S. Foreign Tax Credit for VAT

presented by
Martin B. Tittle

ABA Section of Taxation Midyear Meeting
Hollywood, Florida
January 2007

Copyright © 2007 Martin B. Tittle. All rights reserved.

<http://www.martintittle.com>

Introduction

- Capped FTC for VATs = limited credit against U.S. income tax for the current value-added taxes of other countries
- VAT credit is a particularization of an old idea: capped credit for all foreign taxes. See Joseph Isenbergh, “The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes,” 39 *Tax L. Rev.* 227, 294-295 (1984).
- VAT credit is not an intrinsically “good” idea; rather, it’s a mechanism for adapting worldwide taxation to gain at least some of territoriality’s benefits.

U.S. Foreign Tax Credit for VAT

2

Copyright © 2007 Martin B. Tittle. All rights reserved.
<http://www.martintittle.com>

Modified Worldwide Taxation

- Taxation of active foreign-source income is deferred until repatriation
- Highly mobile foreign-source income is taxed as it's earned, regardless of repatriation
- Double taxation is addressed via foreign tax credit
 - Implements Capital Export Neutrality (CEN) by minimizing consideration of taxes in the decision whether to invest in the U.S. or abroad

Modified Worldwide Taxation

Disadvantages

- Repatriation “penalty” encourages permanent reinvestment of foreign-source income overseas
- Complex foreign tax credit planning

Territorial Taxation (“Exemption”)

- No taxation of offshore active income
 - Can be implemented by offsetting deduction
- Foreign tax credit takes a back seat
 - Not needed for active foreign-source income, which is about 80% of all foreign-source taxable income
 - Still needed if a Subpart-F-type regime taxes offshore passive/mobile income

Territorial Taxation

Disadvantages

- Domestically-incurred expenses that are properly allocated to exempt income cannot be deducted -- ever
 - Example: General and administrative expenses incurred by U.S. parent that benefit foreign subsidiary. These expenses can be deducted currently by the parent under modified worldwide taxation.
- Transparent offshore entities like branches may need to be treated as nontransparent
- Royalties may need to be imputed to branches that earn exempt income
- Source rules and aggressive transfer pricing become even more important than they are in worldwide taxation

3 Features of Capped VAT Credit

1. Layered on top of existing FTC system, so current income tax and FTC rules remain unchanged
 - Avoids learning curve associated with switching to a completely new system
 - No recharacterization of current deductions and intercompany payments
2. Inherently leveraged because VAT is a tax on gross sales, while income tax is a tax on net income

3 Features of Capped VAT Credit

3. WTO-compliant

- Satisfies SCM Art. 1.1(a)(1)(ii) because tax otherwise due is not foregone
 - The WTO Appellate Body in the ETI decision included foreign tax credits in the benchmark for U.S. taxation of foreign income.
- Satisfies SCM Art. 1.1(b) because there is no benefit to the taxpayer
 - The taxpayer has paid the VAT underlying the credit, so there is no benefit unless the foreign-tax-credit method of double-taxation relief is itself a benefit, and the WTO has thus far not stated that conclusion.
- Complies with the export-neutralization principle stated in the ETI Panel decision
 - Goods that are manufactured partially or wholly outside the U.S. and that generate VAT credit can be sold in the U.S.
- Can be unified with the existing U.S. foreign tax credit system via a common underlying theory

Conceptual Unification with Existing FTC System

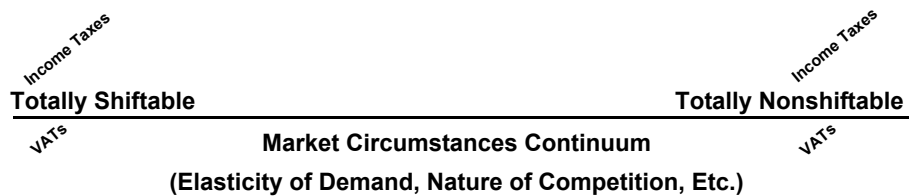
- Current FTC limited to income-type taxes
- Unstated rationale: nonshiftability
 - Direct taxes like income tax traditionally considered to be nonshiftable -- incidence borne by the nominal payor
 - Indirect taxes like VAT traditionally considered to be shiftable -- incidence transferred by nominal payor to others

Conceptual Unification with Existing FTC System

- Theoretical importance of shiftability
 - FTC allows businesses to make domestic-vs.-foreign investment decisions on the economic merits of the underlying investment opportunities
 - If a tax is nonshiftable, it will impact a business's ROI and therefore should be mitigated by FTC
 - If a tax is shiftable, its imposition is irrelevant in the evaluation of competing investment opportunities, and FTC would create a windfall gain

Conceptual Unification with Existing FTC System

- Traditional understandings of shiftability and nonshiftability as fixed characteristics of different taxes have been superseded by the Market Circumstances Continuum



Implementation of VAT Credit

- Technical Standards
 - Only allow “technical taxpayer” to claim VAT credit (*cf.* Treas. Reg. Sec. 1.901-2(f))
 - Require proof tax was not refunded (*cf.* Treas. Reg. Sec. 1.905-3T(c))
 - Require proof of payment directly to foreign government
 - Allowing any taxpayer with a VAT charge on an invoice to claim the credit could undermine validation by CEN

Implementation of VAT Credit

- Political Challenges
 1. Pre-enactment congressional testimony and enactment language need to establish the partial nonshiftability of both income taxes and VATs
 - WTO rejection of ETI as a double-taxation-avoidance measure was in part based on the fact that ETI did not mesh with other U.S. double-taxation-avoidance measures
 - A common theoretical base for both FTC and VAT credit helps avoid this objection

Implementation of VAT Credit

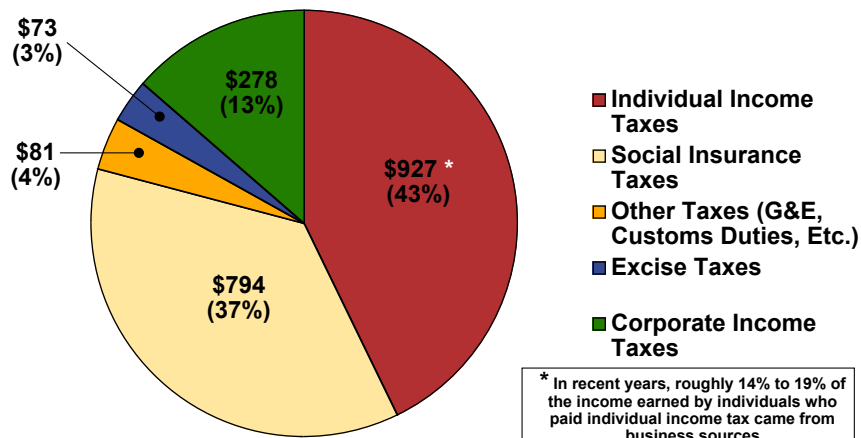
- Political Challenges
 2. If structuring for U.S.-based firms will be permitted, pre-enactment testimony should establish avoidance of VAT liability due (at least in part) to lack of credit, and enactment language should indicate that structuring is intended to be a corrective measure
 - Structuring is permitted to take advantage of benefits intended by Congress. See the WHTC cases.
 - However, structuring to intentionally incur a tax that has been avoided in the past could suggest violation of the WTO prohibition in SCM Art. 1.1(a)(1)(ii) regarding remission of "government revenue . . . otherwise due."
 - Conclusion: enactment language may need to state that structuring by U.S.-based firms will be permitted on a temporary basis and will be subject to evaluation and report by the Treasury Department.

Cost/Revenue Loss of VAT Credit

- If . . .
 - VAT credit had been enacted in 2000
 - Initial cap on credit had been set at \$500 per taxpayer
 - Credit had been claimed only by taxpayers who also claimed foreign tax credit for income taxes
- maximum cost in 2001 would have been \$2.87 million.
- What would the maximum cost be if the cap were set high enough to eliminate U.S. tax on all active, foreign-source taxable income?

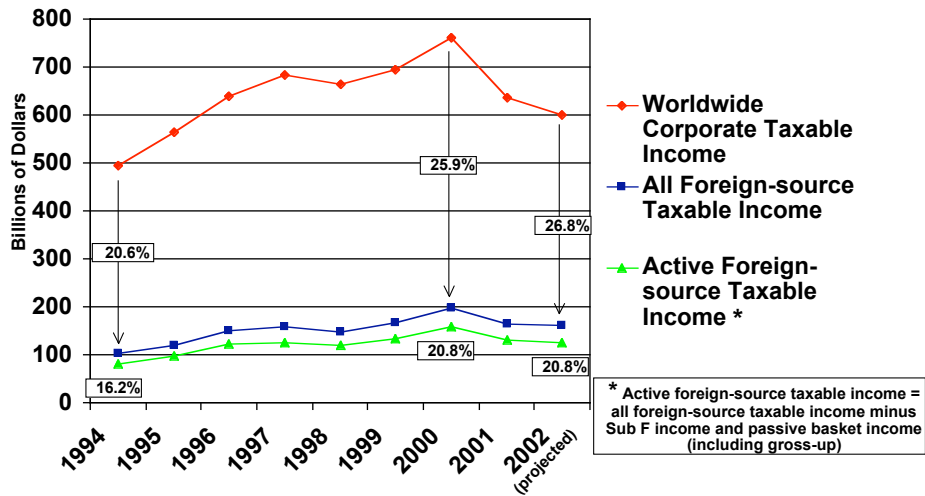
Cost/Revenue Loss of VAT Credit

Distribution of Federal Tax Revenue by Type of Tax, Fiscal Year 2005
 (\$ billions - Total: \$2,153)



Source: GAO-06-1113T, Sept. 20, 2006

Active Foreign-source Taxable Income as a Percentage of Worldwide Corporate Taxable Income



SOI Data Sources: Corp. Complete Reports, Corp. FTC Reports, Corp. FTC Bulletin Articles
U.S. Foreign Tax Credit for VAT

17

Copyright © 2007 Martin B. Tittle. All rights reserved.
<http://www.martintittle.com>

Assumptions for Projection of Maximum Revenue Loss from VAT Credit

- Active foreign-source taxable income is still only 20.8% of worldwide corporate taxable income and 77.7% of total foreign-source taxable income
- All foreign-source taxable income is active except Subpart F income and passive basket income
- All VAT credit would offset only corporate income tax
- After accounting for FTC, a diminution in income creates a perfectly proportional diminution in tax revenue
- No change in TP behavior (not because I think there will be none, but because the quantity of change can't be predicted and therefore can't be modeled)

U.S. Foreign Tax Credit for VAT

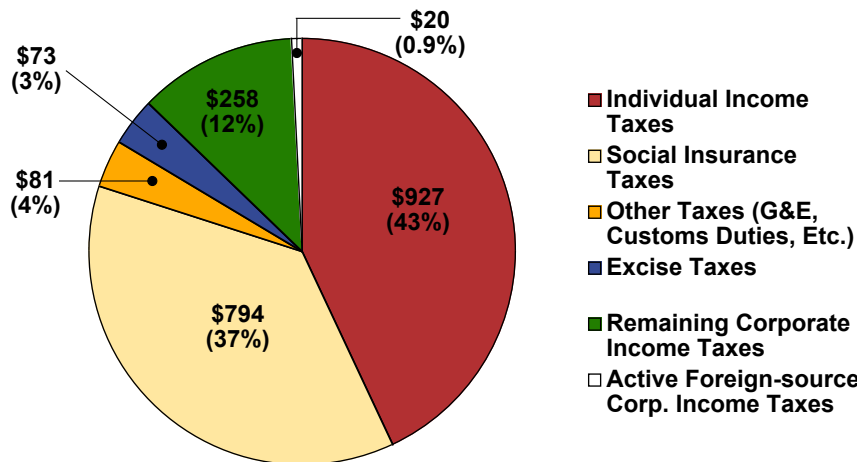
18

Copyright © 2007 Martin B. Tittle. All rights reserved.
<http://www.martintittle.com>

Maximum 2005 Revenue Loss from VAT Credit: \$20 Billion, or 0.9% of Total Federal Tax Revenue

Distribution of Federal Tax Revenue by Type of Tax, Fiscal Year 2005

(\$ billions - Total: \$2,153)



Adapted from GAO-06-1113T, Sept. 20, 2006

U.S. Foreign Tax Credit for VAT

19

Copyright © 2007 Martin B. Tittle. All rights reserved.
<http://www.martintittle.com>

Trade Law Bonus

- By giving credit against a direct tax -- U.S. income tax -- for payment of an indirect tax -- VAT -- VAT credit throws a monkey wrench into the WTO/GATT trade law gears that maintain the distinction between direct and indirect taxes.
- Current WTO/GATT rules state that remission of an indirect tax on exported goods is not an export subsidy, but remission of a direct tax is.
- Both Democrats and Republicans, as well as non-partisan commentators, agree that the traditional distinction between direct and indirect taxes is outdated because today, direct and indirect taxes are just alternate methods for allocating the same economic tax burdens.
- By blurring the line between direct and indirect taxes, VAT credit might be helpful as future U.S. trade negotiators work to dismantle this anachronistic distinction.

U.S. Foreign Tax Credit for VAT

20

Copyright © 2007 Martin B. Tittle. All rights reserved.
<http://www.martintittle.com>

Possible Next Steps . . .

1. Evaluate/compare transition costs

- Cost of some TPs structuring to take advantage of VAT credit
 - Mainly U.S.-based businesses without foreign affiliates

vs.

- Cost of some TPs structuring to avoid the increases in domestic tax base that are predicted to accompany territoriality

Possible Next Steps . . .

2. Evaluate/compare marginal costs of funds for VAT credit & territoriality

- Marginal cost = ratio of static revenue estimate (assumes no change in TP behavior) to actual revenue estimate (incorporates projected changes in TP behavior)*
- If marginal cost = 1, change is maximally efficient because there is no opportunity for avoidance

* Slemrod & Yitzhaki, Int'l. Monetary Fund Working Paper (vol. 43 #1 1995).