



**A Projection of the Maximum
U.S. Revenue Loss From Foreign
Tax Credit for VAT**

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In July 2006 I suggested that the U.S. could achieve some of the benefits of territoriality without giving up its current worldwide tax system if it adopted a capped foreign tax credit for value added taxes.¹ Although I noted that a minimal implementation of VAT credit could cost less than US \$3 million per year in lost revenue,² I left open the issue of the cost to the U.S. fisc if the cap were set high enough to eliminate all tax on active foreign-source income. This article explores factors that would likely be involved in a static estimate of the maximum revenue loss from VAT credit.³

One factor would be a definition, for statistical purposes, of active foreign-source income (AFSI). The IRS's Statistics of Income Division reports foreign-source income data for corporations,⁴ includ-

ing a breakdown for the different foreign tax credit baskets and for subpart F income, but it does not provide a statistical projection for AFSI.

A conservative proxy for AFSI⁵ would be all foreign-source income less subpart F and passive basket income. Column K in the table below presents this proxy for 1994-2002,⁶ and columns D, I, and J contain the SOI data (total foreign-source income, passive basket income, and subpart F income) from which the proxy is calculated. Column L restates column K's active foreign-source numbers as a percentage of total foreign-source income.

Another factor in calculating the maximum cost of VAT credit would be the current tax credit for foreign income taxes. My July 2006 article suggested that VAT credit be layered on top of the current foreign tax credit system, as opposed to being integrated into it. Therefore, any projection of the maximum cost of VAT credit would first have to account for the foreign tax credit that would offset tax on active foreign-source income, even in the absence of VAT credit.

The easiest way to take the current foreign tax credit into account is to use SOI data, not for tax paid, but for tax owed. First, for each sample year, total tax owed before all credits (see column C in the table below) is multiplied by the percentage of worldwide corporate taxable income that is foreign source (column D, all taxable foreign-source income, divided by column C, worldwide corporate taxable income). That calculation reveals the amount of total tax owed before credits that is properly allocable to all foreign-source corporate income (column E).

Next, the foreign tax credit allowed for each year (column F) is subtracted from the tax allocable to

¹Martin B. Tittle, "Achieving a Territorial Result Without Switching to a Territorial System," *Tax Notes Int'l*, July 3, 2006, p. 41.

²*Id.* at 42.

³A static revenue estimate assumes no change in taxpayer behavior, while an actual revenue estimate incorporates behavioral changes that might reasonably be anticipated. See Joel Slemrod and Shlomo Yitzhaki, "The Cost of Taxation and the Marginal Cost of Funds," International Monetary Fund Working Paper (vol. 43, No. 1, 1995). I would guess that taxpayer behavior *would* change if taxation of active offshore income were effectively negated by VAT credit. However, I have no current data with which to model how it might change, and therefore, I leave the formulation of an actual revenue estimate for a later paper.

⁴Although 14 percent to 19 percent of the income earned by individuals who pay individual income tax comes from business sources (see [GAO-06-1113T](#) (Sept. 20, 2006)) and thus may include some AFSI, it seems more likely that VAT credit would be claimed by corporations whose subsidiaries or branches are VAT taxpayers in other countries. Reuven

(Footnote continued in next column.)

Avi-Yonah suggested at the 2007 midyear meeting of the American Bar Association Section of Taxation that VAT credit could be limited to corporations, just as the current indirect foreign tax credit is. See, generally, Internal Revenue Code section 902.

⁵By "conservative proxy," I mean one that would, if anything, overstate the amount of AFSI, and thus produce a high estimate for the potential maximum cost of VAT credit.

⁶2001 is the latest year for which all SOI data needed to project a maximum cost of VAT credit is available. For 2002, one factor had to be estimated.

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foreign-source income (column E) to produce a net income tax on foreign-source income (column G). If no other credits could be taken against foreign-source income, this would be the amount remitted to the government and included in total tax paid.

Finally, the net income tax on all foreign-source income (column G) is multiplied by the percentage of foreign-source income that is active (column L) to yield the tax that would be owed on active foreign-source income alone (column H). This is the maxi-

mum tax revenue that would be eliminated if the cap on VAT credit were set high enough.

For 1994-2002, column H shows the loss would have varied from a low of about US \$8 billion in 1994 to a high of US \$16.5 billion in 2000. If this loss of revenue were presented as a percentage of total corporate tax owed before credits, it would vary from a low of 4.4 percent in 1997 to a high of 6.5 percent in 1999. ◆

Maximum Revenue Loss from Foreign Tax Credit for VAT

A	B	C	D	E	F	G	H	I	J	K	L
Year	Raw Data in 000's	Raw Data in 000's	Raw Data in 000's	Raw Data in 000's	Raw Data in 000's	Raw Data in 000's	Raw Data in 000's	Raw Data in 000's	Raw Data in 000's	Raw Data in 000's	Raw Data in 000's
	Worldwide corporate taxable income from Corporation Complete Report, Table 1, col. (9) "Income Tax"; see http://www.irs.gov/taxstats/bustaxstats/article/0,,id=112834,00.html	Total income tax owed before all credits from Corporation Complete Report, Table 1, col. (10) "Total Income Tax"; http://www.irs.gov/taxstats/bustaxstats/article/0,,id=112834,00.html	Total taxable foreign-source income from SOI Bulletin "U.S. Corporation Returns with a Foreign Tax Credit," Table 1, Col. 37 (1994-98) & Col. 36 (1999-2002); see http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96337,00.html#3	Nominal total income tax owed before all credits that is allocable to all foreign-source income (Col. C* (Col. D/ Col. B))	Foreign tax credit allowed from Corp Report, Table 1, col. (11) "Foreign tax credit"; http://www.irs.gov/taxstats/bustaxstats/article/0,,id=112834,00.html	Net total income tax owed on all foreign-source income (Col. E) less all foreign tax credits (Col. F)	Nominal income tax owed on active foreign-source income (total income tax owed allocable to all foreign-source income after foreign tax credits (Col. G) times % that active foreign-source income is of total foreign-source income (Col. L))	Passive basket taxable income after adjustments from SOI Bulletin "Corp. For'n Tax Credit" articles, Table 2, Col. 25 (1994-98), Col. 24 (1999-2001); see http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96337,00.html#3	Includable income ^b from "U.S. Corporation Returns with a Foreign Tax Credit," Excel files, Col. 6 (data from Form 1120, Sched. C, line 14, col. (a)); see http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96337,00.html#3	Active foreign-source taxable income (total taxable foreign-source income (Col. D) less passive basket taxable income and includable/sub F income (Cols. I & J))	Active foreign-source taxable income (Col. K) as % of total taxable foreign-source income (Col. D)
Formulae ^a for data cells:	hard data	hard data	hard data	=C*(D#/B#)	hard data	=E#-F#	=G#*L#	hard data	hard data	=D#-(I#+J#)	=K#/D#
1994	493,996,239	172,776,719	101,521,278	35,507,382	25,401,339	10,106,043	7,990,318	3,666,059	17,587,673	80,267,546	79.06%
1995	564,733,017	198,786,648	120,517,753	42,422,383	30,420,276	12,002,107	9,580,679	3,047,115	21,267,370	96,203,268	79.82%
1996	639,839,995	223,712,985	150,826,345	52,734,765	40,243,751	12,491,014	10,106,454	3,589,504	25,203,555	122,033,286	80.91%
1997	683,792,847	239,394,206	157,989,290	55,311,665	42,199,558	13,112,107	10,505,560	5,243,251	26,163,328	126,582,711	80.12%
1998	663,385,528	231,399,671	147,116,869	51,316,759	37,396,469	13,920,290	11,310,108	5,398,410	22,187,348	119,531,111	81.25%
1999	693,735,694	241,987,588	165,712,961	57,803,685	38,389,989	19,413,696	15,790,789	6,452,643	24,472,051	134,788,267	81.34%
2000	760,404,334	266,281,801	196,675,289	68,872,635	48,505,841	20,366,794	16,462,743	8,151,307	29,548,804	158,975,178	80.83%
2001	635,257,416	220,874,245	164,753,343	57,283,503	41,063,165	16,220,338	12,901,872	5,977,114	27,729,237	131,046,992	79.54%
2002	600,553,517	209,691,130	160,855,609	56,164,844	42,021,526	14,143,318	10,992,803	5,469,091 ^c	30,362,525	125,023,993	77.72%

^aThe symbol "#" in the formulae is a placeholder for a row number.

^bIncludable income was the income of U.S.-owned foreign corporations that was taxable to their U.S. shareholders under sections 951-964 ("subpart F").^c Corporate Source Book Line Items, Code Value 66.

^cThe 2002 passive basket number was estimated as a percentage of 2002 total taxable foreign-source income.

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