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Should the US Dictate World Tax Policy? Reflections on PPL

Reuven S. Avi-Yonah
University of Michigan Law School, aviyonah@umich.edu

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By Reuven S. Avi-Yonah

The U.S. Supreme Court’s decision to grant certiorari in PPL offers it a unique opportunity to change the law regarding foreign tax credits that has significantly impeded the ability of other countries to engage in meaningful tax reform. In 1938 the Court said in dicta that to qualify for the FTC a tax had to be an income or excess profits tax (or a tax imposed in lieu thereof) under U.S. tax principles. This statement has led to an elaborate set of regulations defining what is an income tax, which has significantly hampered the ability of foreign countries to adopt tax reforms for fear that their taxes would not be creditable. It is time for the Court to declare that any tax whose burden falls on the taxpayer — that is, any direct tax — is a creditable tax, and prevent manipulation of the existing definition at the expense of the treasury.

To qualify for the FTC, a tax must pass through three hoops (and related sub hoops). First, the taxpayer must show that it made a payment to the foreign government, that what it paid was a tax, and that it did not receive a refund or a subsidy in return. Second, the taxpayer must show that it was the party that bore the burden of the tax under foreign law, although that hoop has been interpreted (too restrictively, as I will argue below) as simply asking on whom the foreign tax falls as a matter of foreign law (the technical taxpayer rule). Third, under Biddle and the section 901 regulations, the taxpayer must show that the tax was an income tax, which means that it must satisfy three tests:
- the tax cannot be levied on more than gross income;
- the tax should allow for approximately the same deductions as the U.S. income tax; and
- the tax should generally not be imposed before realization.

The first two hoops are necessary. The taxpayer must show that a tax was paid, because as Judge Richard A. Posner said it is a foreign tax credit, not a foreign fraud credit. It must be a tax. It must not be refunded under the table or be a hidden royalty imposed in return for a specific economic benefit.

The second hoop is needed because the purpose of the FTC is to prevent double taxation, and double economic taxation exists only when the taxpayer defining all of those as “income taxes.” As stated in the amicus brief filed by a group of distinguished public finance economists:

This regulatory misinterpretation of section 901(b)(1) is analogous to the following. Suppose that (a) a statute provides a tax benefit for the raising of “chickens, ducks, and geese,” (b) the regulations refer to “chickens, ducks, and geese” as “chickens,” and (c) the IRS, following these regulations, rules that no tax benefit is allowed for the raising of ducks and geese, because ducks and geese are not chickens. The violence done to the statutory language of section 901(b)(1) by the regulations in section 1.901-2 is only slightly less obvious than that done in this hypothetical example. To prevent this type of travesty, the regulations misinterpreting section 901(b)(1) must be disregarded.


*As recently redefined in National Federation of Independent Business v. Sebelius, 132 S. Ct. 2566 (2012).*
bears the burden of the tax. Thus, taxes borne by the taxpayer are different from taxes like the VAT, which are generally passed on to consumers. While this line is an inexact one because of the difficulty of establishing tax incidence, it is based on the familiar distinction between direct and indirect taxes. The technical taxpayer rule, however, is too narrow a construction of this hoop and invites manipulation, as shown by Compaq and IES. Instead, the line should be whether the tax is border adjustable under the WTO rules, which permit imposing a tax on imports and rebating it on exports only when it is generally passed on to consumers. If a tax is border adjustable like the VAT, it is an indirect tax and not creditable; if not, it is a direct tax and creditable.

Most of the problems of the foreign tax credit stem from the third hoop. As Joseph Isenbergh stated some time ago, the third hoop mostly restricts the ability of foreign governments to fashion tax reforms, without really protecting the U.S. fisc. The most blatant example is the Bolivian tax reform of the 1990s, which has been described by McLure and Zodrow. Bolivia decided to follow the advice of U.S. economists and convert its corporate tax to a cash flow tax by permitting expensing of all capital expenditures. Initially, the Bolivians adopted the R form of the tax, ignoring loans and interest expenditures. That, said the FTC gurus in the U.S. Treasury, violated the net income prong because it did not permit a deduction for interest. The Bolivians then proposed the economically identical R-F form of the cash flow tax, under which loans are included in income and principal and interest are deductible. No, said the gurus, now you violate the gross income prong by including loans in income. In the end, the Bolivians gave up because U.S. investment was too important to them. The really unfortunate part of the story is that when the United Kingdom adopted expensing in its corporate income tax in the 1970s, nobody in the United States suggested that made the U.K. tax not creditable. It seems that creditability depends on the economic clout of the country you are dealing with.

A more recent example from Latin America came when Mexico’s Congress, at the end of 2007, enacted the impuesto empresarial a tasa unica (IETU). In general terms, it is a type of flat tax, comparable to the Italian IRAP, where relevant items of income such as wages, interest, and dividends are neither includable as income nor deductible from its taxable base.

After the IETU came into force, Mexican authorities announced that almost all of its tax treaty partners considered the new tax as a tax covered by the “identical or substantially similar tax rule” (OECD Model Art. 2.4). It is significant that the list does not include the United States.

Early in 2008, the IRS and Treasury released Notice 2008-3, 2008-2 IRB 253, stating that both offices were evaluating the new Mexican single rate business tax to determine whether the tax is eligible for treaty relief. Under the notice, until any further decision is taken, taxpayers’ position on the creditability will not be challenged. Therefore, taxpayers rely on the position that the tax is creditable until the IRS and Treasury decide otherwise. This is not a comfortable position.

Also, the three prongs of the third hoop can be manipulated easily. In the early 1990s, the Russians imposed strict limits on the deductibility of wages because managers of privatized companies were using wages to loot the companies. The U.S. threatened not to make the Russian corporate tax creditable even by treaty, even though treaties can be used to convert noncreditable taxes (like the Italian IRAP, a form of VAT) into creditable ones. The Russians allowed the full deduction for wages under pressure, but after the treaty was in place imposed a 100 percent tax on the wage recipients. The interesting fact is that this episode happened at the same time that the United States enacted its own limit on wage deductibility under section 162(m).

Even the VAT can be made creditable under the existing rules. What makes the VAT not creditable is the lack of a deduction for interest and wages. A VAT that treats borrowing as a form of consumption and therefore allows a deduction for interest and that treats employees as registered VAT taxpayers and therefore allows a deduction for wages and a corresponding inclusion to the employees would arguably be creditable.

Finally, many taxes can become creditable under section 903 if they are cast as a substitute for an income tax. Some Latin American asset taxes are

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8 Compaq Computer Corp. v. Commissioner, 277 F.3d 778 (5th Cir. 2001); IES Industries v. United States, 253 F.3d 350 (8th Cir. 2001). See also the “foreign tax credit generator” line of cases.

9 This means that the foreign country needs to choose between border adjustability and creditability and incorporates a meaningful legal distinction that the United States is bound by into the direct vs. indirect tax constitutional dichotomy.


creditable and others are not, depending primarily on the sophistication of the foreign government and its U.S. advisers.

It is time to do away with these games and with the extensive litigation on which foreign taxes pass the third hoop. The Supreme Court should use PPL to declare that any foreign tax that passes the first two hoops — that is, any tax that is a tax paid by the taxpayer with no refund and no subsidy and that is a direct tax (as defined by the Court’s constitutional jurisprudence and by the WTO treaties) — is creditable. We should not be in the business of dictating to the world what kind of tax reforms they can adopt.