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DOUBLE TAX RELIEF FOR FOREIGN INCOME: A COMPARATIVE STUDY OF ADVANCED ECONOMIES

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I. INTRODUCTION

International trade is not a zero sum game. The theory of comparative advantage asserts that some companies are better positioned to produce or provide certain goods or services more efficiently than others. As a result, comparative advantages cause both parties to international trade, the exporter and the importer, to become economically better off through cross-border buying and selling. Barriers to trade inhibit commercial exchanges that otherwise occur, slowing the accumulation of global wealth. In short, free trade enhances global wealth, while trade barriers depress it.

Foreign direct investment represents another way in which companies conduct international business. Unlike international trade, foreign direct investment involves the cross-border transfer of capital rather than finished goods, components, or services. Similar to international trade, the absence of barriers, such as differential tax rates, allows countries to supply those production factors in which they possess comparative advantages. The free flow of investment capital results in a more efficient allocation of worldwide resources and increases global wealth. [FN1]

This article is a comparative analysis of tax laws providing unilateral relief that reduce or eliminate the double taxation of foreign income. Countries use two general methods to provide such relief: the exemption method (EM) and the foreign tax credit (FTC). [FN2] In its simplest form, the EM requires the home country to forgo taxation of foreign source income. Tax jurisdiction, in effect, extends only to the national border. Countries with territorial tax systems usually depend on the EM as the primary means to relieve double taxation, although its use in global tax systems is common for certain income classes or sources, such as international shipping income. In contrast, the FTC is a legal provision commonly found in the laws of countries taxing residents on a global basis. As further discussed below, the FTC requires the home country to provide a credit against its own tax liability when resident companies pay foreign income tax.

To the extent the EM, FTC, or some combination of the two fails to relieve double taxation, the income tax discourages foreign direct investments. Thus, the economic implications motivate countries adhering to principles of free trade and the free flow of global capital to assure that their EM or FTC regimes minimize double taxation concerns. Also, relief provisions effective in eliminating double taxation enable resident heads of multinational groups to compete globally on more favorable terms compared to multinational companies based in countries that use less effective measures.

The first section of this article explains the reasons multinational companies make foreign direct investments and the resulting benefits that accrue to home countries. Section two provides an overview of the FTC concept and its

salient features. [FN3] Section three explores two standards for evaluating existing and proposed international tax policies: capital export neutrality and global competitiveness. Section four describes the measures that seven advanced economies use to reduce or eliminate double taxation. Section five compares and evaluates the double taxation relief measures of these countries based on widely recognized tax policy standards.

II. BENEFITS OF DIRECT INVESTMENT ABROAD

Foreign direct investment occurs when a domestic company acquires a significant equity ownership interest in a foreign business, whether established as a subsidiary, branch, or joint venture. Though the percentage constituting a significant interest varies among countries, 10% is a common threshold. Examples of foreign direct investments include such transactions as a U.S. company's purchase of 10% of an Italian corporation's stock, capitalization of a New Zealand wholly-owned subsidiary, or establishment of branch operations in France. When the foreign direct investment is outward bound, it is known as direct investment abroad (DIA). [FN4] Thus, the above examples are instances of U.S. DIA. Through comparative advantages in production factors, such investments provide global benefits that accrue to both home and host countries.

Many economists believe that DIA provides positive economic benefits for the home country and, thus, should be encouraged. [FN5] Though investing capital in another country may decrease exports and domestic employment initially, the long-term net effect can be positive. Establishing production activities abroad often results in increased exports of machinery and equipment during the start-up phase and continued exports of raw materials and components as inputs into the foreign production process. Each $1 billion increase in exports creates approximately 19,000 new domestic jobs. [FN6] Higher domestic employment leads to elevated incomes and standards of living. On a global basis, the increased market share and domestic employment may result in higher global tax revenues.

As barriers to international trade result in inefficiencies, restrictions to DIA impede the most efficient allocation of global capital and, thus, may negatively affect employment levels. One potential impediment is double taxation. Paying tax to both the home and host countries on the same income stream, absent some relief mechanism, impedes DIA. [FN7] Without some machinery for reducing or eliminating double taxation, DIA might rarely occur.

Countries use various tax policy instruments to address the double taxation problem. The most common methods among advanced economies are the EM and FTC. The EM is the dominant method among countries with territorial tax systems. Under the EM, the home country relinquishes its right to tax the foreign income of its resident companies. In contrast, home countries relying on the FTC tax both the domestic and foreign income of resident companies but allow such companies to subtract income tax paid to foreign host countries from home country tax liabilities. Mitigating double taxation through either the EM or FTC increases after-tax rates of return otherwise available. Ceteris paribus, the more liberal (restrictive) a country's EM or FTC policy, the higher (lower) the after-tax return its taxpayers derive from DIA. Higher after-tax rates of return encourage companies to engage in DIA. [FN8] In effect, liberal EM or FTC policies encourage DIA, while restrictive policies impede DIA. [FN9]

III. FOREIGN TAX CREDIT OVERVIEW

Many countries with global tax systems allow an FTC to residents conducting business or investing abroad. The FTC permits a company to credit income tax paid to a foreign host country against its tax liability in the home country and, thus, mitigates the effect of double taxation. Countries often allow an FTC for foreign taxes paid directly (e.g., on branch profits), in lieu of direct taxes (e.g., through remittance withholding on dividends), or indirectly (e.g., on a foreign subsidiary's underlying profits). The home country usually limits the FTC to home country taxes paid on host country income and allows companies to carry over foreign income tax exceeding the limit to other taxable years (as discussed later).

Since the FTC reduces double taxation on the same income stream, it encourages cross-border business transactions and, thus, stimulates DIA. Without an FTC or other means to relieve double taxation, many companies would cease conducting business beyond their borders. Paying taxes to two or more jurisdictions on the same income causes international commerce to be prohibitively expensive for most companies. As a result, international commerce occurs much less frequently. In addition to discouraging domestic companies from conducting business abroad, double taxation concerns can dissuade parent companies of large international groups from basing

operations in a country with an unfavorable or ineffectual FTC.

Although the FTC facilitates DIA, policy makers might adopt a different perspective. Instead of assuming a world with no double taxation relief as the starting point of comparison, one might compare existing FTC measures with a perfectly harmonized world in which no double taxation exists. Since the FTC's primary purpose is to eliminate double taxation, one might view the FTC's restrictive aspects as DIA barriers to the extent the credit does not fully accomplish its purpose. A later section discusses tax policy objectives for evaluating the FTC.

A. Direct Credit

The impact of double taxation and FTC relief is clearest when a company conducts business abroad through a flow-through structure and pays foreign income tax directly. Under such arrangements, foreign profits are subject to tax in both the home and host countries. Home countries tax the income based on the taxpayer's residency. Host countries tax the income according to the profit's source. Examples of business structures resulting in a direct tax on foreign profits include branches, some joint ventures, and partnerships.

To illustrate, assume that a multinational company residing in Country A has a sales branch in Country B and that Country A taxes its residents on a worldwide basis. During the current year, the multinational company earns a $100 profit in Country B attributable to its sales branch. The income tax rates in Countries A and B are 50% and 35%, respectively. Thus, Country A taxes the $100 profit based on the multinational company's residency, and Country B taxes the $100 profit based on its source. If both Countries A and B tax the same $100 profit and the home country, Country A, does not permit an FTC, the company's after-tax profit is only $15. The effective tax rate of 85% (i.e., .50 + .35) discourages most Country A firms from conducting business in Country B and, perhaps, in other countries as well. If, however, Country A provides an FTC for the income tax the company pays to Country B, the multinational company is indifferent between earning $100 in Country A and earning $100 in Country B. The aggregate worldwide tax from the foreign branch's $100 profit is $50 (i.e., $35 Country B tax + $50 Country A tax-$35 FTC that Country A allows), which is the same as Country A's tax on $100 of profit earned domestically.

B. In Lieu of Credit

Most tax systems with FTC rules also permit credits for foreign withholding taxes imposed on dividends, interest, royalties, and other remittances. Because they find it administratively difficult to determine the recipient's deductible expenses attributable to the remitted income, host countries base withholding taxes on gross amounts received rather than net income. Home countries, therefore, allow an FTC for withholding taxes as a substitute for income taxes.

Consider a multinational company from Country C that conducts business in Country D through a wholly-owned subsidiary. Assume that the subsidiary remits $100 of its current profit as a royalty to its parent company and Country D withholds $15 of the royalty income. If Country C's tax law permits an FTC, the parent company can claim a credit for the $15 withholding tax.

C. Indirect Credit

In addition to directly paid foreign income tax and foreign withholding tax, most global systems permit companies to credit taxes that parent companies pay indirectly through a foreign subsidiary (i.e., underlying foreign tax). The indirect FTC equalizes the tax treatment of multinational companies conducting business abroad through foreign branches and foreign subsidiaries. Branches are not separate taxable entities, so companies claim a direct FTC for foreign income tax paid on branch profits. Subsidiaries are separate entities, but many countries allow an indirect FTC for the underlying tax of foreign subsidiaries. In effect, the indirect FTC provision treats parent companies and their foreign subsidiaries as a single entity.

Indirect FTC rules attribute foreign income tax of foreign subsidiaries to their domestic parent company. However, the attribution occurs only when foreign subsidiaries repatriate their foreign earnings as actual dividends or, under controlled foreign corporation legislation, constructive dividends. [FN10] Since the rules attribute underlying foreign income tax to the domestic parent, the parent also reports the "grossed-up" dividends it receives in taxable income. The grossed-up dividends equal the actual, or constructive, dividends the domestic parent reports plus underlying taxes related to the dividends. Thus, grossed-up dividends equal the before-tax profit of the foreign

subsidiary related to the dividends.

A simple example illustrates the concept. Assume that a parent company (PC) resides in a country allowing an indirect FTC, PC owns all the stock of a foreign subsidiary (FS), and the country in which FS resides taxes income at 40%. During the taxable year, FS earns before-tax profit of $100 and pays income tax of $40, leaving after-tax profit of $60. If FS repatriates all of its after-tax profit (i.e., $60) to PC as a dividend, the tax law treats PC as though it earns $100 on which it pays $40 foreign income tax. In other words, the tax law in PC's country attributes the $100 foreign profit and $40 income tax of FS to PC. If FS repatriates only $30 of its after-tax profit to PC (i.e., half of $60), the indirect FTC rules attribute only $50 foreign profit (i.e., half of $100) and $20 foreign income tax (i.e., half of $40) to PC.

If the parent company owns most of its subsidiary's voting power or otherwise controls the subsidiary, this indirect credit mechanism allows the parent company to control the timing of the indirect FTC. If the parent pays no dividend, indirect FTC rules attribute no foreign income tax, at least during the current year. Many multinational companies time dividends so they can average high-taxed and low-taxed income, thereby optimizing their FTC results.

D. Credit Limit

Allowing taxpayers to claim an FTC for all foreign income tax directly or indirectly paid, as well as all foreign withholding tax, leads to indifference among multinational companies regarding the magnitude of foreign tax rates. Even when rates are very high, a multinational company can claim the full amount as an FTC and pass along the cost of high rates to the home country's treasury. However, the potential loss of tax revenue from a limitless FTC concerns policy makers and legislators. Most countries permit the FTC to offset domestic income tax paid on foreign, but not domestic, income. Consequently, national tax laws often limit the FTC to the result of a formula that, although expressed in different terms, reduces to the following: foreign taxable income multiplied by the domestic tax rate, where foreign taxable income cannot exceed worldwide taxable income. Absent the FTC limitation, host countries might inflate their income tax rates to unreasonably high levels, knowing that the taxpayer's home country, through the FTC mechanism, reimburses income tax the host country collects. In effect, the limitation formula prevents host countries from siphoning tax revenues from other treasuries into their own and preserves domestic tax revenue from domestic income.

Countries vary in the manner in which they limit the FTC of taxpayers. Some apply the limit to a company's overall income. Others segregate a company's income into baskets and apply a separate limitation formula to each basket. Each basket might contain a different type of income (e.g., passive income in one basket and business income in another) or income from only one country. Basket approaches limit the ability of taxpayers to average ("mix" or "cross credit") high-taxed and low-taxed foreign income, thereby diminishing the FTC benefit.

To illustrate, assume that a multinational company resides in Country E, where the income tax rate is 33%. The company has branch operations in Countries F and G, in which the foreign income tax rates are 50% and 30%, respectively. In addition, the multinational company has portfolio investments in several unrelated companies residing in Country F. During the current year, the company derives $400 business profit from each Country, F and G, and $200 dividends from Country F portfolio investments. Country F withholds a 10% tax on dividends remitted to the multinational company parent. Thus, Country E's tax on the multinational company's income is $330 (i.e., $1,000 x .33) before considering the FTC. The foreign income tax on the same $1,000 is $340 (i.e., ($400 x .50) + ($400 x .30) + ($200 x .10)).

Absent a limitation, Country E allows the entire $340 foreign tax as an FTC. If, however, Country E's tax law provides for an overall limit (i.e., no segregation of income into baskets), the FTC is $330 (i.e., $1,000 foreign income x .33 domestic tax rate). In effect, an overall limit allows the credit to offset all the home country tax on foreign income, yet precludes a credit for any home country tax on home country income (i.e., the limit disallows a credit for $10 of the foreign tax).

By comparison, if Country E's law provides for a per-country limitation, the Country F basket includes $220 foreign income tax (i.e., ($400 x .50) + ($200 x .10)) and is limited to $198 (i.e., $600 foreign income x .33 domestic tax rate). Similarly, the Country G basket includes $120 foreign income tax (i.e., $400 x .30) and is limited

to $132 (i.e., $400 foreign income x .33 domestic tax rate). Accordingly, the FTC allowed using per-country limitations is $318 (i.e., $198 + $120). The per-country approach effectively reduces the FTC allowed vis-a-vis the overall limitation by $12 (i.e., $330 FTC under overall limit-$318 FTC under per-country limit).

Continuing with the same example, assume Country E's tax law provides for separate baskets for active business income and passive income. The business income basket includes $320 foreign income tax (i.e., ($400 x .50) + ($400 x . 30)) and is limited to $264 (i.e., $800 foreign business income x .33 domestic tax rate). The passive income basket includes $20 foreign income tax (i.e., $200 x .10) and is limited to $66 (i.e., $200 foreign income x .33 domestic tax rate). Therefore, the FTC using type-of-income limits is $284 (i.e., $264 + $20). Under this approach, the FTC is less than the FTC using either an overall limit (i.e., $330) or a per-country limit (i.e., $318). Of course, the results vary under different facts, but the overall limit is the least restrictive when both domestic and foreign activities are profitable.

The FTC limitation might preclude a company from crediting all foreign income tax paid during the taxable period, resulting in an "excess credit." Excess credits result from conducting business abroad in high-tax countries or from earning income taxed at relatively high rates. High-taxed foreign income usually incurs no additional or residual domestic tax liability since the foreign tax exceeds the domestic tax otherwise due. In the examples above, the excess credit was $10 with the overall limitation (i.e., $340 foreign income tax-$330 limit), $22 with the per-country limitation (i.e., $340 foreign income tax-$318 limit), and $56 with the baskets based on income type (i.e., $340 foreign income tax-$284 limit). The larger FTC results from using the overall limitation because that approach permits the taxpayer to average high-taxed and low-taxed foreign income in a single basket.

In order to mitigate the artificial constraints of taxable years, tax laws often allow multinational companies to carry over excess credits and treat them as foreign income tax paid in other taxable years. If instead of an excess credit, the FTC limit exceeds the foreign income tax paid, the difference is an "excess limit." Excess limits result from doing business in low-tax countries or from earning relatively low-taxed income. Low-taxed foreign income incurs a "residual tax" in the home country equal to the difference between the domestic tax otherwise due and the foreign tax. If a multinational company conducts business through a foreign subsidiary, it can defer the residual tax until the subsidiary remits its profits as dividends. An excess limit represents a multinational company's capacity to absorb excess credits during any allowable carryover period. In contrast to the FTC, the EM does not require the multinational company to pay a residual tax to the home country and, thus, provides an incentive for conducting business in low-tax countries.

E. Deduction Option

Instead of requiring taxpayers to claim an FTC, many countries permit a deduction for foreign income tax paid. When allowed only in lieu of a credit, most multinational companies for go the deduction and claim the FTC because credits are more valuable than deductions of similar magnitude. To illustrate, suppose a multinational company earns $1,000 profit in a foreign country that imposes a 30% income tax (i.e., foreign income tax is $300). Assume the home country taxes worldwide income at 35% (i.e., income tax is $350 before considering tax benefits from paying the foreign tax). If the company claims the FTC, it pays $50 to its home country (i.e., $350-$300 FTC). However, if the company opts to deduct the foreign income tax, then it pays $245 to the home country (i.e., ($1,000 profit-$300 foreign tax) x .35). In this example, the FTC reduces the overall tax burden $195 more than the deduction (i.e., $245 home tax with deduction-$50 home tax with FTC).

Nonetheless, in some cases, a deduction provides greater benefits. For example, tax laws usually deny the FTC to taxpayers with domestic losses greater than foreign profits. The FTC limit equals foreign taxable income multiplied by the domestic tax rate, where foreign income cannot exceed worldwide income. If a multinational company's worldwide activities produce a loss (i.e., zero income), foreign taxable income equals zero in calculating the FTC limit. If the limit is zero, the tax law disallows the FTC. Deducting the overall loss (i.e., increasing the net operating loss) may therefore be more beneficial than claiming the FTC. This is particularly the case if the net operating loss carryover period is more generous than the FTC's carryover period.

As indicated earlier, many countries force taxpayers to choose between the FTC and a deduction for foreign income taxes. Other countries allow deductions for taxes that the FTC limit disallows. In some cases, deductions

minimize lost present value benefits by carrying forward excess credits, as well as lost benefits from credits that cannot be absorbed before they expire.

IV. TAX POLICY OBJECTIVES

Whether a country's double taxation relief measures encourage or discourage DIA depends on the standard of comparison. Countries normally base their international tax policies on guiding principles, such as capital export neutrality and capital import neutrality. Adherence to these neutrality standards encourages DIA, but departures that sometimes occur because of competing objectives discourage DIA. This section examines two widely recognized policy objectives and uses them in a later section to analyze the EM and FTC of seven advanced economies.

A. Capital Export Neutrality

Capital export neutrality involves establishing policies that, ceteris paribus, cause the tax burden to be the same for domestic and foreign investments. In effect, a country's tax policies that are capital export neutral create neither an incentive nor a disincentive for DIA. When the worldwide tax burden on foreign business profits exceeds the tax burden on a similar magnitude of domestic business profits, the tax system discourages DIA because it does not entirely achieve capital export neutrality. Such a discrepancy exists when companies are unable to claim an FTC for all foreign income tax paid on DIA (i.e., an excess credit results due to the FTC limitation, as explained earlier). In effect, such companies incur an overall tax burden greater than the tax liability they would have incurred on a similar domestic venture. Accordingly, the more likely a country's FTC mechanism is to allow a credit for all foreign income tax paid, the more capital export neutral the FTC as a policy instrument.

To illustrate this concept, assume that a multinational company residing in a country that taxes worldwide income has $1,500 of domestic and $1,000 of foreign income. Assume further that the domestic and foreign tax rates are 30% and 40%, respectively. Thus, the domestic tax before FTC is $750 (i.e., $2,500 x .30), and the foreign income tax is $400 ($1,000 x .40). Given these facts, the capital export neutral policy should result in an overall tax burden of $750 (i.e., the same as though the entire $2,500 had been domestic income). To fully achieve neutrality, the home country should allow an FTC for the full $400 foreign tax. That is, capital export neutrality results when the domestic tax is $350 (i.e., $750-$400 FTC); the overall tax burden is then $750 (i.e., $400 foreign tax plus $350 domestic tax).

Most countries, however, limit their FTC to the domestic tax imposed on foreign income. In the previous example, the FTC limit is $300 (i.e., $1,000 foreign income x .30 domestic rate). The domestic tax is, therefore, $450 (i.e., $750-$300 FTC), and the overall tax burden is $850 (i.e., $400 foreign tax plus $450 domestic tax). The limit precludes capital export neutrality since, in this example, the taxpayer pays $100 more tax than under pure capital export neutrality (i.e., $850 overall tax with FTC limit-$750 overall tax without FTC limit). FTC provisions are not capital export neutral when a company conducts business abroad in a country imposing higher taxes than the home country, as in this example (i.e., .30 domestic rate versus .40 foreign rate).

The FTC's oft-stated purpose is to eliminate double taxation and thereby to achieve capital export neutrality. [FN11] When conducting business in high-tax countries, however, the home country often wishes to protect its domestic revenue base. Limiting the FTC to the domestic tax on foreign income accomplishes this secondary objective, but not without diminishing capital export neutrality. [FN12]

Pursuing both goals through the FTC is a hybrid policy objective known as "defensive neutrality." [FN13] Defensive neutrality imposes on companies a disincentive to invest abroad in high-tax countries. [FN14] However, the FTC limit does not restrict the FTC when conducting business abroad in low-tax countries, so the system achieves capital export neutrality for such investments. Given the typical FTC limit, ceteris paribus, multinational companies are less likely to invest abroad in countries with tax rates that are relatively high compared to their home country tax rates. Therefore, to encourage DIA, the before-tax returns must be higher in high-tax countries than in the home country. Countries with relatively low tax rates find it more difficult to achieve capital export neutrality because of the FTC limit. Taxpayers from such countries incur foreign income tax liabilities that exceed domestic tax liabilities for the same amount of profit.

In contrast to the FTC, the EM makes no pretense of achieving capital export neutrality. Under the EM, the home country abstains from taxing foreign income. Accordingly, the overall effective tax rate on foreign income depends entirely on the host country's tax system. If the host country's tax rate differs from the home country's tax rate, then capital export neutrality does not exist. In effect, the EM creates an incentive (a disincentive) for DIA in low-(high-) tax countries since the overall effective tax rate from such investments is lower (higher) than the effective tax rate from a similar domestic investment.

B. Global Competitiveness

In contrast to capital export neutrality, capital import neutrality exists when the tax burden on DIA is the same as the tax burden of companies residing in other countries and conducting business in the same market. Suppose that a U.S. company conducts business through a wholly-owned subsidiary in Spain. The U.S. tax policy is capital import neutral if the worldwide tax burden on the U.S. company's DIA is the same as the tax burden multinational companies from Italy, Canada, and other countries (including Spain) incur on the same profit derived from a similar DIA in Spain. If capital import neutrality is a policy goal, tax rules should not place firms at a disadvantage to competitor firms from other countries. [FN15] When the tax burden on DIA from the home country exceeds the tax burden on DIA from third countries, the home country tax law fails to achieve capital import neutrality and discourages DIA.

Capital import neutrality involves more than a fairness issue. When present, capital import neutrality promotes the efficient allocation of global resources, which leads to higher worldwide production levels and standards of living. Any policy impeding the free flow of global capital, such as tax rules resulting in burdensome levels of double taxation, causes inefficient allocations of global resources and precludes attainment of optimal production levels and living standards. Further, lower production levels arguably lead to lower global tax collections.

Policy makers sometimes use the term "capital import neutrality" synonymously with global competitiveness. Although recommended changes following the two policy goals coincide in many situations, they differ in others. While capital import neutrality seeks equality and fairness in treatment, global competitiveness seeks changes that allow domestic firms to compete on more favorable terms in global marketplaces. The two concepts are not necessarily the same. Thus, a country with tax laws discouraging international commerce compared to competitor nations might change its rules so that the overall tax burdens on its domestic companies are approximately the same as the overall tax burdens of their global competitors from other countries. Such tax law changes achieve capital import neutrality and increase the global competitiveness of domestic companies conducting business abroad. On the other hand, a country with tax laws that are already capital import neutral might decide to make its tax laws even more favorable for domestic companies involved in international commerce. Such changes increase the global competitiveness of these firms but represent a movement away from capital import neutrality.

Compared with the FTC, the EM more nearly achieves capital import neutrality. The EM is capital import neutral when compared with third countries relying on the EM and the host country. Also, the EM eliminates double taxation without the recordkeeping burden of tracking foreign income, foreign taxes, and the FTC limitation applicable to each basket (i.e., foreign income times domestic tax rates). Less recordkeeping decreases administrative expenses, which leads to increased global competitiveness.

The application of capital import neutrality principles to tax policy issues is sometimes straightforward. In other cases, the application is less clear. For example, the general idea of allowing an FTC is easy to justify on capital import neutrality grounds. Without the FTC (or, alternatively, the EM), companies may face double taxation that disadvantages their operation in foreign markets. However, the application of capital import neutrality principles is much less clear when an FTC is already in place and the issue involves specific aspects of the FTC (e.g., changes to the basket or carryover rules). Inter alia, differences in host country tax rates and differing tax rates in countries where major competitors reside complicate the evaluation of any proposed change to an existing FTC regime. For example, a change to a country's FTC rules may achieve capital import neutrality for domestic companies competing in Country X against Country Y companies. However, the change may fail to achieve, or even improve, capital import neutrality for domestic companies competing in Country X against Country Z companies or in Country Z against companies from either Countries X or Y. For these reasons, this article embraces global competitiveness,

rather than capital import neutrality, as the policy standard in the following analysis. Adopting global competitiveness as the evaluation standard enables policy makers to analyze specific aspects of the FTC mechanism. Furthermore, adoption of the global competitiveness standard facilitates comparisons among countries with EM, FTC, or hybrid regimes for combating double taxation concerns.

V. DOUBLE TAX RELIEF IN SPECIFIC COUNTRIES

Many countries that tax the worldwide income of resident companies rely partially or wholly on the FTC to mitigate the effect of double taxation. However, the exact provisions of each FTC mechanism differ among these countries, making some FTC laws more effective than others in achieving capital export neutrality and encouraging global competitiveness. Similarly, countries with territorial tax systems and, to a lesser degree, some countries with global tax systems rely on the EM for double taxation relief. This section discusses the double taxation relief measures in seven advanced economies. Each discussion is brief, focusing on the salient features of each country's EM or FTC that the article compares and analyzes in the following section.

A. Australia

Since 1990, Australia has embraced a hybrid approach to double taxation relief. The EM applies to foreign investment in listed countries. [FN16] For this purpose, listed countries include approximately sixty foreign jurisdictions, most of which have an income tax treaty in force with Australia. [FN17] The FTC applies to residual DIA. [FN18]

Under the EM regime, branch profits derived from conducting business through permanent establishments in listed countries are exempt if the host country does not offer concessions (i.e., reductions or exemptions) from the normal tax rates. [FN19] Similarly, dividends that Australian companies receive on nonportfolio investments are exempt if a listed foreign country has taxed the underlying profits at full rates (i.e., no concessions). However, when deriving foreign income from unlisted countries and concession foreign income from listed countries, Australia disallows the EM. Australia's EM applies to the bulk of income that resident companies derive from DIA.

If not exempt under the rules above, taxpayers include foreign profit in assessable income, and Australia grants an FTC for direct foreign income tax and foreign withholding taxes. Also, resident Australian companies can claim an indirect FTC for the income tax that a foreign subsidiary pays on its profits unless the subsidiary's dividends are exempt under the rules discussed above. An actual or constructive dividend from the foreign subsidiary triggers the indirect credit. To be eligible for the indirect FTC, Australian parent companies must own at least 10% of their foreign subsidiaries' voting rights. Foreign income tax paid by lower-tier subsidiaries also qualifies for the indirect FTC if the ownership chain meets two requirements. First, the next highest company in the ownership chain must own at least 10% of the lower-tier subsidiary. Second, the parent company must indirectly own at least 5% of the lowertier subsidiary. Under Australian law, no limit exists to the number of foreign subsidiaries in the chain. For example, a tenth-tier foreign subsidiary that satisfies the ownership requirements and pays a dividend to the ninth-tier foreign subsidiary can qualify the chain's Australian parent company for an indirect FTC (assuming each tier continues paying dividends up the chain to the parent). However, Australian law makes no provision for resident companies to deduct excess credits or foreign income tax in lieu of the FTC.

Domestic law limits the FTC to Australian taxes payable on foreign source income. Separate baskets apply to passive income, offshore banking income, and residual income. Taxpayers can carry forward, but not back, any amount exceeding the limits in the respective baskets for the next five years.

B. Canada

Canada, like Australia, relies partially on the EM to relieve double taxation. Under the Canadian version, "exempt surplus" dividends received from foreign affiliates are exempt, while "taxable surplus" dividends are not. Exempt surplus dividends are distributions of underlying business profits a Canadian company receives from a foreign affiliate residing and conducting an active business in a listed country. The Canadian recipient includes exempt

surplus dividends in taxable income and then claims an offsetting deduction, which is equivalent to an exemption. The foreign affiliate pays other dividends from taxable surplus. Thus, taxable surplus includes after-tax profits that foreign affiliates derive as passive income from any country or business income from unlisted countries. Unlisted countries are generally those with which Canada has no income tax treaty, although the list also contains a few nontreaty countries.

Canadian law grants taxpayers an FTC for foreign income tax directly paid and foreign withholding tax. The FTC for these levies cannot exceed the portion of the Canadian income tax attributable to the related foreign taxable income. Taxpayers calculate this limitation separately for each country. Within each country, separate limitations also apply to business and nonbusiness income. Consequently, two baskets might exist for a given country. Taxpayers can carry excess credits on business income back three years and forward seven years. Although taxpayers cannot carry over excess credits attributable to nonbusiness income, they can deduct these amounts.

Unless exempt under the rules discussed above, Canadian parent companies must include in taxable income actual dividends from noncontrolled foreign affiliates and constructive dividends (i.e., "imputed income") from controlled foreign affiliates whenever such income is attributable to taxable surplus. Similar to an indirect FTC, however, Canada allows resident corporations to deduct grossed-up foreign income tax that its foreign affiliates pay from the taxable surplus (i.e., underlying income from unlisted countries and nonbusiness income from all countries). Foreign affiliates include foreign corporations in which the Canadian parent directly or indirectly owns 10% of the stock. Canadian law imposes no further constraints on what constitutes a foreign affiliate, thus allowing multinational companies to pass the grossed-up tax deduction through an unlimited number of tiers.

The benefit formula for the indirect foreign income tax is:

$$\text{Deduction} = \frac{\text{Dividends or Imputed Income} \times \text{Foreign Tax Rate}}{\text{Canadian Tax Rate}}$$

The deduction exactly offsets the amount included in the parent company's income, either as dividends received or imputed income, when the foreign and Canadian tax rates are the same. When the foreign tax rate exceeds the Canadian tax rate, the statute limits the deduction for underlying business income to included dividend income. Similar to the carryover of excess credits, taxpayers can carry any excess deduction attributable to underlying business income forward five years. They can likewise deduct indirect foreign taxes exceeding either related dividends or imputed income if the dividends are attributable to underlying nonbusiness income.

C. France

Unlike the other countries this article examines, France has a territorial tax system. Due to the fact that France generally taxes resident companies only on their domestic source income, foreign branch profits and 97.5% of dividends from 10%-owned foreign subsidiaries are exempt. France usually grants a credit for foreign withholding taxes on interest and royalties if this income has its source in a treaty country. Since the FTC primarily applies to lowtaxed passive income, excess credits usually do not result. Taxpayers deduct interest and royalty taxes that nontreaty countries withhold.

Notwithstanding the general treatment described above, with consent from the Ministry of Economy and Finance, resident companies can include branch operations in the computation of French taxable income as well as dividends from foreign subsidiaries in which they directly or indirectly hold at least 50% of the voting power. Under this election, multinational companies claim a "set off," which is equivalent to an FTC, for underlying foreign income tax on 50% holdings and direct foreign income tax paid on branch profits. The election benefits taxpayers during years when a branch has operating losses, by allowing such foreign losses to offset domestic income. Thus, this elective provision removes the disincentive that might otherwise exist in conducting business abroad when taxpayers expect early-year losses.

As an exception to the EM explained above, France taxes foreign income derived from certain "privileged fiscal" (i.e., low-tax) jurisdictions and, in return, allows the taxpayer to claim an FTC. The facts and circumstances for each taxpayer determine whether a foreign jurisdiction is privileged. However, a foreign tax burden of less than two-thirds of the French tax burden on an equivalent amount of domestic income generally establishes a presumption of privilege. Foreign branch profits and dividends from 10%-owned foreign affiliates are potentially taxable under this anti-abuse provision. Nonetheless, if the taxpayer can demonstrate that the foreign site has a bona fide business purpose and principally trades in the local market, France's EM continues to shield such foreign income from double taxation.

D. Germany

Recent tax reform has changed Germany's approach to double taxation relief. Before reform, Germany relied primarily on the FTC. Beginning January 1, 2002, both the EM and FTC provide relief.

The EM applies to the receipt of foreign dividends. Like dividends from domestic sources, 95% of foreign dividends German corporations receive are exempt, regardless of percentage ownership or holding period. Five percent of dividends received are taxable, which approximates costs the payor previously deducted.

The EM for foreign dividends eliminates the need for an indirect FTC and in lieu of credit for dividend withholding tax. The EM provides more liberal benefits than many indirect FTC regimes. No limitation applies to the tax benefit (i.e., no excess credits result), and the lack of percentage ownership requirements means that even dividends from portfolio foreign holdings (i.e., equity positions less than 10%) qualify for double tax relief.

German companies can claim an FTC for foreign income tax on branch profits and foreign withholding tax on interest and royalties received. The FTC limit, for domestic tax on foreign source income, applies separately for each host country. German law makes no provision for taxpayers to obtain the FTC for foreign tax paid on income earned in a different assessment period. For example, German companies cannot claim tax paid on 2001 foreign income against its 2002 German income tax. In effect, this procedure prohibits taxpayers from carrying over and absorbing excess credits in other assessment periods. However, if they so elect, taxpayers can deduct foreign income taxes instead of claiming the FTC.

E. Japan

Japan allows an FTC against its corporate income tax and, within certain limits, local inhabitants taxes for foreign income tax paid and withholding taxes. However, Japanese law disallows an FTC for any foreign tax paid at an effective rate greater than 50% and any interest withholding tax at a rate greater than 10%, but only for the excess in each case. Instead of claiming the FTC, taxpayers can elect to deduct foreign income tax, as well as any FTC disallowed under the 50% and 10% limits described above.

Parent companies can claim an indirect FTC when they own 25% of either the outstanding shares or voting stock of their foreign subsidiaries. As with the indirect FTC in other countries, the payment of dividends triggers the credit, and Japanese law attributes the underlying income tax to the parent company in the proportion that dividends bear to undistributed earnings. Dividends that second-tier foreign subsidiaries pay also can be used by parent companies to claim the indirect FTC. However, Japanese law does not allow the indirect credit for underlying foreign income tax that third-or lower-tier subsidiaries pay.

Japanese law limits the FTC to the proportion of national corporate income tax that foreign source income bears to total income, which is equivalent to the Japanese tax on foreign source income. Japan does not require that taxpayers determine foreign income tax paid and the limitation formula separately for different types of income or for operations in different countries. Thus, the FTC regime places foreign income and related taxes in an overall basket. Taxpayers can carry forward for three years any foreign income tax disallowed because of the FTC limitation. Also, a taxpayer with an excess limit can carry it forward. Carrying forward an excess limit is equivalent to allowing the taxpayer to carry excess credits back. Thus, one might view the actual carryover period for excess credits as three years back and three years forward.

F. United Kingdom

The United Kingdom allows an FTC for foreign income tax paid directly, as well as foreign withholding taxes. Instead of the FTC, taxpayers can deduct foreign income taxes. U.K. law allows an indirect FTC for the underlying income tax paid by foreign subsidiaries. To qualify, the U.K. parent company must directly or indirectly own at least 10% of the subsidiary's voting power. Underlying tax paid by lower-tier foreign subsidiaries also qualifies for the indirect FTC if the affiliated group meets the ownership requirements for each link in the chain and remits profits up the chain in the form of dividends.

U.K. law limits the FTC to the portion of the U.K. income tax liability attributable to foreign source income. It also requires separate baskets for income derived from different countries. Taxpayers can carry excess credits for foreign tax paid greater than the FTC limitation back three years and forward indefinitely.

Historically, U.K. multinational companies established "mixer companies" to minimize excess credits lost as a result of the percountry basket rules. A mixer company is an offshore intermediate holding company (e.g., in the Netherlands) that the U.K. parent established to own the stock of its foreign affiliates and to receive their dividends. Since the U.K. parent received dividends from its mixer company, a single source, this strategy effectively averaged profits from high-tax countries and low-tax countries to minimize lost excess credits. In other words, a single basket for the country where the mixer country resided replaced multiple baskets based on each country where a subsidiary resided.

Effective for distributions after March 30, 2001, new "mixer cap" and "on-shore pooling" rules apply. The mixer cap limits the underlying tax allowed as an FTC on dividends received to an amount based on the U.K. corporate rate, which is currently 30%. For example, if the underlying effective foreign tax rate is 35%, the mixer cap limits the FTC to the product of foreign income and 30%. The U.K. parent company can pool the disallowed excess, known as "eligible unrelieved foreign tax," and claim an FTC for the excess against the U.K. tax on "qualifying foreign dividends," which are dividends from foreign affiliates subject to low foreign tax rates. Notwithstanding the general provision for on-shore pooling, multinational companies cannot claim an FTC to the degree the foreign tax rate on underlying income exceeds 45%.

G. United States

United States tax law permits companies to claim the FTC for foreign income tax paid, foreign withholding tax, and tax deemed paid. Claiming the FTC is an annual election. If not elected, taxpayers can deduct foreign income tax. However, unlike some countries, taxpayers cannot credit some foreign tax and deduct others, such as those exceeding the FTC limitation, within the same taxable year.

The indirect FTC is available for foreign income tax that tierone through tier-six foreign subsidiaries pay. The U.S. parent company must own at least 10% of the first-tier foreign subsidiary's voting power to claim an indirect FTC for its subsidiary's foreign income tax. A dividend from the subsidiary to the parent company triggers the indirect FTC. For the parent to claim the indirect FTC for foreign income tax paid by its second-tier foreign subsidiary, the first-tier subsidiary must own at least 10% of the second-tier subsidiary's voting power, and the parent company must indirectly own at least 5% of the second-tier entity's voting power. A dividend from the second-tier subsidiary to the first-tier entity and a dividend from the first-tier entity to the domestic parent allow the parent to claim the indirect FTC for foreign income tax paid by the second-tier entity. The rules are similar for claiming the indirect FTC for third-through sixth-tier foreign subsidiaries.

The FTC cannot exceed the U.S. tax liability on foreign source income. A separate basket applies to each type of income but not to income from different countries. U.S. law establishes baskets for passive income, high withholding tax interest, dividends from noncontrolled foreign subsidiaries (i.e., 10% to 50% ownership), financial service income, shipping income, and oil and gas income. In addition, separate baskets apply to three types of export-related profits. A general basket applies to business profits and any income not falling into the other baskets (e.g., royalties). Taxpayers can carry excess credits back two and forward five years.

VI. COMPARATIVE ANALYSIS

Regardless of a country's primary policy objective--capital export neutrality or global competitiveness--a comparative analysis of double taxation relief provisions is worthwhile because double taxation can negatively affect DIA. If a country's EM or FTC is too restrictive or otherwise less effective compared to those of other countries, legislative adjustments may encourage DIA. This study examines the double taxation relief mechanisms in seven advanced economies: Australia, Canada, France, Germany, Japan, the United Kingdom, and the United States. This comparative analysis treats Canada and Japan as high-tax countries, and Australia and the United Kingdom as low-tax countries.

Changes to existing FTC regimes can facilitate capital export neutrality by taxing the foreign and domestic income of taxpayers similarly. Such changes simultaneously promote both global competitiveness by making excess credits easier to absorb and increasing after-tax rates of return. As discussed earlier, when a company pays foreign income taxes that it cannot credit, the tax system does not fully achieve capital export neutrality. In addition, double taxation reduces after-tax rates of returns, which may hamper a company's ability to compete globally against multinational companies from other countries. Similarly, EM provisions in some countries may tax foreign profits at higher effective rates than domestic profits and, in so doing, discourage DIA by not achieving capital export neutrality.

This section compares and evaluates the seven countries discussed above, based on the standards of capital export neutrality and global competitiveness. These standards facilitate comparisons among tax systems that rely on the EM, FTC, or a combination of the two for double taxation relief. After an analysis of the EM, this section examines five aspects of the FTC mechanism: basket structures of the FTC limit, options for deducting foreign income taxes, allowable tiers for the indirect FTC, carryover rules related to excess credits, and de minimis provisions. Other dimensions of the FTC also might merit attention, but these five aspects significantly affect the tax liabilities of multinational companies in general.

A. Exemption Method

Of the seven advanced economies, only France's tax system is territorial. Under territorial tax principles, France relies heavily on the EM to provide double taxation relief. French companies use the FTC only when they elect either to apply global tax principles to their activities or to prevent taxpayer abuse from locating foreign activities in "privileged fiscal" countries. Although the other six countries have global tax systems, Australia and Canada rely heavily on the EM when DIA occurs in listed countries, and Germany applies the EM to foreign source dividends.

The EM achieves capital import neutrality when compared with host country taxpayers and resident companies of third countries relying on the EM. Also, the EM is capital import neutral when compared with third-country residents investing in host countries with relatively high tax rates and relying on the FTC for double taxation relief. When compared with third-country residents investing in low-tax host countries and relying on the FTC, the EM yields a lower overall tax burden (because no residual tax is due to the home country) and, thus, provides a nonneutral, but globally competitive, incentive for DIA.

For these reasons, Australian, Canadian, French, and German multinational companies with DIA in low-tax countries are globally more competitive than their counterparts from advanced economies relying on the FTC. The lower the tax rate in the host country, the greater the competitive advantage. In contrast to Australian, Canadian, French, and German companies that are eligible for the EM, multinational companies relying on the FTC for double taxation relief in low-tax countries must pay a residual tax to their home countries. The residual tax reduces the after-tax rate of return of these companies compared to companies using the EM and, thereby, lessens global competitiveness. Of course, the longer multinational companies can defer the residual tax, the smaller the present value of the residual tax and the smaller the gap in global competitiveness between countries relying on the EM or FTC. Japan, the United Kingdom, and the United States do not broadly rely on the EM. As a result, multinational companies from these countries are at a disadvantage in host countries with relatively low tax rates when competing against companies relying on the EM.

In contrast to the global competitiveness standard, the EM usually does not achieve capital export neutrality. When DIA occurs in low-tax host countries, multinational companies applying the EM experience a lower-tax burden on DIA versus domestic investment. Although this lower-tax burden may increase global competitiveness, it is not

capital export neutral. When the DIA occurs in hightax host countries, the opposite result occurs--the EM discourages DIA compared to domestic investments. Thus, one downside of the EM is its failure to encourage DIA in high-tax countries when similar opportunities exist in the domestic market. In effect, DIA in high-tax countries should occur only when companies expect the risk-adjusted, before-tax rates of return to be higher on foreign rather than domestic business opportunities. This failure to achieve capital export neutrality potentially affects DIA from countries with relatively low entity tax rates, such as Australia and the United Kingdom.

B. Basket Structure

The FTC limit prevents a company from reducing domestic income tax on domestic profit, which protects a country's tax revenues on domestic income. Without the limit, a company could conduct business abroad in a high-tax country and claim the entire foreign income tax paid as an FTC. As a result, the FTC eliminates all domestic tax on foreign source income, although the remaining FTC reduces domestic tax on some domestic income.

As discussed earlier, the FTC limit represents a departure from strict capital export neutrality principles. Only tax systems allowing the FTC for all foreign income tax are fully capital export neutral. Thus, the more restrictive the FTC limit, the further the departure from capital export neutrality. Similarly, restrictive FTC limits that decrease the likelihood that multinational companies can minimize excess credits by averaging high-taxed and low-taxed foreign profits lessen global competitiveness. FTC mechanisms in countries with relatively low company tax rates, where domestic companies conduct business abroad in relatively high-tax countries, are less likely to be capital export neutral, ceteris paribus.

Constraints related to the FTC limit primarily take the form of baskets. Baskets separate low-taxed and high-taxed income so that companies cannot average ("mix" or "cross credit") the two together to obtain a more favorable outcome. In this manner, baskets often increase companies' overall tax burdens and reduce both capital export neutrality and global competitiveness.

The basket approach to segregating foreign income and taxes varies considerably among the six advanced economies with global tax systems. Australia and the United States use separate baskets for different types of income. Australia's special baskets for passive and offshore banking income quarantine low-taxed from high-taxed foreign income without undue restriction or complexity and, given Australia's primary reliance on the EM, do not severely hamper double taxation relief. The multiple baskets under United States law effectively segregate low-taxed and high-taxed foreign income but result in frequent excess credits and complexity and, thus, impede global competitiveness. The recordkeeping required to track foreign income and taxes in the various baskets exacts a high compliance cost. Statutory changes could combine baskets intended to capture low-taxed income, such as that related to passive income or export profits, with relatively little overall revenue loss but significant compliance savings.

Japanese tax law does not place foreign income and taxes in separate baskets. At first glance, Japan's no-basket approach provides the most opportunities for domestic companies to average low-taxed and high-taxed foreign income, which comes closest to meeting the dual standards of capital export neutrality and global competitiveness. The ability of Japanese companies to absorb excess credits against Japan's local inhabitants tax also lessens the chance of excess credits.

Japan's lack of baskets, however, can impair attainment of these standards in some cases. To illustrate, assume that a multinational company based in Country A earns $1,000 profit from Country B and incurs a $1,000 loss in Country C. Without baskets, the net foreign income is zero (i.e., $1,000 profit-$1,000 loss). As a result, the FTC limit is zero, and the multinational company can claim no FTC. With per-country baskets, the multinational company can claim an FTC for the income tax paid in Country A, since the baskets segregate the foreign loss from the foreign profit. The basket containing foreign profit, as a result, has an FTC limit above zero, which allows the company to claim an FTC for some or all the income tax paid to Country B. In order to facilitate the taking of an FTC for foreign tax paid in one country when a company experiences a loss elsewhere, Japan might allow its multinational companies to choose between an overall limitation and per-country baskets.

In addition to the possible downside of Japan's overall basket approach in the presence of foreign losses, Japanese

law contains three other restrictions that increase the likelihood of double taxation. First, as noted earlier, foreign tax paid exceeding a 50% effective rate and withholding tax on interest exceeding 10% are ineligible for the FTC. These 50% and 10% limitations function similarly to other basket schemes in that they prevent averaging hightaxed and low-taxed income when foreign tax rates exceed the respective thresholds. In effect, the limitations discourage DIA in some of the highest-tax jurisdictions and decrease the options for debt financing of foreign operations. Second, Japan treats twothirds of foreign source income that avoids foreign income tax as domestic income. Similarly, export profit that does not incur a foreign income tax is not deemed to be foreign income and, thus, does not inflate the FTC limitation. These restrictions prevent Japanese multinational companies from using large portions of low-taxed foreign income to absorb excess credits from high-taxed foreign income. Third, with some exceptions, Japan's formula limits foreign source income to 90% of worldwide income. Therefore, even if a Japanese multinational company derives all of its income from foreign sources, this 90% restriction, in effect, causes the FTC limitation to equal only 90% of foreign source income multiplied by the domestic tax rate.

In summary, Japan's overall basket approach allows many opportunities for averaging high-taxed and low-taxed foreign income, thereby avoiding excess credits. However, the three restrictions described above seriously curtail such opportunities. On the other hand, since Japan has one of the highest effective corporate tax rates among the seven advanced economies, excess credits should not occur when conducting business abroad in most countries.

Canada's FTC limit is one of the more restrictive among advanced economies. It separates business income from nonbusiness income in addition to segregating income based on the country from which the income is sourced. Accordingly, tax planning strategies to absorb excess credits, when they occur, are limited in effectiveness. The inability of some Canadian multinational companies to avoid and then absorb excess credits precludes capital export neutrality and impairs global competitiveness on those investments. However, Canada's combined national and provincial taxes result in one of the highest corporate tax rates among advanced economies. Like Japan's system, Canadian law discourages DIA in only the highest-tax foreign jurisdictions, but conducting business in most other countries should not result in significant excess credits.

Germany's per-country limitation segregates profits in lowtaxed countries from income earned in high-taxed countries. However, it does not preclude averaging within country baskets; consequently, taxpayers can average low-taxed investment income with high-taxed business income from the same country. Although less effective in protecting tax revenues on domestic income, the wider opportunities to average income under a per-country regime often result in fewer excess credits than a basket regime based on income type. For this reason, the German FTC is probably more capital export neutral than other FTC regimes, such as that of the U.S.

United Kingdom law requires that multinational companies place foreign income and taxes from each country in separate baskets. Although the new mixer cap rules do not allow direct averaging of high-taxed and low-taxed income, the companion on-shore pooling rules diminish the double taxation concern. However, because the United Kingdom's corporate tax rates are relatively low, DIA in many countries raises double taxation concerns regardless of on-shore pooling. Partial FTC ineligibility when the applicable foreign rate surpasses 45% intensifies such concerns. Excess credits that expire unused and disallowed foreign taxes under the 45% rule impair capital export neutrality. The tax burden is effectively greater on DIA than on comparable U.K. investments.

C. Deduction Options

As analyzed above, deducting foreign income taxes provides a smaller tax benefit than claiming a credit of the same magnitude. However, the FTC limitation can result in excess credits. Taxpayers can absorb excess credits during the allowable carryover period if they can bring low-taxed income into the same basket. The opportunity to average might be the result of beginning business operations in a low-tax country, declining tax rates in foreign countries with existing operations, increasing home country tax rates, or tax planning strategies. If excess credits cannot be absorbed, the taxpayer loses potential benefits. The ability to deduct foreign income tax is important to multinational companies, for they can lose significant tax benefits when unused excess credits are large.

Australia does not permit multinational companies to deduct foreign income tax. The lack of a deduction can decrease the aftertax return on DIA for multinational companies with excess credits that expire unused, impairing capital export neutrality and global competitiveness. Canada permits a deduction only for excess credits in

nonbusiness income baskets, which is a favorable provision that provides some double taxation relief when host countries impose high withholding taxes on investment income. France allows companies to deduct foreign withholding tax on interest and royalties remitted from nontreaty countries. The absence of an FTC for interest and royalty payments constricts the options of French multinational companies that wish to remit profits from nontreaty countries. The deduction provides partial relief, but much less than the FTC regime. Since Australia, Canada, and France depend primarily on the EM for double taxation relief, the macroeconomic impact of deduction allowances for foreign income tax, as explained above, is relatively small.

Germany, Japan, the United Kingdom, and the United States permit a deduction instead of the FTC. The election to deduct foreign income tax is available annually. If elected, the taxpayer must deduct all foreign income tax for that year. Thus, the deduction option is not available selectively. In a slight departure from an all-ornothing rule, Japan permits a deduction for foreign income tax that is ineligible for the FTC because the foreign income tax rate exceeds 50%. The deduction alternatives offered by Germany, Japan, the United Kingdom, and the United States provide benefits only in certain situations, such as when the domestic parent company has domestic losses and chooses to forgo the FTC. Accordingly, tax benefits to multinational companies in the aggregate are relatively small because the companies usually elect the FTC rather than a foreign income tax deduction.

As noted previously, multinational companies with excess credits that expire unused experience greater overall tax burdens than similar companies conducting only domestic business. Although deducting foreign income tax does not reduce tax liability as much as the FTC, the deduction provides some tax relief, thereby moving the FTC regime closer to one that is capital export neutral. One option to enhance the deduction benefit is to allow the taxpayer a deduction for excess credits by election at any time. For example, a multinational company conducting business in a high-tax country could be allowed to claim the FTC for foreign income tax up to the limit (i.e., foreign income times domestic tax rate) and, if not absorbed, deduct the excess foreign income tax in the current or any later year. Although such a deduction does not achieve capital export neutrality, it moves the FTC mechanism closer to such a standard and permits multinational companies to compete on more favorable terms.

D. Allowable Tiers

Two aspects of the indirect credit are particularly important when discussing capital export neutrality and global competitiveness: ownership requirements and the number of tiers that qualify. Regarding ownership, Australia, Canada, the United Kingdom, and the United States require domestic companies to own 10% of a foreign company in order to qualify for the indirect FTC. Japan, by comparison, requires 25% ownership. This higher percentage discourages Japanese companies from DIA ranging between 10% and 25% compared to companies from other advanced economies. The disincentive to invest suggests that Japanese companies must sometimes pass up profitable business opportunities because of the inability to obtain an indirect FTC. Passing up profitable opportunities decreases global competitiveness.

The number of tiers from which a domestic parent company can obtain an indirect FTC also has policy implications. The fewer the allowable tiers, the fewer the options for establishing or restructuring foreign operations without forgoing the indirect FTC for foreign income tax that lower-tier affiliates pay. Japan allows an indirect FTC for only two tiers. Thus, reorganizations that call for adding a third tier involve the future loss of the indirect FTC that otherwise would have been available with more lenient rules. When compared to domestic restructuring in Japan, the two-tier constraint on the indirect FTC treats foreign structures less favorably. Foreign restructuring calling for third or lower tiers must either suffer the loss of the indirect FTC for these affiliates or restructure in a less optimal way. In either case, the constraint tends to thwart capital export neutrality and restrains the global competitiveness of those multinational companies affected.

At the other extreme, Australia, Canada, and the United Kingdom allow multinational companies to obtain an indirect FTC (or, in the case of Canada, its deduction equivalent) from an unlimited number of lower tiers. To qualify in Australia, the domestic parent company must indirectly own 5% of each second-and lower-tier affiliate, and each immediately higher foreign company in the chain must directly own 10% of the foreign company in question. To qualify in Canada, the domestic parent must directly and indirectly own 1% of each second-and lower-tier affiliate, and the Canadian parent with related companies must directly and indirectly own 10% of the same affiliates. The United States has similar percentage ownership rules to Australia, although the qualifying chain of

ownership extends down through only six chains, and the last three tiers must qualify as controlled foreign corporations of the U.S. parent company. For Australia, Canada, and the United States, the greater number of tiers from which a domestic taxpayer can derive an indirect FTC represents a step closer to capital export neutrality compared to the other countries analyzed. Also, the flexibility of the more lenient lower-tier rules allows multinational companies from these countries to compete globally on more favorable terms.

E. Carryover Provisions

The years to which countries allow multinational companies to carry excess credits can affect global competitiveness and, again, has implications for capital export neutrality. Ceteris paribus, the more stringent the carryover period, the more likely excess credits will expire unused. Carryback procedures allow taxpayers to absorb excess credits currently. Carryforward procedures permit taxpayers to absorb excess credits in future years, which entails some loss of present value benefits compared to the carryback procedure or current absorption.

Canada, Japan, and the United States have roughly similar carryover periods. Each country permits a carryback of excess credits for two or three years. The carryforward period ranges from Japan's three years to Canada's seven years. In contrast, Australian law does not permit multinational companies to carry back excess credits. The inability of Australian companies to carry back excess credits, particularly given its recently reduced corporate tax rates, results in the loss of some FTC benefits, at least on a present value basis.

The United Kingdom's three-year carryback and indefinite carryforward is the most generous of the countries examined. With the low U.K. tax rate and the increased opportunities to accumulate excess credits, the indefinite carryforward period provides additional time to mitigate the effect of double taxation. The longer the carryforward, the more likely U.K. multinational companies will absorb excess credits. However, the present value benefit of absorbing excess credits diminishes for long carryforward periods. For example, a $1,000 excess credit not absorbed for ten years is worth only $386 in present value terms, assuming a 10% discount rate. Excess credits that taxpayers do not use in the first several years might expire, but even if absorbed, their present value is smaller than their stated currency value.

Unlike the other countries, Germany permits no carryover of excess credits, which is the least favorable approach on this aspect of the FTC. Allowing no carryover can force short-term decisions based on taxes rather than the before-tax income opportunities. Liberalizing the carryover feature is a shift toward capital export neutrality and increases global competitiveness. Germany's partial reliance on the EM mitigates the macroeconomic impact the lack of FTC carryover procedure otherwise might have on DIA.

F. De Minimis Rules

The extensive recordkeeping requirements and sheer complexity of the FTC rules of some countries may deter smaller companies and companies new to the international marketplace from initiating DIA. The FTC limitation may discourage the same companies from DIA in high-tax countries because such investments are not capital export neutral. Providing de minimis FTC rules might encourage some companies to make DIA.

None of the countries relying primarily on the FTC for double taxation relief--Japan, the United Kingdom, and the United States--allow companies to claim de minimis amounts of FTC free of the normal limitation (foreign income times domestic tax rates) and attendant recordkeeping. However, de minimis rules simplify the transition from conducting business solely in the domestic marketplace (or through exporting) to maintaining a more tangible presence abroad. Ignoring the normal limitation causes the FTC to be capital export neutral and encourages DIA.

In addition to simplifying the administrative burden, de minimis rules waiving the normal FTC limitation increase after-tax rates of return from DIA in high-tax countries, which boosts the global competitiveness of qualifying firms. Since de minimis rules apply only to a relatively small amount of a country's total DIA, the home country is less vulnerable to the risk that another country may inflate its tax rates, permitting multinational companies to claim higher FTC benefits and thereby "raid" the home country's treasury.

VII. CONCLUSIONS

This article compares the EM and FTC regimes of seven advanced economies. Australia, Canada, France, and Germany rely primarily on the EM for double taxation relief, with the FTC as a backup measure. Japan, the United Kingdom, and the United States use the FTC to mitigate double taxation.

Tax burdens under the EM depend entirely on foreign tax rates and thus often vary from the tax burden on a comparable domestic investment. In fact, the EM does not even pretend to attain capital export neutrality. However, the EM comes closer to achieving capital import neutrality than the FTC, and policy makers view the EM as a more globally competitive provision, especially in host countries with low tax rates. Although both relief measures are capital import neutral in high-tax countries, the EM more broadly achieves neutrality when the host country has a low effective tax rate.

In contrast, the FTC is more capital export neutral than the EM. However, the FTC limitation creates excess credits when multinational companies conduct business abroad in high-tax countries. Expired excess credits result in tax burdens exceeding the tax liability due on a comparable amount of domestic profits, which reduces capital export neutrality. Ceteris paribus, the FTC limitation creates an advantage for companies conducting business domestically compared to those doing business abroad in high-tax jurisdictions. Allowing easier absorption of excess credits represents a shift toward capital export neutrality and also allows multinational companies to compete globally on more favorable terms.

Based on this article's comparative analysis, the governments of most advanced economies can modify their respective FTC regimes to increase the global competitiveness of their multinational companies and move their overall tax systems closer to capital export neutrality. For example, Australia might allow taxpayers to deduct foreign income tax as an alternative to claiming the FTC and include a carryback period for excess credits. Although Australia relies primarily on the EM, these changes to its FTC regime would lessen the current tax disincentive for DIA in unlisted countries. Given Australia's relatively low corporate rates, DIA in unlisted countries with moderate or high tax rates results in excess credits.

U.K. tax rates also are relatively low, which raises concerns about excess credits and the inability to achieve capital export neutrality. However, the newly enacted on-shore pooling rules may enable U.K. multinational companies to absorb most foreign income tax paid, especially considering other countries' FTC provisions. Specifically, the unlimited tiers that U.K. law allows in determining the indirect FTC, as well as the unlimited carryforward of excess credits, are policies that provide U.K. multinational companies with considerable flexibility in addressing excess credits when they exist.

Although their tax rates are relatively high, Canada and Japan can adjust their respective FTC regimes to reduce double taxation concerns when resident companies invest abroad in higher-tax jurisdictions. Canada can reform its FTC limit calculations so that the rules do not quarantine income and related foreign tax into so many baskets. Although the current scheme of segregating income and tax into business and nonbusiness categories, as well as requiring segregation by country, protects Canadian tax revenue on domestic income, it does so at a cost. Some Canadian multinational companies are unable to use excess credits and may forgo some otherwise attractive international business opportunities because of double taxation concerns. Japan might extend the indirect FTC to include foreign income tax that third-and lower-tier foreign affiliates pay. The increased flexibility from such a change can decrease the role of taxes on international restructurings.

The United States should consolidate some of its FTC baskets to reduce complexity. Consolidation allows some taxpayers to average low-tax and high-tax income more easily, but the lost tax revenue is a small cost for the decreased complexity, increased efficiency in domestic resource allocations, and increased global competitiveness. Finally, each country studied might consider adding de minimis FTC rules to reduce both recordkeeping burdens and the complexities involved in tracking foreign income and taxes to specific baskets and across taxable years.

Germany's recent tax reform provides interesting opportunities for its multinational companies. Exempting foreign dividends creates incentive for DIA in countries with lower income tax rates. Unlike Australia and Canada, which exempt foreign dividends only when the DIA occurs in listed countries, Germany permits the EM regardless of

where the DIA occurs. Germany's EM is broader in scope and avoids complex tracing and look-through issues. These attributes suggest that Germany's EM will significantly increase the global competitiveness of German multinational companies.

The implications of this article's comparative analysis are particularly important for smaller companies and those venturing into the international marketplace for the first time. These are the companies that most often experience the most difficulty claiming the FTC for all foreign income taxes paid. Larger multinational companies are more diversified in business activities and geographical locations. Such diversification affords larger companies more opportunities for averaging high-taxed and low-taxed foreign income than smaller firms, minimizing the excess credits of larger firms and maximizing the FTC and after-tax rates of return. For example, many multinational companies move into and out of excess credit positions every few years, which suggests that such companies are implementing tax planning strategies to absorb excess credits and avoid double taxation. The diverse nature and location of their business activities also provide many opportunities to shift income through aggressive transfer pricing policies, which can facilitate the averaging of high-taxed and low-taxed income. Finally, large multinational companies have access to more qualified professional tax staffs, whether in-house or through public accounting firms, and more sophisticated tax planning software than smaller companies or companies that previously conducted business only domestically. Such tax staffs often assist the larger multinational companies in finding and implementing ways of reducing or eliminating double taxation.