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The Future of Capital Export Neutrality: A Comment on Robert Peroni's Path to Progressive Reform of the U.S. International Tax Rules

Stanley I. Langbein

University of Miami School of Law, slangbei@law.miami.edu

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The Future of Capital Export Neutrality: A Comment on Robert Peroni's Path to Progressive Reform of the U.S. International Tax Rules

STANLEY I. LANGBEIN*

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I. INTRODUCTION

Robert Peroni's paper *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules* represents a thoughtful and welcome contribution to the continuing debate concerning taxation of transactions which cross international borders. The paper reflects an awareness of the numerous substantial contributions the current tax system makes to the public revenues of the United States and of other nations, and a healthy caution toward radical revisions of the existing system. Professor Peroni recognizes that the existing approach to taxing international transactions can be improved, and that any such reform might forestall resort to more sweeping—but potentially misdirected and costly—new alternatives.

Professor Peroni proceeds by first expressing support for a general policy framework. He then details three very major concrete reforms, as well as three other reforms which are perhaps more peripheral to the functioning of the international provisions of the current income tax. The general policy framework is a reaffirmation of the principles of residence basis taxation, the economic theory of capital export neutrality, and the link of those principles to the principles of vertical and horizontal tax equity. The three major policy proposals are: the repeal of the "deferral" of taxation of foreign income of multinational enterprises; the reform of the foreign tax credit so that the credit is limited on a per country basis, or, if that is politically infeasible, through substantial revi-

* Professor of Law, University of Miami School of Law.

sions of the existing "basket" limitation system and; movement toward a formulary apportionment approach to transfer pricing. The three peripheral reforms are: repeal of special preferences for export income; repeal of the foreign earned income credit and; repeal of special penalty provisions concerning foreign income. Both the general policy framework and the particular proposals are useful and deserve separate consideration.

II. RESIDENCE VS. SOURCE BASIS TAXATION

Professor Peroni begins by articulating, as the basis of the international tax regime, the principle of residence basis taxation, and the related principles of capital export neutrality. The principal grounds for the position are best expressed in the paper written by Hugh Ault and David Bradford quoted in Professor Peroni's paper:¹ that source has no bearing on ability to pay, and thus implementation of principles of horizontal and vertical equity is served only if "residence" is the criterion for determining how to tax income earned by a "resident" of one jurisdiction from a "source" in another. Professor Peroni appears to subsume the position opposing the residence and capital export neutrality principles under arguments in favor of enhancing the competitiveness of United States firms or of simplifying the international taxing system.²

There may, however, be serious shortcomings to the residence and capital export neutrality principles, which have little to do with the concededly oversimplified goals of "leveling" the international "playing field," or simplifying the income tax. First, principles of capital export neutrality as well as horizontal and, in particular, vertical equity, play a transparent role in relation to the taxation of individuals with cross border income, as well as to portfolio income earned across international borders. However, their role with respect to the most important and controversial form of income subject to the international tax rules—the active business income of multinational enterprises—is less clear. Corporate income taxes are imposed largely as a convenience or an anti-avoidance device. Corporations really do not have an "ability to pay," because they are not natural persons, and do not, in any strict sense, "consume" or "accumulate" wealth in and of themselves.³ They represent, ultimately, natural persons who do consume and own resources in

1. See Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Tax Rules*, 51 U. MIAMI L. REV. 975, 981-82 (1997) (quoting Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in TAXATION AND THE GLOBAL ECONOMY (Assaf Raxin & Joel Slemrod eds. 1990) [hereinafter Peroni]).

2. See Peroni, *supra* note 1, at 983-85.

3. Ability to pay is theoretically defined as the sum of rights exercised in consumption plus

their own right. It is controversial and uncertain precisely *whom* they represent. In legal form, they ordinarily represent their shareholders or other "beneficial owners." To the extent they generate abnormal "business" returns in excess of "marginal" returns, however, they may also represent their managers, "entrepreneurial" service providers, their workers, or even their customers or other factor suppliers. Whom they represent need not detain us in this context. The point is they do not have an ability to pay in their own right, but only represent others whose ability to pay is in question, although not subject to precise measurement as regards the income in corporate solution. The corporation is taxed to prevent individuals, who do have an ability to pay, from avoiding taxation by routing it through corporate enterprises; the corporation tax is an "advanced" tax, a form of collection, and necessarily an approximation, at its absolute best.

Furthermore, as a practical matter, the international tax system appears to have long distinguished active business income from "portfolio" income, and to have had both what we might call a "jural" and an economic reason for doing so. The economic reason concerns the responsiveness of the form of investment involved to differences in rate of return. Pure theory states that capital will move to the place it earns the highest effective return to the capital owner. The tax authority is presumed to be financially interested in where the investment is placed, but only on an *ex post* basis, and to be uninvolved in the decision where to place the capital. Thus, what matters is the after tax effective rate of return, which is, of course, affected by the tax rate.

But this construct, though conventional, presupposes the mutual perfect substitutability—the proper economic term, which I suppose is the equivalent of the term more commonly spoken in tax circles, "fungibility"—of the targets of potential investment. With "direct" capital, which earns "active business" income, the targets appear not to be perfectly substitutable, and they are probably not even imperfectly substitutable in any meaningful sense. This may presuppose the opportunity to earn abnormal entrepreneurial returns. If this is the case, they may be source specific and generate an ineluctable claim by the sovereign in the locale to impose a tax. This is true in part because it is the opportunity, not the opportunist, which will exist in any event (that is, whether taxed or not), and in part because there is ample room to drive the aftertax "effective rate" down from its "pretax" level without destroying the opportunity.

Moreover, the residence principle overlooks the admixture of

the change in market value of property rights held between the beginning and the end of a taxable period. See HENRY C. SIMONS, PERSONAL INCOME TAXATION 62 (1938).

objectives which territorial or import neutrality principles serve—in particular, that source basis taxation simultaneously solves a second problem which the residence principle ignores. This is the determination of which public authority receives the tax imposed on the basis of ability to pay. Ability to pay is a principle of equity and perhaps efficiency, which ordinarily, and probably necessarily, concerns the taxpayer, not the tax authority. Ability to pay principles enjoy some sanction in extant international tax agreements, but they are rendered much more controversial if they are taken to imply that the “home” country gets to keep the tax collected. Territorial tax rights assure collection by the “host” country of some of the revenue earned by the “guest” enterprises, with the operation of the ability to pay principle protected by exemption or foreign tax credit systems in the home states. Pure residence principles overlook this, and thus threaten to trigger controversies which might disrupt existing arrangements which are theoretically imprecise, but, both operational and in terms of substantive public policy objectives, satisfactory.

Finally, the entire debate over source and residence principles presupposes that we are accurate in aiming “direct” taxes at such things as income (or at total consumption, in the case of “cash flow” consumption taxes, which are more a matter detailed in commentary than enacted in legislation). This presupposition may not be entirely accurate, however, in a steady state in which taxes are, and have been, imposed long enough, and which allows deductions against the “comprehensive” taxes imposed on payors, also allowed long enough, for the prices of goods, services, and factors, to have adjusted to take account of the taxes. If equal and opposite tax effects are generated by transactions, at relatively high and roughly comparable tax rates imposed upon payors and payees, and generally deductible payments, the amount effectively “paid” by the transactors – measured in terms of the difference between net government collections without the tax and net government collections with it – will be more properly measured by the difference between the rate of tax on the payor and that on the payee, rather than the nominal rate on either. The practical effect of the tax will be substantial price distortion, rising exponentially in proportion to the generally effective rates, but reflected in actual collections only as the product of the (presumably ordinarily relatively low) differences in rates times the amount of the distortion. But if the transaction is cross border, the effect of price distortion on the allocation of revenues is quite perverse, because the small net burden borne by the parties is effected through a substantial payment to the jurisdiction of the payee, offset by a substantial rebate from the jurisdiction of the payor.

If this is an appropriate or superior way of viewing “steady state” effects of so-called direct taxation, then one is in all likelihood driven to advocacy of “transaction-oriented” (which is different from “consumption-oriented”) taxation – consumption taxes of the sales or value-added type, or payroll taxes. But while income taxes are in effect, it is clear, on these assumptions, both that their application to international transactions has untoward base allocation consequences, and that driving the system in the direction of “residence,” rather than “source” basis, taxation only aggravates these consequences.

III. DEFERRAL REPEAL

The foregoing discussion implies considerable skepticism about proposals to “repeal” the “deferral” of the foreign income of subsidiaries of United States based multinational enterprises. The proposal is, as Professor Peroni emphasizes, rooted in the framework of emphasizing the residence principle and the principle of capital export neutrality. But the proposal touches upon precisely the more controversial and dubious aspects of those ideas—namely: their application to the active business income of multinational enterprises; their uncertain conception of who is a “resident” and; the imperfections of employing “residence,” especially of corporations, as a proxy for “ability to pay.” Deferral repeal proposals may antagonize our trading partners, because, to the extent we or they view place of incorporation as a “natural” proxy for “residence” or a “personal” link to a tax jurisdiction, “repeal” renounces the view. It is also inescapable that, to the extent competitor trading partners do not take the same steps and the proposal results in enhanced taxation of the foreign operations of United States enterprises, repeal operates as a corporate tax increase would operate. It impairs the competitiveness of United States firms, precisely in relation to the areas of enterprise (operations abroad) where competitive burdens are apt to have the heaviest impact.

IV. FOREIGN TAX CREDIT REFORM

Professor Peroni indicates that the foreign tax credit cannot be characterized as a pure device for achieving capital export neutrality.⁴ When the credited foreign rates get too high, the statutory limit intervenes and cuts off the credit at the amount determined under the United States rate. Thus, the statutory scheme at some point is concerned about division of revenue, preserving the United States tax on United States source income regardless of foreign rates, so that the United States fisc does not

4. See Peroni, *supra* note 1, at 977-79, 994-95.

bear the financial burden of offsetting the economic consequences of foreign countries' high taxes. The regulations adopted in the early 1980's go further by denying "income tax" characterization, and thus "creditability," to devices intended to collect revenue for foreign authorities without increasing the tax burden on the United States persons subject to the foreign tax.⁵ Not only is there dubious statutory ground for this effort, as a practical matter, it is probably futile. The effort probably ought to be abandoned.

The United States, however, does not intervene as between different foreign jurisdictions taxing United States enterprises. The United States does not necessarily deny the credit in those circumstances where the credit would be denied if the foreign taxing authority were the sole such authority and the income it taxed was the only foreign income. Nor does the United States impose a "per country" limitation. The overall limitation serves to assure that the United States collects the amount of tax it would impose on domestic income; it allows a particular foreign jurisdiction to impose a heavy tax if there is another jurisdiction which imposes a light one. Thus, the overall limit serves the residence principle and "capital export neutrality," at least if the latter is conceived narrowly enough. Even if there were collusion among the foreign jurisdictions, which ordinarily there manifestly is not, would it make any difference to the United States, which with the overall limit still collects the amount of revenue it would collect under autarky, that some foreign jurisdiction may be "getting away" with a deviation from "capital export neutrality," by collecting a higher tax than would be possible in a two-country world under the assumptions of that system?

This brief discussion is to suggest that even assuming capital export neutrality principles, the policy bases for per country limitations are unclear. The entire "basket" system, as I understand it, is premised on an effort to approximate a per country limitation. If the policy basis of a per country limitation is uncertain, it follows that the reasons for the basket system are even more so. This is partly why the basket system appears grotesquely complex, and why there frequently appears to be so little guidance rooted in policy for resolving the many interpretive ambiguities posed by the statutes and regulations implementing the system. Attempting to "perfect" and "improve" the "politically feasible" basket regime may backfire.

The per country system is viewed as mandated by capital export neutrality upon a broad interpretation of that principle. The foreign tax credit is a system which cedes to the source jurisdiction a "primary"

5. See Treas. Reg. §§ 1.901-2(c) (soakup taxes), (e)(3) (subsidies), (e)(4) (multiple levies), (e)(5) (noncompulsory amounts) (1983).

right to tax but preserves to the United States a residual right to tax if the "source" country does not exercise its "right" to the full extent, determined by what the United States tax would be on the foreign income. This residual right to tax assures capital export neutrality, and the foreign tax credit limitation prevents erosion of the United States revenue base. The limitation fine tunes the concession of the right to tax to a right *actually exercised*; we are not conceding a right to grant a tax holiday. A limitation fully implementing a policy of this sort would not only be per country, it would be a "base limitation" like the second limitation in the estate tax foreign tax credit provisions,⁶ or the creditable amount determined under the safe harbor rules of the "dual capacity" taxpayer regulations.⁷ The cession should be limited, and not expanded by the actions of other countries, actions by the taxing countries which are conscious of the foreign tax credit or which rig prices in anticipation of foreign tax credit consequences, or by any form of tax incentives of the foreign country, and certainly not by the unilateral actions of the taxpayer in determining the "source" of income when the source can be determined without affecting the rate of return.

The policy concerns underlying the refinement of the foreign tax credit reflect a preoccupation, by the Congress as much as the administrative authorities, not only with implementing the policy of protecting the United States' residual right to tax, but with implementing a policy which ensures participation by the United States tax authority in determining the content of that right. The latter policy is neither easily accomplished nor clearly worth pursuing. It is, furthermore, unclear that it is really an established aspect of the United States' unilaterally determined tax structure, and much less clear whether it is a legitimate part of the "international" structure.

V. FORMULA APPORTIONMENT

Professor Peroni advocates United States action to move toward formula apportionment on an "evolutionary" basis.⁸ Professor Peroni's position is novel, because it is the first time that any scholar has simultaneously taken a clear position advocating residence basis taxation, while endorsing formula apportionment as at least potentially superior in theory to the "arm's length" standard. But, as Professor Peroni recognizes, formula apportionment would require agreement on the international allocation of jurisdiction to tax. Multilateral authorities are not currently

6. I.R.C. § 2014(b)(2) (1982).

7. Treas. Reg. § 1.901-2A(e)(1) (1983).

8. See Peroni, *supra* note 1, at 1002-04.

working on such an agreement, and it has proven difficult to get them to do so.

Formula apportionment remains the most significant way to focus government officials on the question of which government should have the right to tax which part of the income of multinational enterprises. The foreign tax credit problems described above reflect of the United States, concern that the credit will be manipulated to damage its power to impose tax even on the "domestic" tax base. Such an objective, however, is difficult to accomplish, or even to render coherent, absent an international effort to address questions of the division of the tax base on terms which make greater sense than does the prevailing "arm's length" standard. At the same time, in immediate and substantive terms, what Professor Peroni calls the "modified" arm's length standard – the rules embodied in the 1993 United States regulations⁹ and the principles adopted by the OECD's transfer pricing guidelines – represent a substantial movement away from the ambiguities of the traditional standard, and do introduce the possibility of working toward the kind of results that would be achieved under an international formulary standard. Those rules remain critically unclear in certain important respects, notably the manner in which one determines pricing where a transfer of "intermediate" tangible property involves an "embedded" intangible,¹⁰ and the question whether under the comparable profits method different "tested parties" may be used in constructing an "arm's length range."¹¹

VI. EXPORT INCENTIVES

Professor Peroni advocates the repeal of the FSC provisions, and of the inventory title passage rules, as well as other export incentives of present law. These proposals would contribute to tax simplification.

It is doubtful that the export incentive embodied in the FSC is of great importance. When the predecessor DISC provisions were in effect, the advocates of repeal simultaneously argued that those provisions constituted an ineffective trade incentive, and were an undue irritant to our trading partners, if not a violation of the General Agreement on Tariffs and Trade. Ultimately, the United States more or less conceded that DISC violated the GATT. FSC was designed by the Reagan Administration as a "GATT-compliant" trade incentive. The GATT members who objected to DISC have never conceded that FSC complies with GATT. They have not objected to it either, although their case would appear to be pretty strong. This suggests they do not care. If so,

9. See Treas. Reg. §§ 1.482-1-482-6 (1994).

10. See *id.* § 1.482-3(f).

11. See *id.* § 1.482-5(b)(2)-(3).

it is probably because FSC does not have too much effect. If it has enough effect to quell the domestic advocates of tax based export incentives and not enough to provoke the foreign opponents of such schemes, it probably strikes an appropriate balance, and ought to be left alone.

VII. EARNED INCOME EXCLUSION

Repealing the earned income exclusion is a bad idea. I noted above that one problem with the idea of capital export neutrality and the residence principle is that it begs the question of who is a resident for purposes of the neutrality principle. The major problems involve corporations. But in regard to individuals, the United States is the only major economic power which imposes plenary taxation on the basis of citizenship. This is a peculiar if not irrational feature of the law which is best restricted. Measures like the earned income credit, which restrict it, are thus salutary and should not be cut back.

VIII. PENALTY PROVISIONS

The penalty provisions discussed in Professor Peroni's paper are irrational, anachronistic, and contribute to the excessive complexity of the Code. Professor Peroni's suggestions that they be removed should be given careful consideration.

IX. CONCLUSION

Overall, Professor Peroni's paper represents a deliberative effort to advance the debate over the taxation of cross-border transactions. His cautious reforms, both major and peripheral, deserve consideration in the effort to improve the existing approach to taxing international transactions.