Brooklyn Journal of International Law

Volume 26 | Issue 4 Article 11

5-1-2001

International Tax Policy: Capital Vs. Labor

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INTERNATIONAL TAX POLICY: CAPITAL VS. LABOR

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It is a great pleasure to read a paper by someone who writes so well, from whom well-turned phrases flow so readily, rendering even the most difficult subject matter easy to digest. And this paper well serves its role, which is to stimulate further thought. It is a broad and comprehensive essay.

I must confess, of course, that I was surprised to learn that our rules for the taxation of cross-border investment have been founded solely on concerns of worldwide economic efficiency. I had assumed that academics spent time discussing this matter because they feared that politicians and administrators would not, and they did not want it to be overlooked, particularly given the principle of retaliation (*i.e.*, if our efforts to use our cross-border tax policies to enrich ourselves are—as Professor Graetz suggests—likely to be copied by the rest of the world, we might at least wind up with a world that is economically efficient). Certainly such perusals of the legislative history of statutes, and of the preambles to regulatory issuances, as I have made in the course of my practice, do not suggest that the people who are responsible for our rules on cross-border taxation have been obsessed by matters of worldwide economic efficiency, or even of national economic efficiency. If that is the subject that has preoccupied the academy, then it would appear that the academy has had relatively little influence.

Rather, the people responsible for the rules that I have encountered have been concerned (not surprisingly) with *who* pays for the cost of our government, and I do not mean

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which nation–I mean which Americans. I thought, for example, that the heart of the capital export neutrality debate was this: According to the Democrats, if U.S. corporations are forced to export most of their capital to low-tax foreign jurisdictions, then the United States will not collect any tax in respect to the income derived by that capital, and labor will be forced to make up the difference. According to the Republicans, if U.S. corporations are prevented from so exporting their capital, the world's markets will be exploited instead by foreign corporations which (like the beast in *Alien*), having grown large on their feedings abroad, will invade the domestic market, and we shall all suffer the fate of the 1970s. There is, of course, much to be said in response. To the Democrats, that like an ocean, the liquid flow of portfolio investment equalizes capital investment in labor worldwide, and thus, to the extent that domestic corporations export capital to exploit investment opportunities abroad, foreign capital will flow inbound to exploit U.S. investment opportunities and support domestic labor. To the Republicans, that profits from the exploitation of worldwide markets go to capital, not labor, and the idea of shifting the cost of government from those who have so much money that they can think of nothing better to do with it than invest it in U.S. multinationals to those who cannot yet afford to buy their first homes is perverse, particularly given the current state of our schools, neighborhoods, healthcare and infrastructure. But I don't frankly recall the participants in this debate referencing worldwide economic efficiency to any great extent, although I'm sure they must have–they referenced everything else.

Certainly this is the theme that I have seen played out of late in the debates over Notices 98-5 and 98-11, over Section 894(c) and the associated regulations, over interest expense allocation, over subpart F re-examination and the problem of "mobile" capital, and over the growing arsenal of cross-border transactions designed to lower U.S. and foreign tax. I therefore think that when Professor Graetz declares in Part III of his paper that, having set aside all this nonsense about worldwide economic efficiency, "We can now ask the straightforward but difficult question: What international tax policy is in the best interests of the people of the United States, . . . "[1] he has set

1. Michael J. Graetz, *Taxing International Income: Inadequate Principles,*

aside a straw horse and begged the very question that lies at the heart of our cross-border tax policy. The question is not "what policy is in the best interests of the people of the United States?," but "which policy is in the interests of *which* people in the United States?"

More gripping, for me at least, is the more technical discussion of outdated legal concepts in Part II of the paper. It seems clear to me as a practitioner that the current rules of taxation based on legal formalisms, on economically meaningless distinctions between corporations, partnerships, and branches, and on equally meaningless "transactions" among related entities, produce results that are complex, arbitrary and subject to manipulation. I likewise agree that these rules are outdated, modeled as they are on the "manufacture and sale of widgets" model that characterized the industrial economy of a century ago. As the recent efforts to grapple with the income derived by financial institutions from "global dealing" suggest, we would be far better off determining a single worldwide income, assessing a single tax, and dividing it up amongst participating nations based on some sort of apportionment formula. However, this would require far more cooperation in the international arena than we have at present. Indeed, if the European Union should founder, it shall be more on questions of taxation than of monetary policy.

As for the question that Professor Graetz has in fact asked—what policy is in the best interests of the United States as a whole?—I do think that there are some changes in policy that might benefit everyone in the United States more or less, primarily at the expense of foreigners, and thus assuming no retaliation, our policy might be improved. For example, it strikes me as odd that in the midst of the heated capital export debate, our policy with respect to the attraction of inbound portfolio capital is virtually ignored. While crying "capital poor" with respect to the allocation of our own savings, we seem to be throwing foreign capital away with both hands. How can we ask foreign investors in U.S. equities to pay tax on the income they derive at the domestic corporate level and then a second time when the income is withdrawn, all before the income even reaches their local shores? We should be grateful, rather than

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troubled, when foreign investors use derivatives to avoid the second tax by characterizing the nominal form of their investments in the United States as inbound loans. So backwards has our policy been in this regard that it took us until the 1980s to repeal the U.S. withholding tax on outbound payments of interest, and then only because business had already managed a de facto repeal of the tax through the use of the Netherlands Antilles.

However, I don't feel the same way about the two changes proposed by Professor Graetz. The first of these is that we move from a credit system to an exemption system in dealing with the foreign source income derived by U.S. multinationals. This generally would permit U.S. multinationals to invest capital in low-tax foreign jurisdictions and repatriate the earnings free of U.S. tax. That is, of course, the proposal that Republicans consistently make in the name of national competitiveness or capital import neutrality, and that Democrats consistently oppose based on concerns about "runaway plants" and capital export neutrality. In other words, it is a proposal that favors capital over labor. Regardless of what can be said for or against this proposal, I don't see how it can be viewed as a proposal that is "in the best interests of the people of the United States" as a whole.[2]

The second proposal is to deny foreign tax credits to U.S. individuals. This proposal may well support labor more than capital, but I'm not sure I understand the analysis that leads Professor Graetz to that proposal. He points out that the income from outbound portfolio investment is subject to relatively low rates of foreign tax, an undeniable fact. He appears to conclude from this, however, that such investment is tax-advantaged as compared to domestic portfolio investment. But of course, given that we have not yet adopted an exclusion system for foreign source income, income from outbound portfolio investment is subject to the same amount of tax as income from domestic portfolio investment. How then does it follow that the former is tax advantaged, and how would it help to repeal the foreign tax credit, thereby rendering the former tax disadvantaged? Professor Graetz effectively is proposing that we permit Americans to invest their capital abroad only if they do so

2. *Id.*

through domestic corporations. The foreign source income earned by these domestic corporations would then be free altogether of U.S. tax under Professor Graetz's first proposal. It is not clear to me how this plan would favor all Americans or why it would be better than our current system.

In any event, the real point of Professor Graetz's paper is that we should be thinking more about our foreign tax rules and the policies behind them. With this I wholeheartedly agree. It is a great pleasure to read such a well-written and thought-provoking piece.