

2001

## The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies

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### Recommended Citation

Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001).  
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# The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies

MICHAEL J. GRAETZ\*

## I. INTRODUCTION

It is a pleasure to be here today to deliver the first David R. Tillinghast Lecture of the 21st century,<sup>1</sup> a lecture honoring a man who has done much to shape and stimulate our thinking about the international tax world of the 20th.

Our nation's system for taxing international income today is largely a creature of the period 1918-1928, a time when the income tax was itself in childhood.<sup>2</sup> From the inception of the income tax (1913 for individuals, 1909 for corporations) until 1918, foreign taxes were deducted like any other business expense.<sup>3</sup> In 1918, the foreign tax credit (FTC) was enacted.<sup>4</sup> This unilateral decision by the United States to allow taxes paid abroad to reduce U.S. tax liability dollar for dollar—taken principally to redress the unfairness of “double taxation” of foreign source income—was extraordinarily generous to those nations where U.S. companies earned income. In contrast, Britain, also a large capital exporter, until the 1940's credited only foreign

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\* Delivered at New York University School of Law, October 26, 2000.

<sup>1</sup> Or, in my obviously minority view, the last Tillinghast Lecture of the 20th century.

<sup>2</sup> For description and analysis of this formative period of U.S. international income tax policy, see Michael J. Graetz & Michael M. O'Hear, *The “Original Intent” of U.S. International Taxation*, 46 *Duke L.J.* 1021, 1022-28 (1997).

<sup>3</sup> Revenue Act of 1913, Pub. L. No. 63-16, ch. 16, 38 Stat. 114; Corporation Excise Tax Act of 1909, Pub. L. No. 61-5, ch. 6, § 38, 36 Stat. 11, 112-17. The reasoning behind the international tax aspects of the 1913 Act is difficult to discern from the historical sources. Some scholars have concluded that “it is quite likely that Congress gave little or no thought to the effect of the Revenue Act of 1913 on the foreign income of U.S. persons or the U.S. income of foreign persons.” Alan G. Choate, Steven Hurok & Samuel E. Klein, *Federal Tax Policy for Foreign Income and Foreign Taxpayers—History, Analysis and Prospects*, 44 *Temple L.Q.* 441, 481 (1971). The decision in 1913 to tax the worldwide income of taxpayers simply may have followed the earlier decision to tax worldwide income in the 1909 federal excise tax on corporate income. Corporation Excise Tax Act of 1909, Pub. L. No. 61-5, ch. 6, § 38, 36 Stat. 11, 112-17.

<sup>4</sup> Revenue Act of 1918, Pub. L. No. 65-245, ch. 18, § 238(a), 40 Stat. 1057, 1080-81 (1919).

taxes paid within the British Empire and limited its credit to a maximum of one-half the British taxes on the foreign income.<sup>5</sup>

In 1921, Congress limited the foreign tax credit to ensure that a taxpayer's total foreign tax credits could not exceed the amount of U.S. tax liability on the taxpayer's foreign source income.<sup>6</sup> This limitation was enacted to prevent taxes from countries with higher rates from reducing U.S. tax liability on U.S. source income.<sup>7</sup>

In 1928, the League of Nations issued drafts of model bilateral income tax treaties for the reciprocal relief of double taxation of international income.<sup>8</sup> These models, as modified from time to time, have served as the common basis for more than 1700 bilateral income tax treaties now in force throughout the world.<sup>9</sup> The system for taxing international income produced in that decade—often referred to in the literature as the 1920's compromise<sup>10</sup>—is routinely characterized as allocating the taxation of business income to the country of its source and the taxation of portfolio income to the country of the capital supplier's residence.

Nothing comparable to the thoroughgoing multilateral restructurings of international monetary and trade relationships that followed the Second World War (which themselves have been substantially revised and refined since) has affected the system of international income taxation.<sup>11</sup> It is remarkable that not only the fundamental structure of the system for taxing international income today, but also many of the core concepts used to implement that structure—concepts such as permanent establishment, corporate residence, and arm's

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<sup>5</sup> Graetz & O'Hear, note 2, at 1045-48.

<sup>6</sup> Revenue Act of 1921, Pub. L. No. 67-98, ch. 136, § 222(a)(5), 42 Stat. 227, 249.

<sup>7</sup> Internal Revenue: Hearing on H.R. 8245 Before the Senate Committee on Finance, 67<sup>th</sup> Cong., 74 (1921) (statement of T.S. Adams), reprinted in 95A Internal Revenue Act of the United States 1909-1950: Legislative Histories, Laws, and Administrative Documents (Bernard D. Reams, Jr. ed., 1979) [hereinafter Adams Statement]; Graetz & O'Hear, note 2, at 1054-56.

<sup>8</sup> Id. at 1066-89.

<sup>9</sup> U.N. Conference on Trade and Development, World Investment Report 1998: Trends and Determinants xix (1998) [hereinafter UN Report].

<sup>10</sup> Graetz & O'Hear, note 2, at 1026.

<sup>11</sup> Professor Richard Vann of Australia has described this circumstance as follows:

Although it is possible to refine the actual terms of the OECD Model and to elaborate the commentary so as to cover new cases as they arise, the time has passed for radical revision within the current bilateral framework. In a sense the opportunity to go in another direction was lost before the 1963 draft appeared. The failure to adopt any new approach to international tax after the Second World War (compared to trade law and the international monetary system) meant that effectively the solution adopted after the First World War continued by default. In other words the OECD Model is the culmination of 50 years of development, rather than a new departure.

Richard J. Vann, *A Model Tax Treaty for the Asian-Pacific Region?* (pt. I), 45 Bull. Int'l Fisc. Doc. 99, 103 (1991).

length pricing—date from a time when airplanes were first becoming a regular means of travel, and when the “wireless” was a relatively new instrument of communication, and when Dorothy Parker, Robert Benchley, and Haywood Broun were holding court in the lobby of the Algonquin Hotel, a mile away.

The rules for taxing international income put in place following the First World War, however, have been tweaked from time to time, usually in response to one perceived abuse or another. This audience requires no litany of these occasions, but, to avoid misunderstandings, let me name a few: the foreign personal holding company rules, added in the 1930's,<sup>12</sup> Subpart F, enacted in the 1960's,<sup>13</sup> the earnings stripping rules and PFIC regime added in the 1980's,<sup>14</sup> the various methods for allocating deductions between domestic and foreign source income adopted in 1977<sup>15</sup> and revised substantially since, and most recently, refinements in the methods for determining, verifying, and enforcing related-company transfer prices.<sup>16</sup>

Likewise, the method for determining the limitation on foreign tax credits has taken a variety of forms over the years, having been computed based on a taxpayer's overall foreign source income when first enacted in 1921,<sup>17</sup> limited to the lesser of an overall or per-country amount in the 1930's, 1940's, and early 1950's,<sup>18</sup> and computed country by country in the latter half of the 1950's.<sup>19</sup> Beginning in 1960, taxpayers were given the option of an overall or per country limitation<sup>20</sup> until 1976 when the per country limitation<sup>21</sup> was repealed and the law returned to its 1921 shape.<sup>22</sup> There it rested until 1986 when today's system, which categorizes various types of income into so-called baskets for purposes of calculating the foreign tax limitation, came into effect.<sup>23</sup> Whenever the limitation has changed, Congress

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<sup>12</sup> Revenue Act of 1937, Pub. L. No. 75-377, § 201, 50 Stat. 813.

<sup>13</sup> Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960.

<sup>14</sup> Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7210(a), 103 Stat. 2106, 2339.

<sup>15</sup> Tax Reduction & Simplification Act of 1977, Pub. L. No. 95-30, 91 Stat. 126.

<sup>16</sup> Reg. § 1.482-1 to-8.

<sup>17</sup> Revenue Act of 1921, Pub. L. No. 67-98, ch. 136, § 222(a)(5), 42 Stat. 227, 249.

<sup>18</sup> Revenue Act of 1932, Pub. L. No. 32-154, ch. 109, § 131(b), 47 Stat. 169, 211.

<sup>19</sup> Internal Revenue Act of 1954, Pub. L. No. 83-591, ch. 736, § 904, 68A Stat. 3, 287-88.

<sup>20</sup> Act of Sept. 14, 1960, Pub. L. No. 86-280, § 1(a), 74 Stat. 1010, 1010.

<sup>21</sup> Tax Reform Act of 1976, Pub. L. No. 94-455, § 1031, 90 Stat. 1610, 1620-24 (codified as amended at IRC § 904).

<sup>22</sup> *Id.*; Graetz & O'Hear, note 2, at 1056 n.141.

<sup>23</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, § 1201, 100 Stat. 2085, 2520-28 (codified as amended at IRC § 904(d)). For a more detailed description of this history, see Graetz & O'Hear, note 2, at 1056 n.141.

has expressed concern with protecting the U.S. tax on U.S. source income from erosion.<sup>24</sup>

Each time the law has changed, it has introduced new challenges for tax compliance and administration. Thus, although the fundamental structure of international income taxation devised in the 1920's remains in force, the legal rules detailing the implementation of that structure today comprise a cumbersome creation of stupefying complexity. Moreover, whenever this or some other first-world nation struggles to keep its income tax law intact by responding to new ways of doing business—for example, electronic commerce, innovations in financial practices or instruments, or novel business combinations and linkages—the new domestic law often produces aftershocks abroad. The use of the check-the-box rules for entity classification by hybrid foreign entities may serve as Exhibit 1 for this point.<sup>25</sup>

Along with its complexity, the importance of the regime for taxing international income has also increased dramatically since the 1920's, even since it was last reexamined in the 1980's. And the United States, which for most of the century could be viewed simply as a capital-exporting nation, is now *both* a large capital importer and exporter. Indeed, just looking at its net position, the United States has changed from being the world's largest creditor to being one of its largest debtor nations.<sup>26</sup>

Two major developments should be emphasized. First, the gross flows of capital both from the United States abroad and from the rest of the world into the United States are very large and increasingly important to the U.S. economy.

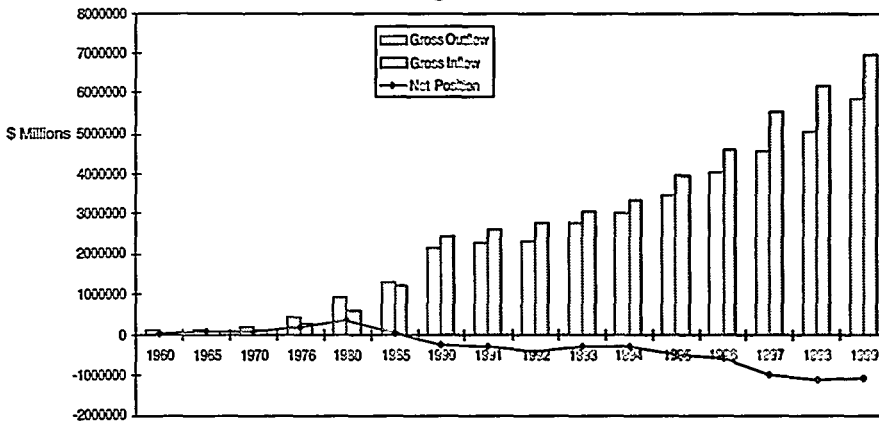
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<sup>24</sup> See text accompanying note 149 (statement of T.S. Adams).

<sup>25</sup> The check-the-box regulations allow many entities to elect whether to be treated as corporations or partnerships or to be disregarded as a branch. Reg. § 301.7701-1 to -3. The box is checked on Form 8832.

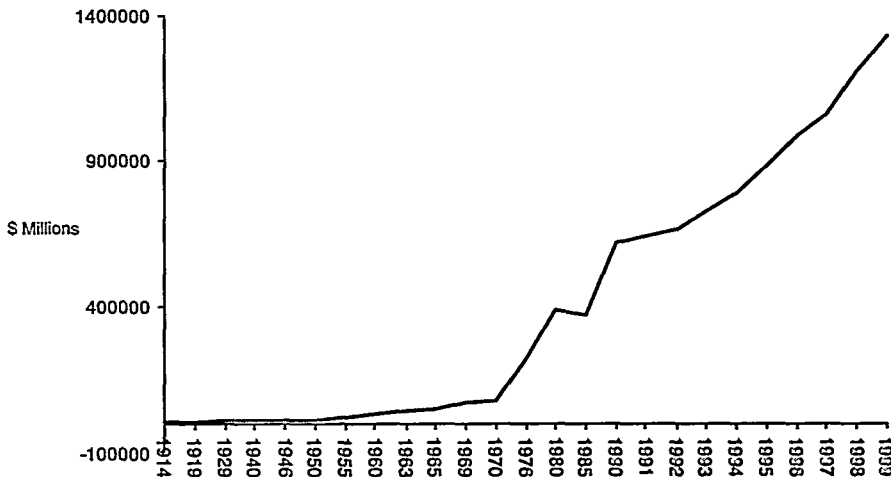
<sup>26</sup> The United States had been the world's largest debtor nation until June, 2000, when Japan took over first place, relegating the U.S. to second. See Japan Largest Debtor Nation, *The Financial Times*, June 24, 2000 at 8.

**FIGURE 1**  
**U.S.-Owned Assets Abroad, Foreign-Owned Assets, and Net Position of U.S. Using Current-Cost Method**



Source: Russell B. Scholl, *The International Investment Position of the United States at Yearend 1999*, 80 *Survey of Current Business* (July 2000); Russell B. Scholl, *The International Investment Position of the United States: Developments in 1971*, 52 *Survey of Current Business* (Oct. 1972).

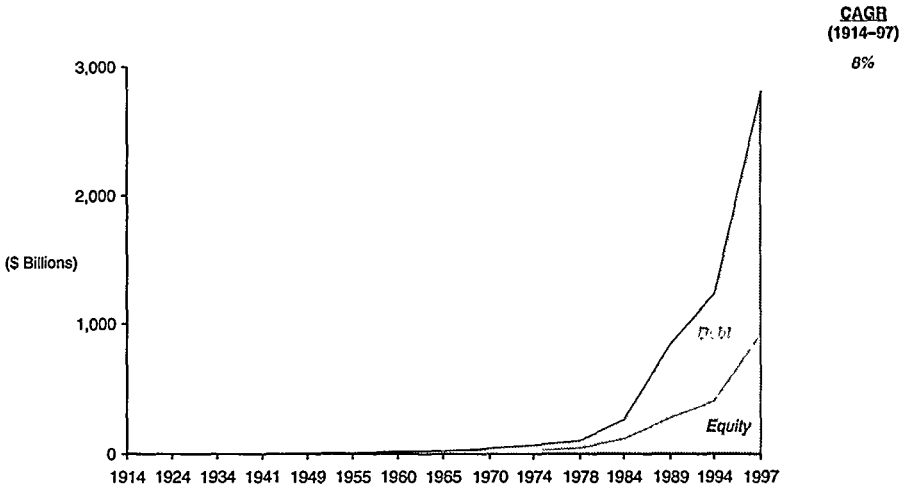
**FIGURE 2**  
**Direct Investment Outflow, 1914-1999 (Current-Cost Method)**



Source: Mira Wilkins, *The Maturing of Multinational Enterprise: American Business Abroad From 1914 to 1970* (1974); Russell B. Scholl, *The International Investment Position of the United States at Yearend 1999*, 80 *Survey of Current Business* (July 2000).

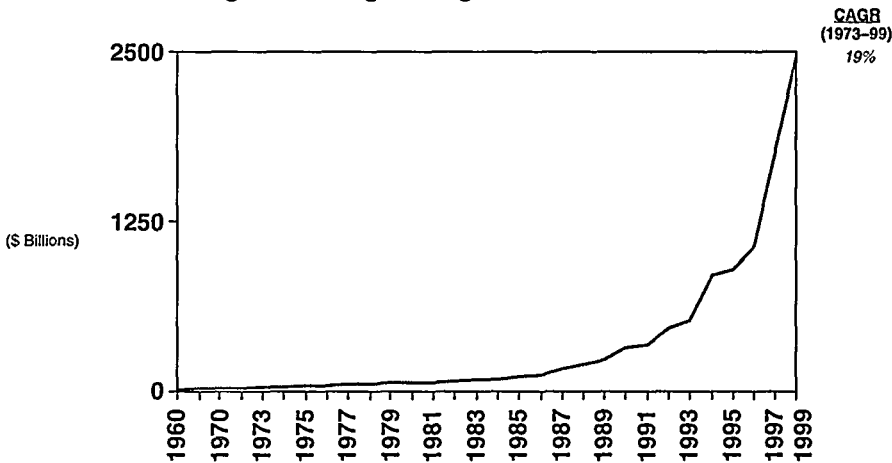
Second, the growth in cross-border portfolio investments has been stunning in recent years.

FIGURE 3  
Foreign Holdings of U.S. Long-Term Securities, 1914-1997



Source: U.S. Treasury Dep't, Foreign Portfolio Investment in the United States as of December 31, 1997.

FIGURE 4  
U.S. Holdings of Foreign Long-Term Securities, 1960-1999



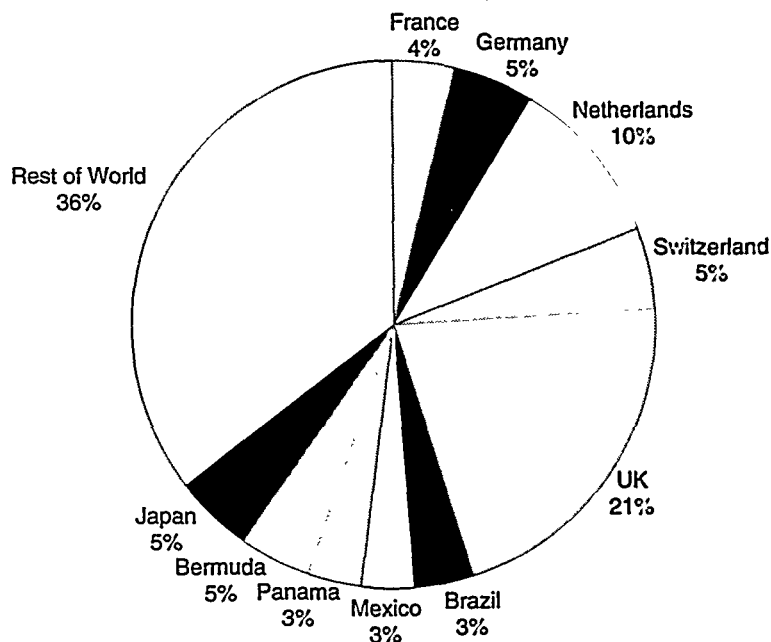
Source: Russell B. Scholl, *The International Investment Position of the United States in 1988*, 69 *Survey of Current Business* (June 1989); Christopher L. Bach, *International Transactions, Revised Estimates for 1974-1996*, 77 *Survey of Current Business* (July 1997); U.S. Treasury Dep't, *Report on U.S. Holdings of Foreign Long-Term Securities as of December 31, 1977 and December 31, 1999* (Apr. 2000).

Note: 1997 and 1999 data comes from the U.S. Treasury Report on U.S. Holdings of Foreign Long Term Securities. Earlier data is only available through the standard *Survey of Current Business* publication and revisions, and is likely underestimated.

Thus, although the founders of the system for taxing international income confronted only one important issue, the taxation of foreign

direct investments by U.S. multinationals, policymakers today must address the taxation of large inbound and outbound flows of both direct and portfolio investment. Moreover, just looking at the incoming and outgoing flows of direct investment in the figures below, it is clear that, for corporations at least, tax considerations play a significant role. Luxembourg, for example, supplies almost as much direct investment to the United States as France and Canada, and the size of direct investment from the United States to Bermuda and Panama surely is not justified by economic considerations alone. The important role played by tax considerations in business activities is not surprising, and is confirmed by more sophisticated empirical analyses.<sup>27</sup>

FIGURE 5  
U.S. Direct Investment Destinations, by Selected Nations, 1999

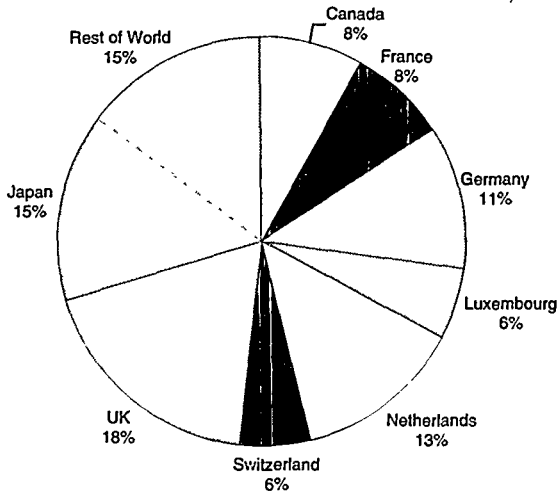


Source: Sylvia E. Bargas, Direct Investment Positions for 1999, 80 Survey of Current Business 57 (July 2000).

<sup>27</sup> See, e.g., Rosanne Altshuler, Harry Grubert & T. Scott Newlon, Has U.S. Investment Abroad Become More Sensitive to Tax Rates? (NBER Working Paper No. 6383, 1998, available at <http://papers.nber.org/papers/W6383>); Rosanne Altshuler & T. Scott Newlon, The Effect of U.S. Tax Policy on the Income Repatriation Pattern of U.S. Multinational Corporations, in Studies in International Taxation 77-115 (Alberto Giovannini, R. Glenn Hubbard & Joel Slemrod eds., 1993); Harry Grubert, Taxes and the Division of Foreign Operating Income among Royalties, Interest, Dividends and Retained Earnings, 68 J. Pub. Econ. 269-90 (1998); James R. Hines, Jr., Lessons From Behavioral Responses to International Taxation, 52 Nat'l Tax J. 305-22 (1999).



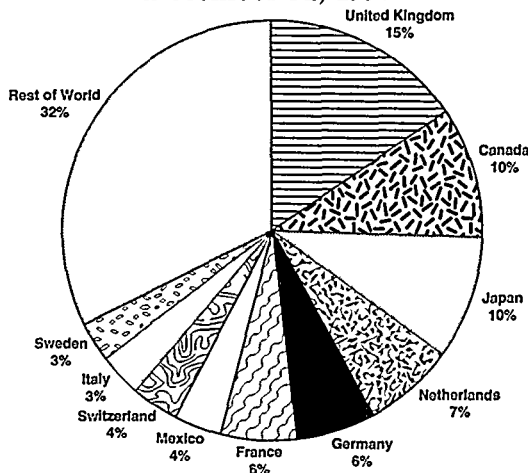
FIGURE 6  
Percentages of Total Foreign Direct Investment in the U.S., by  
Selected Nations, 1999



Source: Sylvia E. Bargas, *Direct Investment Positions for 1999*, 80 *Survey of Current Business* (July 2000).

Looking at portfolio investment, on the other hand, seems to suggest that the flow of dollars is being driven by the underlying economics.<sup>28</sup>

FIGURE 7  
U.S. Holdings of Foreign Long-Term Securities for the Top 10  
Countries of Investment and the Rest of the World, as of  
December 31, 1997



Source: U.S. Treasury Dep't, *Report on U.S. Holdings of Foreign Long-Term Securities as of December 31, 1997 and December 31, 1999* (Apr. 2000).

<sup>28</sup> See Figure 7.

Despite the age of the international income tax regime and the dramatic economic changes since it was put in place, Congress has shown little interest in ideas for fundamental restructuring or even review of the basic international income tax arrangements. Instead, the international income tax system lurches from one perceived threat to another: transfer pricing abuses yesterday, "harmful" tax competition and under-reporting of portfolio capital income today, and who knows what tomorrow. Despite the obvious strain, the wheels do not seem to be coming off, at least not yet. In fact, the international income tax system has served reasonably well; it has not proven a significant barrier to the international flows of goods, services, labor, or capital, and may even have facilitated such flows. This no doubt is why it has survived intact for so long.

Nevertheless, this is a propitious time for a fundamental reexamination of the system of international income taxation and the principles and concepts on which it is based. Recent changes in the world economy—the unprecedented movement of goods and services and of labor and capital throughout the world, the innovations in financial instruments and business combinations, the economic and political unification of Europe, the emergence of capitalism in the former Soviet Union and eastern Europe and of China as a major economic force, the advent of electronic commerce, and ongoing integration of the world's economy—demand a thoroughgoing review. Such a reexamination may conclude that today's international tax regime is the best we can do, or it may reveal opportunities for major improvements.

But we—and here by we, I mean the professional international tax community—lawyers, accountants, and economists, in the universities, private practice, and the government—are not well-positioned to conduct such a comprehensive review. We have been blinded by adherence to inadequate principles and remain wedded to outdated concepts. As a result, we have no sound basis for pronouncing our international tax policy satisfactory or unsatisfactory. Fashioning proper policy requires clear and appropriate normative bearings. Even then, it is a daunting task.

## *II. Inadequate Principles*

Discussions of the principles and goals motivating international income tax policy are perplexing to the nonspecialist. Often description of foundational principles is omitted altogether; many authors simply assume that the normative basis for international income tax rules is widely understood and enjoys universal agreement. One common shorthand, especially prevalent in the legal literature, is to begin by

announcing acceptance of the “1920’s international tax compromise” and then proceeding to describe how a modern transaction or problem might be shoehorned into that regime.<sup>29</sup>

Frequently, the normative and policy discussions of international income taxation, including not only the academic publications of both economists and lawyers, but also—and perhaps most importantly—most of the key serious government analyses containing any normative discussion, begin and end with an assumption—not an argument—that the proper goal for U.S. international tax policy is advancing worldwide economic efficiency.<sup>30</sup> Achieving such efficiency typically is said to involve two kinds of neutralities. The first is capital export neutrality (CEN), which is neutral about a resident’s choice between domestic and foreign investments providing the same pretax rates of return. CEN requires that a resident of any nation pays the same marginal rate of income taxation regardless of the nation in which she invests. CEN is not only neutral about where such investments are made but also is indifferent about which country collects the tax revenue when capital originating in one country produces income in another. Typically, economists regard CEN as essential for worldwide economic efficiency, because the location of investments would be unaffected by capital income taxes.<sup>31</sup>

Sometimes a second kind of neutrality, capital import neutrality (CIN), is supported. CIN requires that all investments in a given country pay the same marginal rate of income taxation regardless of the residence of the investor. CIN thus subjects all business activity

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<sup>29</sup> See, e.g., Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 *Tex. L. Rev.* 1301 (1996); H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the “International Tax System,”* 53 *Tax L. Rev.* 137 (2000);

<sup>30</sup> See, e.g., Joint Comm. on Tax’n, 106<sup>th</sup> Cong., *Overview of Present-Law Rules and Economic Issues in International Taxation* (Comm. Print 1999) [hereinafter *JCT Economic Issues Report*]; Joint Comm. on Tax’n, 102d Cong., *Factors Affecting the International Competitiveness of the United States* 5 (Comm. Print 1991) [hereinafter *JCT Competitiveness Report*]; David F. Bradford & U.S. Treasury Dep’t, *Blueprints for Basic Tax Reform 89-90* (2d ed. 1984) [hereinafter *Blueprints*]; *The President’s Tax Proposals to the Congress for Fairness, Growth, and Simplicity* 383 (1985) [hereinafter *Treasury II*]; Treasury Dep’t, *Selected Tax Policy Implications of Global Electronic Commerce* 19 (1996) [hereinafter *Treasury Electronic Commerce Report*]; Inland Revenue, *Double Taxation Relief For Companies: A Discussion Paper* (1999) (UK Ministry of Finance), available at <http://www.inlandrevenue.gov.uk/consult/dtrc.htm>. [hereinafter *British Green Paper*]. The U.S. Treasury study of Subpart F issued in December 2000, after this lecture was delivered but while in press, contains an elaborate argument favoring capital export neutrality as the appropriate goal of U.S. international tax policy. Treasury Dep’t., *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study* 23-54 (2000) [hereinafter *Treasury Subpart F Study*].

<sup>31</sup> The Treasury Subpart F Study, note 30, at 23-54, contains a review of the economic literature.

within a specific country to the same overall level of taxation, whether the activity is conducted by a resident or a foreigner. If CIN holds, all savers, regardless of their residence, receive the same after-tax returns. They therefore face the same prices for future versus present consumption and the allocation of savings is efficient.<sup>32</sup>

CEN usually is said to imply taxation only by the country of residence. Indeed the economic literature often suggests that if either national or worldwide economic efficiency is the goal, source countries should forgo any tax on foreign businesses operating within their borders.<sup>33</sup> But countries universally impose source-based taxes whenever there is substantial business activity by both foreign and domestic companies. Thus, CEN in practice has come to mean that if the source country imposes tax, the residence country should grant a credit for the foreign tax. To fully implement CEN, the foreign tax credit should not be limited to the residence country's tax rate; income of foreign subsidiaries should be taxed currently by the residence country, and no cross crediting of foreign taxes on income taxed differently at source should be allowed. CIN, on the other hand, is said to support taxation only by the source country with the residence country exempting foreign source income from tax.<sup>34</sup>

Thus, policy discussion of international income tax policy is now dominated by a simple matrix, where capital export neutrality and capital import neutrality generally constitute the normative universe. Implementing these policies requires respectively, worldwide taxation with a foreign tax credit or "territorial" taxation with foreign earnings exempt from tax.<sup>35</sup> In theory, CEN gives the prime claim to tax international income to the country of residence and CIN awards that right to the country of source.

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<sup>32</sup> E.g., sources cited in note 30; see also Michael Keen, *The Welfare Economics of Tax Coordination in the European Community*, 1993 *Fiscal Studies*, reprinted in Michael P. Devereux, *The Economics of Tax Policy* (1996).

<sup>33</sup> Several authors have urged that zero is the optimum tax rate on inward investment. See, e.g., Roger H. Gordon, *Taxation of Investment and Savings in a World Economy*, 76 *Am. Econ. Rev.* 1086 (1986); Joel Slemrod, *Effect of Taxation With Capital Mobility, in Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* 115 (Henry J. Aaron, Harvey Galper & Joseph A. Pechman eds., 1988).

<sup>34</sup> See, e.g., Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in *Taxation in the Global Economy* 11 (Assaf Razin & Joel Slemrod eds., 1990); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 *Cornell L. Rev.* 18, 86 (1993) (urging the United States to move from source-based income taxation to a residence-based system); Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 *Tax Notes* 581, 582-87 (Apr. 30, 1990).

<sup>35</sup> The Treasury Subpart F Study, note 30, at ix-xi, makes much of the distinction between "worldwide" and "territorial" systems.

It is by now known that it is impossible to achieve CEN and CIN simultaneously in the absence of either a worldwide government or identical income tax bases and rates in all nations.<sup>36</sup> This means that the analyst either must choose between these conflicting norms or—since both residence and source countries exercise their rights to tax income—urge some “compromise” between them. CEN enjoys the greatest normative support both in government analyses and in the academy.<sup>37</sup> This is because distortions in the location of investments are thought to be more costly than distortions in the allocation of savings. Many economists regard the choice between CEN and CIN as essentially empirical, turning on the relative elasticities of savings and investment.<sup>38</sup> Since investment is thought to be more responsive to changes in levels of taxation, a policy of CEN predominates. But the British economist Michael Keen emphasizes that “we currently know

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<sup>36</sup> See, e.g., JCT Competitiveness Report, note 30, at 5. My favorite way of making this point is in terms of an irreconcilable conflict among the following three simple principles:

*Principle 1:* People should pay equal taxes on their income regardless of the country that is the source of that income. In particular, U.S. taxpayers should be treated equally regardless of the source of their income.

*Principle 2:* All investments in the United States should face the same burden regardless of whether a U.S. person or a foreign person makes the investment. In other words, U.S. and foreign-owned investments and businesses should be treated equally.

*Principle 3:* Sovereign countries should be free to set their own tax rates and to vary them as their domestic economic situations demand.

The essential difficulty is that the first two principles can hold simultaneously only when capital income is taxed at the same rate in all countries. This requires identical tax systems, including identical tax rates, tax bases, and choices between source- and residence-based taxation. That has never happened, and it never will. Moreover, there would be no way to keep such a system in place without violating Principle 3. Bilateral treaties in which the United States gives benefits to certain foreign investors or foreign-owned businesses, in exchange for their countries giving reciprocal benefits to U.S. investors or businesses, also defeats the ability to satisfy Principles 1 and 2 simultaneously. This difficulty makes compromises between these principles inevitable.

Principle 1 states a requirement of capital export neutrality. Principle 2 states a version of capital import neutrality, although it also expresses a desire for nondiscrimination either in favor of or against foreign-owned businesses and investments.

This way of putting the dilemma was first expressed in a speech I gave on March 1, 1990, to the U.S. chapter of the International Fiscal Association, when I was serving as Treasury Deputy Assistant Secretary (Tax Policy). *International Tax Policy Makers Should Strive for Balance*, Treasury Official Says, *Daily Tax Rep. BNA*, Mar. 2, 1990, at G-7. Kenneth W. Gideon, then the Assistant Secretary Tax Policy, subsequently delivered much of the speech again, making the same point. Kenneth W. Gideon, *Dinner Speech*, 9 *Am. J. Tax Pol'y* 71, 72-74 (1991).

<sup>37</sup> See, e.g., Treasury Subpart F Study, note 30, at 42-54; Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 *U. Miami L. Rev.* 975 (1997).

<sup>38</sup> E.g., Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 *Q.J. Econ.* 793, 793-98 (1980).

almost nothing about the quantitative welfare implications of alternative tax treatments of cross-national direct investment.”<sup>39</sup>

The conversation is not unanimously in favor of CEN. In the absence of perfect competition, some economists suggest that deviations from CIN may enable high marginal cost producers to co-exist with, or even drive out low-cost producers.<sup>40</sup> Some legal scholars argue for the predominance of source-based taxation, government documents sometimes hedge their enthusiasm for CEN, and the U.S. business community consistently opposes CEN in the name of improving the “competitiveness” of U.S. multinationals abroad.<sup>41</sup> In expressing concern for the “competitiveness” of U.S.-based multinationals, business representatives sometimes seem to be suggesting that any additional U.S. tax will be passed on to consumers in the foreign market in the form of higher prices (a somewhat unlikely scenario) but more often contend that if the U.S. tax system increases their cost of capital relative to that of foreign competitors, beneficial foreign projects will be forgone and undertaken by foreign-based companies.<sup>42</sup> There is considerable debate about the welfare implications if this occurs.<sup>43</sup>

Determined opposition to CEN as the goal of U.S. international income tax policy has led the U.S. business community to vigorously oppose elimination or reduction of the ability of U.S. multinationals to postpone U.S. taxation of foreign-source income until repatriated. But it has not yet resulted in the business community’s embracing the CIN-linked policy of exemption of foreign source income.

The idea that CEN should be the lynchpin of U.S. international tax policy was first voiced by the Kennedy administration in connection with its 1962 international tax proposals, proposals that led to the

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<sup>39</sup> Keen, note 32, at 206, and authenticated therein.

<sup>40</sup> *Id.*

<sup>41</sup> E.g., Green, note 34, at 63-86 (discussing alternative approaches for enhancing the stability of international income taxation); Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income* (George Mason University, Law & Economics Working Paper No. 00-16, 2000), available at [http://papers.ssrn.com/sol3/papers.cfm?cfid=85477&cftoken=89823350&abstract\\_id=224377](http://papers.ssrn.com/sol3/papers.cfm?cfid=85477&cftoken=89823350&abstract_id=224377); National Foreign Trade Council, Inc., *The NFTC Foreign Income Project: International Tax Policy for the 21<sup>st</sup> Century*, 1999 TNT 58-17, Mar. 26, 1999, available in LEXIS, TNT File [hereinafter *NFTC Foreign Income Project*].

<sup>42</sup> Both the U.S. Treasury and the staff of the Joint Committee on Taxation simply define “competitiveness” as the ability of U.S. firms, headquartered in the United States with production facilities abroad, to compete with resident companies in the host country and multinational firms based elsewhere. Treasury Subpart F Study, note 30, at 55; JCT Competitiveness Report, note 30, at 7-8. The JCT pamphlet also discusses “trade competitiveness” and “standard of living competitiveness.”

<sup>43</sup> The Treasury Subpart F Study, note 30, at 56, for example, contends that enhancing “competitiveness” of U.S. multinationals could “cause a decrease in overall economic welfare.”

adoption of Subpart F.<sup>44</sup> Treasury since that time often has expressed the view that CEN should guide policy. A few important examples include Blueprints for Tax Reform, issued in 1976, President Reagan's tax reform proposals of 1985, the 1996 Treasury White Paper on the International Taxation of Electronic Commerce, and Treasury's Study of Subpart F, issued in December 2000.<sup>45</sup>

Congress has often refused to enact CEN-based proposals, however, and current law has come to be described routinely as a compromise between CEN and CIN.<sup>46</sup> It is, for example, now commonplace, whenever international tax issues come before the taxwriting committees of Congress, for the pamphlets of the Staff of the Joint Committee on Taxation to describe a choice or compromise between CEN and CIN as the normative framework through which international tax policy issues should be addressed.<sup>47</sup>

This is no longer just a U.S. phenomenon. The 1999 British Green Paper analyzing their foreign tax credit system and suggestions for change grounded the analysis and conclusions in a rather convoluted consideration of CEN and CIN.<sup>48</sup>

Occasionally, international tax policy analysts give a brief nod to the misnamed norm of "national neutrality," which takes a national rather than worldwide point of view. This norm seeks neutrality between the pretax return on domestic investments and the return on foreign investments after the payment of foreign taxes (which is said to represent the return on foreign investments to the capital exporting country.) In essence, this norm regards domestic investment as preferable to foreign investment because the U.S. Treasury gets to keep the revenue from taxing the income from domestic production.<sup>49</sup> National neutrality would treat foreign taxes the same as domestic costs of doing business and allow only a deduction for foreign income taxes. The AFL-CIO urged replacing the foreign tax credit with a deduction for foreign taxes in the 1970's,<sup>50</sup> and such legislation, the Burke-

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<sup>44</sup> Message from the President of the United States Relative to Our Federal Tax System, H.R. Doc. No. 87-140, at 6-8 (1961).

<sup>45</sup> Blueprints, note 30, at 89-90; Treasury II, note 30, at 383 ("The long standing position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions."); Treasury Electronic Commerce Report, note 30, at 19; JCT Economic Issues Report, note 30, at 38-57; JCT Competitiveness Report, note 30, at 5; Treasury Subpart F Study, note 30, at 23.

<sup>46</sup> E.g., NFTC Foreign Income Project, note 41, ¶ 7.

<sup>47</sup> See, e.g., JCT Economic Issues Report, note 30, at 2-4; JCT Competitiveness Report, note 30, at 5.

<sup>48</sup> British Green Paper, note 30, ¶¶ 3.6-3.25.

<sup>49</sup> Frisch, note 34, at 584-85; see also sources cited in note 30.

<sup>50</sup> C. Fred Bergsten, Thomas Horst & Theodore H. Moran, *American Multinationals and American Interests* 111-12, 174 (1978).

Hartke Bill, was introduced and debated, but Congress rejected the proposal.<sup>51</sup> Today, while the national neutrality idea often is mentioned as a potential norm, national neutrality's policy of allowing only a deduction for foreign taxes generally is discussed only in passing; it is routinely dismissed as unwise and unrealistic.<sup>52</sup>

The relatively simple normative story, which treats international income tax policy as essentially a choice between CEN and CIN, however, fails to explain the international income tax system that actually exists. As I have detailed elsewhere, neither CEN, CIN, or national neutrality played any important role in the development of the U.S. international income tax rules when they were put in place between 1918 and 1928.<sup>53</sup> And, as I have indicated, in 1962 President Kennedy presented to Congress proposals that often are described as designed to implement CEN as the cornerstone of taxation of international business income, but Congress refused to go along.<sup>54</sup> The enactment of subpart F in 1962, however, did begin the characterization of U.S. international tax policy as a compromise between CEN and CIN.

But, even though President Kennedy and Douglas Dillon, his Treasury Secretary, talked about the virtue of equalizing the treatment of income from foreign and domestic investments, it is not accurate to characterize the Kennedy Administration in 1962 as endorsing a policy of CEN—as Treasury has as recently as December 2000.<sup>55</sup> President Kennedy's proposals were not neutral between investments in developed and developing countries, offering a tax advantage to the latter.<sup>56</sup> Moreover, at the same time President Kennedy was urging neutrality between foreign and domestic investment as the guiding light for international tax policy, he also pressed Congress to enact a generous tax credit limited to business investment within the United States.<sup>57</sup> In 1962, both in the White House and Congress, encouraging domestic investment and promoting economic growth within the United States took political and economic precedence over advancing worldwide economic efficiency.

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<sup>51</sup> H.R. 62, 93d Cong. (1973); see also S. 2592, 92d Cong. (1971).

<sup>52</sup> See, e.g., Frisch, note 34 ("There are many reasons this analysis has been criticized by economists. My favorite is that it is a very shortsighted way to maximize U.S. interests. . . .").

<sup>53</sup> See Graetz & O'Hear, note 2, at 1049-53.

<sup>54</sup> See, e.g., NFTC Foreign Income Project, note 41, ¶¶ 64-121. The Treasury Subpart F Study, in contrast, (mistakenly in my view) describes the 1962 congressional action as an endorsement of capital export neutrality. Treasury Subpart F Study, note 30, at 18. ("[T]he Kennedy Administration believed that the compromise statute did not, to any significant extent, sacrifice its concerns about capital export neutrality . . . but, instead, that it sacrificed the original proposal's relative simplicity.")

<sup>55</sup> Treasury Subpart F Study, note 30, at 16-19.

<sup>56</sup> Message of the President, note 44, at 6-8.

<sup>57</sup> *Id.* at 3-6.



The narrow normative focus of the international tax literature contrasts sharply with the domestic tax policy literature, of both the academy and the government, where contentions over normative issues lie at the center of the policy debates.<sup>58</sup> In domestic tax policy, fairness in taxation tends to hold center stage. Achieving fair taxation with a minimal loss of economic efficiency or achieving a proper balance between economic efficiency and equity is routinely described as the appropriate quest for tax policy. Even in the economics literature concerning domestic tax policy, where economic efficiency takes precedence, discussion of other norms, particularly equity norms, is common.

The dominant normative perspective of international tax policy debates—limited to a choice or a compromise between CEN and CIN—both inhibits an adequate understanding of the normative underpinnings of international income tax policy and improperly limits serious consideration of alternative policies. There are three major problems with relying on worldwide economic efficiency (and thus CEN) as the

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<sup>58</sup> The consumption vs. income tax debate could serve as Exhibit 1 for this point. See, e.g., Michael J. Graetz, *The U.S. Income Tax: What It Is, How It Got That Way and Where We Go From Here*, chs. 13, 14 and sources cited therein (1999) [hereinafter *U.S. Income Tax*].

The Treasury Subpart F Study is a curious instance of a reliance on CEN as a basis for making international tax policy. At the outset, that study lists the following multiple goals for U.S. international tax policy: “(1) Meet the revenue needs determined by Congress in an adequate and fair manner; (2) Minimize compliance and administrative burdens; (3) Minimize distortion of investment decisions through tax considerations; (4) Conform with international norms, to the extent possible; and (5) Avoid placing an undue burden on the competitive position of our nationals.” Treasury Subpart F Study, note , at viii (citations omitted). These criteria also are discussed as grounds for recommendations for options for change. *Id.* at 82-95. But it is clear that Treasury’s recommendations are fundamentally intended to further a policy of capital export neutrality. Equity, for example, is treated as identical to capital export neutrality, requiring that “the tax burden should be imposed equally on all income, without regard to its source” with Treasury noting that a “more detailed analysis of equity concepts in international taxation is beyond the scope of this study.” *Id.* at 82-83 n.3. “Competitiveness” is dismissed as having only a little to do with tax considerations, as having no “reliable basis” for assessment, and as being in conflict with other tax policy goals, especially economic efficiency. *Id.* at 55-61, 86. Relatively little discernable weight is given in the recommendations to the goal of simplicity, although option 1, ending deferral of foreign source income and consolidating the income of foreign corporations is claimed to be simpler than the current regime. *Id.* at 90. As for conformity with international norms, Treasury concedes that its first option for change, subjecting all foreign income, including active business income of foreign subsidiaries to current U.S. income taxation, departs from international norms and practice: “[N]o major U.S. trading partners . . . have completely eliminated deferral. Ending deferral would thus set the U.S. regime apart from the regimes of its major trading partners.” *Id.* at 90. Martin Sullivan describes the study as “reaffirm[ing] that capital export neutrality is still the guiding principle of the U.S. government in the formulation of international tax policy” and calls the report a “shrine built to the gods of capital export neutrality.” Martin A. Sullivan, *Treasury Study Justifies Easing Rules on Hybrid Entities*, 90 *Tax Notes* 156, 156-57 (Jan. 8, 2001).

foundation for international income tax policy. First, it seeks to improve worldwide rather than national well-being. Second, the idea of economic efficiency is too limited. Third, focusing on economic efficiency as the guiding light excludes other important values.

#### *A. Rejecting a Worldwide Perspective*

We naturally give primacy to our own citizens in setting national policy, including tax policy. This is both a matter of historical circumstance—some would say accident—and, more importantly, of political organization. In our democratic society, we the people have organized a national government to protect our safety and security, to maintain our liberty, and to promote the well-being of our citizens and residents. By assigning the task of improving the lot of the nation's citizens, including those who are least advantaged, to our government, we have made both economic growth and redistribution of income or wealth a matter of national, rather than worldwide, concern. Likewise, the education of the nation's children and protection of our citizens from economic losses due to ill health, disability, or unemployment, along with ensuring economic security during retirement, are core functions of our national and state governments. Throughout the world, the substance of these protections varies from country to country, depending in democracies like ours ultimately on what the voters say.

National governments assign tax burdens and provide benefits. No function is more at the core of government than its system of taxation. It is no accident that the economic and political unification of Europe has stumbled over issues of taxation. Taxes are imposed by national governments (or their subdivisions); the power to tax is rarely delegated to multinational organizations.

Since World War II, international law has become more protective of fundamental human rights of people throughout the world, even when it limits a nation's internal sovereignty. But I have found no one who argues for grounding U.S. international income tax policy on worldwide economic efficiency (or CEN) who also proposes assessing the fairness of U.S. income tax policy on a worldwide basis. More importantly, no nation has ever made a genuine commitment to worldwide equity.<sup>59</sup> We often take quite seriously our obligations to foreigners and show respect for their rights, but we regard our obliga-

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<sup>59</sup> For a good theoretical discussion of nations' obligations of international redistribution, see, e.g., Charles Beitz, *Political Theory and International Relations* (1979).

tion for the well-being of our fellow citizens as more pressing than for people in need elsewhere in the world.<sup>60</sup>

Why in formulating international tax policy, should we evaluate the distribution of tax burdens (and government benefits, including transfers) within national borders, but be indifferent about where enhanced economic output occurs, whom it benefits, and what national treasury obtains the tax revenues? Why does our higher obligation to U.S. citizens and legal residents not also apply to promoting economic output and improving economic well-being?<sup>61</sup>

When we are talking, as now, about making policy, we cannot ignore history or culture. The freedom and independence, as well as the economic welfare, of people varies from nation to nation. This simply is fact. In the absence of a world government, this is how it must be.

Moreover, although I cannot develop the argument here, I believe this is how it should be. Notwithstanding the utopian philosophical ambitions for worldwide harmony implied by those who urge taking a "one-world view," I agree with those political philosophers who insist that a world government—a political entity exercising the powers now held by national governments—would likely live in a constant state of civil unrest, as various populations and regions contest for freedom, autonomy, and self-government. A "world government" would likely become a dictatorship.<sup>62</sup>

National boundaries often may be arbitrary and no doubt they will continue to shift as they have over time, but they demarcate the political organizations responsible for the well-being of the people within

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<sup>60</sup> For a nuanced discussion of this position, see e.g., John Rawls, *The Law of Peoples* (1999).

<sup>61</sup> Some have suggested that claims by U.S. policymakers favoring worldwide economic efficiency is merely strategic behavior to obtain cooperation from other nations, supplying what game theorists label a "focal point." See generally Eric Rasmusen, *Games and Information* 28-29 (2d ed. 1994) (describing focal points). A similar idea is advanced in a different context by Jack L. Goldsmith & Eric A. Posner, *Moral and Legal Rhetoric in International Relations: A Rational Choice Perspective* (manuscript, Nov., 2000), available at [http://papers.ssrn.com/paper.taf?abstract\\_id=250042](http://papers.ssrn.com/paper.taf?abstract_id=250042). Since I am concerned here with the normative basis of U.S. international tax policy, rather than strategic behavior to implement U.S. policy, I ignore this potential strategic function of the worldwide efficiency norm. But see Robert Gilpin, *War and Change in World Politics* 7, 211-30 (1981) (describing international relations as a "recurring struggle for wealth and power . . . in a state of anarchy").

<sup>62</sup> See, e.g., Rawls, note 60, at 36 (Rawls discussion of this view, based on similar views set forth by Immanuel Kant in *Perpetual Peace* (Liberal Arts Press 1948) (1795), by David Hume in *Of the Balance of Power*, in *Political Essays* (K. Haakonssen ed., 1994), and by F. H. Hinsley in *Power and the Pursuit of Peace* 162 (1996) (discussing the ideas of Montesquieu, Voltaire, and Gibbon regarding universal monarchy)). This, of course, is not to suggest that there are not important roles for international organizations such as the United Nations, the World Trade Organization, and the OECD, to name the three most relevant to international tax policy.

their territory. The people of a nation often share a common language and common political antecedents. In democratic societies, national boundaries determine the jurisdiction of the people's representatives and thereby define the scope of political (and often social) operation.

More than a century ago, John Stuart Mill used the idea of nationality to describe a people's culture, describing a nationality as:

[a] portion of mankind united among themselves by common sympathies . . . which make them cooperate with each other more willingly than with other people, desire to be under the same government, and desire that it should be government by themselves, or a portion of themselves, exclusively.<sup>63</sup>

It is a mistake to believe that the globalization of markets for goods, services, and capital signals the demise of national identity or national politics. Economic globalization does not imply global government. Modern developments, such as mobile capital and e-commerce, may limit the ability of any sovereign state to singlehandedly control its economic destiny, and therefore may usher in a new era of multinational cooperation but they do not mean the end of nationalism.

Each country's history and culture, in conjunction with the ongoing goals and priorities of its people, will continue to shape the lives of its residents and citizens. U.S. families and U.S. voters, along with those of other nations, may well travel more frequently transnationally and are surely spending more time cruising the boundaryless information highway. And the paychecks and job security of many Americans now depend, at least in part, on economic circumstances outside our nation's borders. But most of the important economic facts of our lives involving government action—the education of our children, our families' protections against disability and ill health, the economic security of our retired parents, our tax liabilities, and our government benefits—are still determined by national policies and national politics.

Tax policy decisions, including decisions regarding a country's tax treatment of international income, should be, and inevitably are, decided based on a nation's capacity, culture, economics, politics, and history. In democracies, such decisions are determined by the votes of the nation's citizens and their representatives. Taxation without representation is still tyranny.

Unfortunately, international income tax policy does not enjoy a harmony between national and worldwide interests similar to interna-

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<sup>63</sup> John Stuart Mill, *Considerations* (1862), quoted in Rawls, note 60, at 23 n.17.

tional trade. The consensus of economists insists that a policy of free trade not only improves worldwide efficiency but also improves the economic efficiency of each nation that reduces trade barriers unilaterally.<sup>64</sup> But many economists claim that the benefits of free trade are not replicated by free flows of capital, and no such confluence between national and worldwide gains has been claimed for international tax policy.<sup>65</sup>

International income tax policy guided by worldwide economic efficiency is concerned with increasing economic output and reducing deadweight loss, wherever it occurs. The goal of worldwide economic efficiency tells tax policymakers—the legislators who enact the law and the representatives of the President who negotiate tax treaties—to seek improvements in the amount and/or allocation of world capital, regardless of who benefits and of the revenue consequences to the U.S. treasury. Worldwide efficiency tells a U.S. policymaker to respond with equal vigor to avoidance of a foreign country's taxes and avoidance of U.S. taxes. This criterion is indifferent both about whose well-being is increased and which nation's treasury collects the income taxes that are assessed. If a choice must be made between benefitting the nation's own citizens and residents or benefitting people elsewhere, the principle of worldwide economic efficiency urges policymakers to embrace the larger benefit without regard to where it occurs or who benefits. Worldwide economic efficiency does not heed love of country.

But why should a U.S. President or members of Congress put aside "narrow" national interests to fashion U.S. tax policy in a manner apathetic to whether benefits flow to U.S. citizens or citizens of other nations? Why should they not care whether taxes flow into the U.S. treasury or to some foreign nation? Paying attention to the distribution of the burdens and benefits of taxation among U.S. families and to the revenue consequences of the tax law is a fundamental obligation of both legislators and the executive branch in our democracy.

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<sup>64</sup> The classic statement of this is David Ricardo, *The Principles of Political Economy and Taxation* 81 (J.M. Dent & Sons Ltd. 1911) (1817). See also Elhanan Helpman, *The Structure of Foreign Trade*, *J. Econ. Persp.*, Spring 1999, at 121 (discussing David Ricardo's theories and recent developments).

<sup>65</sup> See, e.g., Jagdish Bhagwati, *The Capital Myth: The Difference Between Trade in Widgets and Dollars*, *Foreign Aff.*, May-June 1998, at 7 (distinguishing the case for free trade and for liberal capital flows); see also Joel B. Slemrod, *Effect of Taxation With International Capital Mobility*, in *Uneasy Compromise*, note 19, at 115, 121-22; Joel B. Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 *Int'l Tax & Pub. Fin.* 471 (1995) (comparing international tax policy to international trade policy). As Peggy Musgrave has pointed out, foreign investment involves transfers abroad of productive resources whereas free trade involves the most productive use of existing resources. (Communication to the author on file.)

Let me not be misunderstood. By urging that this nation's international tax policy be fashioned to advance the interests of the American people, I am not calling for either American imperialism or American isolationism. Nor am I suggesting any retreat from this nation's engagement in the world economy or from political cooperation with other nations and peoples. To the contrary, I am convinced that longstanding U.S. leadership and participation on matters of international tax policy, beginning in the period following World War I, along with our participation in multilateral restructurings of international monetary and trade relationships beginning after World War II and continuing until today, have well served—and will continue to serve—the interests of the American people.

Advocates of worldwide economic efficiency as the guiding principle of U.S. international income tax policy sometimes point to the shortcomings of “national neutrality”—a policy allowing only a deduction for foreign income taxes—as a reason for eschewing a national point of view in fashioning international tax policy.<sup>66</sup> But the inadequacies of that policy do not support worldwide economic efficiency as the proper goal. They serve instead simply to demonstrate that any nation must take the responses of foreign governments into account in making international tax policy, and as a reminder that cooperative multilateral policymaking may benefit both U.S. citizens and foreigners. National neutrality is an example of a policy that may advance national self-interest in the short term but prove self-defeating over the long run.

In some circumstances, domestic investment may be more beneficial to Americans' well-being than foreign investment.<sup>67</sup> At other times, at least for some categories of investment, the converse may be true.<sup>68</sup> And pursuing a policy of capital export neutrality sometimes may best serve the interests of U.S. citizens and residents.<sup>69</sup> But

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<sup>66</sup> See generally Frisch, note 34, at 583-84; Treasury Subpart F Study, note 30, at 36-37; see also note 51.

<sup>67</sup> Indeed, although President Kennedy's tax proposals of 1962 are widely credited with ushering in an era when CEN formed the linchpin of U.S. international tax policy, see, e.g., Treasury Subpart F Study, note 30, at 16-19, President Kennedy concluded that national policy should favor domestic investments through a combination of neutrality between domestic and foreign income generally and an investment tax credit limited to domestic investments. President's Tax Message, note 44.

<sup>68</sup> The period following World War II is the most obvious instance. The Kennedy Administration, in urging repeal in 1962 of postponement of U.S. tax until the income of foreign subsidiaries is repatriated, determined that promoting private investment in Europe and Japan and other developed countries was no longer appropriate. President's Tax Message, note 44, at 6-7. Congress did not enact this recommendation.

<sup>69</sup> The Treasury Subpart F Study asserts, without offering any independent evidence, that national welfare always demands taxation of outward investment at a rate at least as high as domestic investment. Treasury Subpart F Study, note 30, at 41-42. This conclusion

which of these claims is true is an empirical question from a national perspective, a question that may depend on a host of economic, political, and social conditions that vary from time to time. Such empirical claims are very different from the contention that pursuing worldwide economic efficiency is the appropriate principle for formulating U.S. international income tax policy. Making tax policy choices, including international tax policy decisions, routinely requires policymakers to select among competing and controversial empirical claims. Needless to say, the empirical claims about the consequences of alternative international tax policies are often controversial.

### *B. Too Narrow a View of Economic Efficiency*

In denying that a worldwide perspective is the proper lens for U.S. international income tax policy, I am not rejecting an important role for considerations of economic efficiency in formulating that policy. But I believe the proper function of economic efficiency in this context is to ask—from the national perspective—what international income tax rules will enhance Americans' standard of living, now and in future generations, for example, by promoting economic growth in the United States.<sup>70</sup> As with domestic tax policy, the proper question is about the effects of international tax rules on the economic well-being, the welfare, of U.S. citizens and residents.

All taxes have efficiency costs; they change incentives to engage in various activities and affect the allocation of resources. If economic efficiency were the sole goal of tax policy, we would see only per capita taxes, head taxes. Margaret Thatcher tried a little experiment in the United Kingdom along these lines that proved a political disaster.<sup>71</sup>

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starts from the premise that "national neutrality"—allowing only a deduction for foreign taxes—maximizes national welfare, followed by criticisms of articles in the economics literature that suggest that under some circumstances it would be in the national interest to favor foreign investments. *Id.* at 36-41.

<sup>70</sup> This way of putting the economic efficiency question is somewhat different from the way it is usually put by economists. Economists typically, for example, place greater emphasis on individual choice. If economic output were to be increased by a policy to encourage greater savings, an economist would measure the gain in welfare by reducing the increase in output by a measure of the sacrifice by individuals due to the increased savings. See, e.g., Treasury Subpart F Study, note 30, at 25 n.3. This distinction is not important to the point I am making here. Economists also typically measure economic efficiency with reference to a world without taxes. See, e.g., *id.* at 27. I regard this as an inapt comparison since a world without taxes is a world without government, a world without laws or law enforcement, hardly a measuring rod for an economically efficient world.

<sup>71</sup> See, e.g., Peter Smith, *Lessons From the British Poll Tax Disaster*, 44 *Nat'l Tax J.* 421 (1991); Eric M. Zolt, *Prospects for Fundamental Tax Reform: United States vs. Japan*, 83 *Tax Notes* 903, 905 (May 10, 1999) ("[O]ne could design a tax system that imposes a head tax on each individual over 18 years old. While a head tax may strike some as fair, the fall

Taxes on wages or consumption are more realistic alternatives to the income tax. Economists by now have reached a strong consensus that the economically efficient tax rate on income from capital is zero, a level of taxation associated with wage or consumption taxes, but not income taxes. Moreover, the international aspects of wage or consumption taxation are far easier to solve than those of income taxation. Wage taxes are allocated to the nation where the work occurs. The inefficiency that causes, since different levels of taxation may distort people's choices about where to work or live, has been widely accepted on the ground that labor is rather immobile, although that may be changing, especially within Europe. Likewise, by agreeing multilaterally to impose "indirect" consumption taxes on a destination basis, and allocating consumption tax revenues to the nation where consumption occurs, nations now routinely tax consumption at varying rates without distorting private decisions about where to invest or locate productive activity.<sup>72</sup>

If international tax policy were intended solely to further worldwide economic efficiency, we would replace our income tax with a wage or consumption tax and press other countries to substitute wage or consumption taxes for their income taxes. For example, instead of refusing to credit Bolivia's cash flow business tax in the 1990's,<sup>73</sup> we would have embraced it. If we really believed the widespread claims that an international "race to the bottom" would soon (or even ultimately) drive taxes on income from capital toward zero, from the perspective of economic efficiency, we would applaud rather than lament such a development. (It certainly would not be labeled "harmful tax competition."<sup>74</sup>) But our foreign tax credit rules instead stimulate other nations to adopt taxes on income, whether or not their own notions of fairness or of the appropriate trade-off between fairness and efficiency call for income taxation at all. Notwithstanding the advantages in terms of economic efficiency of consumption and wage taxes over income taxes, I assume for purposes of this analysis that the United States (and its major trading partners) will continue to rely on income taxes as a major source of revenue (essentially for reasons of fairness, as discussed in the next Section).

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of Margaret Thatcher's government regarding replacing a property tax with a per person 'community charge' illustrates the political costs of misreading what the public considers fair.")

<sup>72</sup> The growth of e-commerce and related developments, however, may be causing new problems for the international allocation and collection of consumption taxes. See Section II.

<sup>73</sup> Charles E. McLure, Jr. & George Zodrow, *Credibility Concerns Doom Bolivian Flat Tax*, 12 *Tax Notes Int'l* 825, 829 (Mar. 11, 1996).

<sup>74</sup> OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998).



The foreign tax credit is intended to collect U.S. income taxes when other countries do not impose such taxes (at a rate roughly comparable to our own), both because we think fairness demands it and to stem the outflow of capital to other countries that we are concerned otherwise might occur. The limitation on foreign tax credits is intended to protect the ability of the United States to collect taxes on U.S. source income.

As I have indicated, when evaluating these rules (or other international income tax provisions), economists today seldom ask how these rules affect the economic welfare of U.S. citizens or residents.<sup>75</sup> Instead, they generally accept worldwide economic efficiency as the operative norm, and generally conclude that the United States should follow a policy of capital export neutrality. It is worth reviewing how the economics literature came to regard CEN as the appropriate efficiency-enhancing norm.

The seminal analyses of the efficiency aspects of foreign investments by U.S. persons were published in 1963 and 1969 by Peggy Musgrave.<sup>76</sup> The economics literature since has been greatly influenced by her work.<sup>77</sup> Musgrave examined only outbound investment from both a theoretical and empirical perspective and concluded that following a policy of capital export neutrality would maximize worldwide welfare.<sup>78</sup> She also concluded that a policy of allowing only a deduction for foreign income taxes, which she labeled “national neutrality,” would maximize the national welfare of the capital-exporting nation.<sup>79</sup> Importantly, although there have been numerous applications and extensions of Musgrave’s work, there has been no comprehensive reexamination of these issues—for example, to assess whether Musgrave’s proposed policy of national neutrality would have well-

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<sup>75</sup> There are exceptions. See, e.g., Michael P. Devereux & R. Glenn Hubbard, *Taxing Multinationals* (NBER Working Paper No. 7920, 2000), available at <http://papers.nber.org/papers/W7920> (contending that, in some circumstances, national welfare may be maximized by a foreign tax credit coupled with a policy of deferral); Martin Feldstein, *Taxes, Leverage and the National Return on Outbound Foreign Direct Investment* (NBER Working Paper No. 4689, 1994), available at <http://papers.nber.org/papers/W4689> (contending that the United States might be better off taxing foreign income at a lower rate than domestic income). But see Treasury Subpart F Study, note 30, at 36-41 (criticizing this literature).

<sup>76</sup> Peggy B. Musgrave, *Taxation of Foreign Investment Income: An Economic Analysis* (1963) [hereinafter *Economic Analysis*]; Peggy B. Musgrave, *United States Taxation of Foreign Investment Income* (1969) [hereinafter *U.S. Taxation*].

<sup>77</sup> For a review of this literature, see Donald J. Rousslang, *Deferral and the Optimal Taxation of International Investment Income*, 53 *Nat'l Tax J.* 589 (2000).

<sup>78</sup> See generally Musgrave, *U.S. Taxation*, note 76.

<sup>79</sup> *Id.*

served or would now well-serve the interests of the United States—in the 30 years since her work was first published.<sup>80</sup>

Musgrave's analysis was quite straightforward. From a worldwide perspective, she asked what international income tax policies of capital-exporting nations would maximize the sum of domestic and foreign returns on investments and domestic and foreign taxes—the sum of pretax returns—without regard to where in the world returns occur or taxes are collected.<sup>81</sup> From the perspective of worldwide economic efficiency, the best policy is one that has as few efficiency costs as possible. A tax provision is regarded as inefficient whenever the worldwide allocation of investment capital—its location—is different than it would be in the absence of taxes.<sup>82</sup> As noted earlier, taking a worldwide efficiency perspective, CEN generally is thought to dominate CIN because the location of investments is thought to be more sensitive to tax-induced differences in rates of return than the quantity of savings.<sup>83</sup> Avoiding locational distortions of investment therefore is regarded as the most efficient policy.

Subsequent empirical work has tended to support Musgrave's conclusions in this regard, although at least one important analysis suggests that a combination of CEN and CIN will maximize worldwide efficiency.<sup>84</sup> Likewise, recent empirical work has confirmed that loca-

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<sup>80</sup> See, e.g., James R. Hines, Jr., *The Case Against Deferral: A Deferral Reconsideration*, 52 Nat'l Tax J. 385, 402 (1999) [hereinafter *Reconsideration*](calling for such work). Some may regard Rousslang, note 77, as such an effort but it essentially is a critical review of the prior literature, virtually all of which also is cited by Hines. Rousslang's analysis is repeated in the Treasury Subpart F Study, which also reviews and criticizes the extant economic literature assessing international tax policy from the perspective of national welfare. Treasury Subpart F Study, note 30, at 23-54. This Treasury Study concludes that "Musgrave's results have stood the test of time and still appear to provide the best guide for determining appropriate tax policy." *Id.* at 25. There are, however, reasons to be concerned with this review. For example, some economic studies are criticized for their failure to consider alternative taxes that might "optimize" policy, *id.* at 31, 32, 40, but a paper by Treasury economists James Mackie and Donald Rousslang is praised for analyzing "the more realistic case . . . in which tax authorities are unable to impose optimal taxes on the other types of income. . . ." *Id.* at 37 (emphasis added).

<sup>81</sup> See generally Musgrave, *Economic Analysis*, note 76; Musgrave, *U.S. Taxation*, note 76.

<sup>82</sup> In this regard, Musgrave's analysis suffers from the general difficulty of using a world without taxes as a baseline since a market economy simply cannot function in the absence of government institutions, which must be financed through taxation. But, in this instance, investors seeking the highest after-tax rates of return will locate investments where the pretax rates of returns are highest if all investment income is taxed identically. Of course, variations in tax rates on investment income among countries are commonplace.

<sup>83</sup> Musgrave originally avoided this comparison by assuming that the volume of savings is not affected at all by changes in the rate of return. See Rousslang, note 77, at 590-91.

<sup>84</sup> Horst, note 38; see also Rousslang, note 59, at 591-93 (reviewing the subsequent literature) Much of the subsequent economic literature either assumes or urges that income taxes are not levied by the source country. See, e.g., Rousslang, note 77; see also Treasury Subpart F Study, note 30, at 30-31 (criticizing Horst's conclusions).

tional decisions are sensitive to tax rates, although much of this work considers choices among foreign locations once the decision to invest abroad has been taken.<sup>85</sup>

When she shifts to a national perspective—which she unfortunately labels “national neutrality”—Musgrave treats returns earned both here and abroad on investments by U.S. persons and corporations as increasing the welfare of the American people, along with taxes paid to the U.S. government.<sup>86</sup> In contrast, taxes paid to a foreign government are simply a cost from the U.S. perspective.<sup>87</sup> This means that maximum benefits accrue to the United States when pretax returns on domestic investments are equal to after-tax returns on foreign investments, implying a policy of allowing only a deduction for foreign taxes.<sup>88</sup>

The most troubling aspect of Musgrave’s conclusion in this regard is that, given the levels of taxes prevalent throughout the world since World War I, allowing only a deduction for foreign taxes likely would have resulted in little or no U.S. investment abroad. Surely there would have been little or no direct investment in the OECD countries where the bulk of outbound U.S. investment now resides. In many instances, including most of Europe, Canada, and Japan, the combined tax rate on foreign investments by U.S. companies would approach 100% (taking into account both corporate and individual-level income taxes) if only a deduction were allowed for foreign taxes. An empirical test of whether the American people would be better off today without the investments made abroad during the past 82 years (since the enactment of the foreign tax credit) by U.S. multinationals is, of course, not possible, but I find it very hard to believe that we would be. Nevertheless, Musgrave’s analysis has dominated the international income tax policy literature for more than three decades.

Despite their widespread acceptance by public finance economists and many government analyses of international tax policy, there are a number of reasons today to question Peggy Musgrave’s conclusions.<sup>89</sup> Let me offer a few observations that, for me at least, raise serious questions about the ongoing validity of some of Musgrave’s conclusions, particularly her conclusions about the appropriate U.S. international income tax policy to advance our national well-being.

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<sup>85</sup> See text accompanying note 82.

<sup>86</sup> Musgrave, U.S. Taxation, note 76, at 134.

<sup>87</sup> *Id.*

<sup>88</sup> *Id.* at 134, 153-54.

<sup>89</sup> A comprehensive analysis of these issues in the current context to reexamine Musgrave’s conclusions, especially with regard to enhancing national well-being, is overdue. Such an effort, however, is beyond the scope of this endeavor.

First, Musgrave's analysis was done in the 1960's, a time when economists had great faith in the power of domestic fiscal (and monetary) policy to enhance the economic conditions of U.S. citizens. Full employment in the United States, for example, was thought to be achievable simply by fine-tuning fiscal policy. Needless to say, if this were true, we would be far less dependent than we are on worldwide economic conditions generally (and on savings and investment flows from abroad). Since the time of Musgrave's work, governments, including the U.S. government (beginning with the oil shocks of the late 1970's), often have found it difficult to achieve and maintain full employment. Today, both the citizenry and the economics profession are far less confident of the ability of the U.S. President and Congress to obtain beneficial economic results for the American people.<sup>90</sup>

Second, Musgrave assumes a first-best world, one where markets are perfectly competitive and governments are well-behaved.<sup>91</sup> This means, for example, that there are no economies of scale or scope to be achieved by U.S. corporations through investments abroad, an assumption that eliminates one of the major reasons identified by international business analysts for foreign investments of multinational corporations.<sup>92</sup> To take but one example, economies of scale commonly occur when the benefits of successful research and development, patents, and business processes can be exploited worldwide rather than just domestically. Licensing or sharing such knowledge with unrelated foreign third parties may not be a realistic alternative. Some observers have also suggested that the firms principally engaged in foreign direct investment may be operating in an "oligopolistic environment."<sup>93</sup> Likewise, there are no externalities in Musgrave's analysis, such as those that have been widely urged for research and development expenditures undertaken by multinational corporations and by some observers for headquarters operations generally.<sup>94</sup> Musgrave also fails to take into account any potential political benefits to

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<sup>90</sup> Nevertheless, for example, the Treasury Subpart F Study is often critical of economic studies that fail to assume governments can readily adjust other tax policies to make residents better off.

<sup>91</sup> Musgrave, U.S. Taxation, note 76, at 24.

<sup>92</sup> See, e.g., John H. Dunning, *Multinational Enterprises and the Global Economy* 75-86 (1993).

<sup>93</sup> *Id.* at 437-39, 565.

<sup>94</sup> Gary C. Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* 8-17, 77-94, 131-70 (1992). Of course, if stimulation of domestic research and development expenditures were simply the public policy goal, a variety of strategies for subsidizing such activities exist. The income tax, for example, currently provides a tax credit for such expenses and allows them to be expensed currently (IRC § 174); see also Treasury Subpart F Study, note 30, at 39 (concluding that cutting taxes on domestic corporate investment also would favor R&D expenditures).

the United States that have resulted (especially in the years following World War II) and may result from some foreign direct investments.

Musgrave also ignores the fact that the tax policies of government may not be optimal. For example, when she was writing (and at certain other times), the United States provided a generous tax credit available only for investment in equipment used in the United States.<sup>95</sup> Depreciation allowances also often contain advantages for domestic investments.<sup>96</sup> Elsewhere in the world, the rules for dividend relief in schemes for integration of corporate and shareholder income taxes have tended to favor domestic investments.<sup>97</sup>

Musgrave also ignores the practical inability to preclude cross-crediting of foreign taxes, cross-crediting that has always occurred in the U.S. system whether a per-country, overall, or basket method of calculating the foreign tax credit was in effect.<sup>98</sup> Our own history, along with the experience of other nations, such as the United Kingdom, which in practice permits considerable cross-crediting despite its claim to have an item-by-item method of limiting the foreign tax credit, demonstrates that a significant amount of cross-crediting is unavoidable as a practical matter.<sup>99</sup> The ability to aggregate or cross-credit foreign taxes imposed at different rates inevitably affects tax incentives for locating investments.

The key point here is that Musgrave is examining a hypothetical first-best world, not the second- or third-best one we live in. This is common practice in the economics profession, but it suggests caution in accepting her policy conclusions.

Third, Musgrave assumes that a dollar of foreign investment is a dollar of domestic investment lost; in other words, that foreign investment substitutes for domestic investment dollar for dollar.<sup>100</sup> The function of tax policy under such circumstances is simply to affect the allocation of a fixed supply of capital between domestic and foreign investments. This treatment may be reasonable for portfolio investment, which is far more volatile than direct investment and which, because of its liquidity, can readily move in response to changes in rates of return (although the supply of portfolio investment may be

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<sup>95</sup> IRC § 46 (before amendment in 1986).

<sup>96</sup> IRC § 168(g)(1)(A), (B), (h).

<sup>97</sup> See generally Michael J. Graetz & Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxes: An Introduction to The Issues*, in *Treasury Dep't & ALI, Integration of the U.S. Corporate and Individual Income Taxes 3* (1998). In such circumstances, if the policy goal is neutrality for foreign and domestic investments, it may be appropriate to provide some offsetting advantage to foreign investments.

<sup>98</sup> See Graetz & O'Hear, note 2, at 1055 n.138; text accompanying note notes 17-23.

<sup>99</sup> See, e.g., *British Green Paper*, note 30.

<sup>100</sup> Musgrave, *U.S. Taxation*, note 76, at 30, 55.

affected by international tax policy.)<sup>101</sup> But there is considerable evidence that much foreign direct investment by U.S. multinationals is complementary to domestic investment rather than a substitute for it.<sup>102</sup> John Dunning, for example, insists that “increasingly, outward and inward investment are not in competition with one another.”<sup>103</sup> Musgrave, in contrast, assumes that exports are perfect substitutes for foreign investments.<sup>104</sup>

There are, however, many instances where obtaining market share abroad through exports is not possible due, for example, to tariff and nontariff barriers, and foreign direct investment is the only viable option. By capturing foreign markets more effectively than could be done through exports, foreign investment may help provide companies with revenues to finance additional domestic and foreign investments. Likewise, much resource-seeking foreign direct investment, for oil, food stuffs and minerals, for example, is often complementary to domestic investment. Some analysts have suggested that beneficial treatment of foreign income may be appropriate whenever foreign investment is complementary to domestic investment or to desirable domestic activities.<sup>105</sup>

In addition, a number of commentators have noted that the U.S. policy of not taxing foreign earnings until they are repatriated creates an incentive for U.S. multinationals to undercapitalize their foreign subsidiaries.<sup>106</sup> This reduces the effect of foreign investment displacing domestic investment.

Fourth, Musgrave entirely ignores individual-level taxes on both foreign and domestic investments, probably on the assumption that they will have an equal impact on both. But the international tax economist James Hines, has found that, for U.S. multinationals, one dollar of reported foreign profitability is associated with the same level of dividend payments to common shareholders as three dollars

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<sup>101</sup> On direct investment, see UN Report, note 9, at 141-53. On portfolio investment, see also Rousslang, note 77, at 594.

<sup>102</sup> See UN Report, note 9, at 152-53; Dunning, note 92, at 568-70; Hines, *Reconsideration*, note 80, at 395-96; Hufbauer, note 94, at 65, 131-70.

<sup>103</sup> Dunning, note 92, at 569.

<sup>104</sup> Musgrave, *U.S. Taxation*, at 30-31, 55.

<sup>105</sup> Hines, *Reconsideration*, note 80, at 396-97. But see Harry Grubert & John Mutti, *Taxing Multinationals in a World With Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?* 2 *Int'l Tax & Pub. Fin.* 439-57 (1995).

<sup>106</sup> Hines, *Reconsideration*, note 80, at 400; James R. Hines, Jr., *Credit and Deferral as International Investment Incentives*, 55 *J. Pub. Econ.* 323-47 (1994); Hans-Werner Sinn, *Taxation and the Birth of Foreign Subsidiaries*, in *Trade, Welfare and Economic Policies: Essays in Honor of Murray C. Kemp* 325-52 (Horst Herberg & Ngo Van Long eds., 1993); Timothy Scott Newlon, *Tax Policy and the Multinational Firm's Financial Policy and Investment Decisions* (1987) (unpublished Ph.D. dissertation, Princeton University).

of reported domestic profitability.<sup>107</sup> This means that the U.S. classical system of taxing corporate profits is more burdensome for firms with foreign income than for those with domestic income only. In fact, the U.S. Treasury receives greater tax revenues from the foreign operations of U.S. companies by taxing individual income than by taxing the income of the corporations themselves.<sup>108</sup> Hines speculates that “[f]irms reporting foreign profits may have greater need than do others to signal their profitability in the form of dividend payments to common shareholders, because market participants are particularly skeptical of reported earnings that may be denominated in foreign currencies, are subject to exchange rate risk, capital controls, subvention by foreign managers, and various forms of interference by foreign governments.”<sup>109</sup> Hines concludes that this additional cost of capital associated with foreign investment may be a reason for beneficial treatment of foreign investment at the corporate level.<sup>110</sup>

Fifth, Musgrave’s analysis of international income tax policy occurred at a time when the United States was the world’s largest capital exporter.<sup>111</sup> Capital imports at that time were small and presumably were thought to have little effect on the economic well-being of Americans. Thus, Musgrave limited her analysis to the tax treatment of outbound U.S. investment and ignored entirely the tax treatment of foreign-owned investments in the United States. But as Figures 1 and 2<sup>112</sup> demonstrate, times have changed. Today the United States is the world’s second largest capital importer.<sup>113</sup> Our large and recurring trade deficits are financed by capital from abroad. Gross flows of capital both out of and into the United States are very large and growing each year. For the foreseeable future, the United States will be both a large exporter and importer of capital, of both direct and portfolio investments. It is simply not possible today to assess the effect of U.S. international tax policy on the well-being of U.S. citizens without taking both outbound and inbound flows of capital into account.

Despite the favorable tax treatment it receives, the stock of foreign direct investment abroad from the United States is considerably smaller both as a percentage of U.S. GDP and as a percentage of U.S. gross capital formation than the comparable ratios for the stock of

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<sup>107</sup> Hines, *Reconsideration*, note 80, at 397; James R. Hines, Jr., *Dividends and Profits: Some Unsubtle Foreign Influences*, 51 *Fin.* 661-89 (1996).

<sup>108</sup> Hines, *Reconsideration*, note 80, at 397.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.* at 397-98. But see Rousslang, note 77, at 593-94 (suggesting that corporations could repatriate foreign earnings and pay the residual U.S. tax to finance any additional dividends that shareholders may require).

<sup>111</sup> See Figure 1, at page 305.

<sup>112</sup> See page 305.

<sup>113</sup> See note 26.

foreign direct investment of other industrialized nations.<sup>114</sup> For example, the ratio of the U.S. stock of foreign direct investment abroad to GDP is less than one-half the ratio of the United Kingdom or the Netherlands, and the increase in that ratio since 1980 has been relatively small for the United States, compared to the rest of the world.<sup>115</sup> U.S. multinationals have been exceptional in their tendency to concentrate activities, particularly research and development, and resources at home, that is, in the United States.<sup>116</sup>

With regard to inbound direct investment, the World Economic Forum ranked the United States first among industrialized nations and fourth worldwide (behind Singapore, Hong Kong, and China) as a favorable location for investment.<sup>117</sup> This nation's flexible labor markets, our technological and innovative capacities, the strength of our service sector, particularly for financial services, and the high quality of U.S. management and marketing skills on which foreign investors may draw have apparently been the most important factors contributing to our high ranking.<sup>118</sup>

From the perspective of tax policy, the most salient issue for inbound direct investment is the U.S. corporate income tax, which unlike the corporate taxes of many other nations, does not provide any relief from the double taxation of dividends.<sup>119</sup> Because of her exclusive focus on outbound investment, however, Musgrave does not address any issues of domestic corporate income tax policy, a practice also inexplicably followed by most other economic analyses of international income tax policy.

It is not clear to me exactly how the benefits of inbound investment would be taken into account in the formula used by Musgrave and other economists to measure the national welfare effects of foreign investments.<sup>120</sup> Typically economists treat rates of return of foreign

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<sup>114</sup> See UN Report, note 9, at 143, 152.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 151.

<sup>117</sup> See *id.* at 150 (citing the 1997 study of the World Economic Forum).

<sup>118</sup> *Id.*

<sup>119</sup> See generally Graetz & Warren, note 97, at 3.

<sup>120</sup> Rousslang notes that none of the analyses to date "accounts for the substantial two-way flows of international corporate investments that are actually observed," but he claims that so long as countries can cooperate, these flows should "do little to alter the optimal tax strategy" to "maximize global welfare." Rousslang, note 77, at 595. More comprehensive analysis than he offers, however, will be necessary to evaluate the validity of that claim and Rousslang offers no observations regarding the effects of two-way capital flows if the goal is national well-being rather than global. The Treasury Subpart F Study, note 30, at 38, points out that the optimum policy for capital importing nations is sometimes to tax inbound investment income at zero, or up to the tax rate of the capital-exporting nation if that nation allows a foreign tax credit, and in general to balance the benefits of inbound investment against the revenue lost from lowering taxes on such investment. But such flexibility in making tax policy may not exist as a practical matter. For example, it would



investment as accruing to the suppliers of capital. But the benefits of inbound direct investment to the host country are surely substantial. Otherwise nations and states would not compete as they do to attract such capital. Ignoring the benefits of inbound investments seems a major shortcoming of Musgrave's analysis as a basis for policymaking.

Sixth, Musgrave fails to take into account potentially offsetting or retaliatory actions by foreign governments. If, for example, the United States were to follow Musgrave's "national neutrality" policy of allowing only a deduction for foreign taxes, foreign governments also might decide to allow only a deduction for U.S. taxes on their nationals' investments in the United States. The policy of "national neutrality" would likely then not only serve to inhibit outbound investment from the United States but also would stifle inbound U.S. investment from abroad. I find it very hard to believe that this state of affairs would improve the economic status of Americans.

Ignoring potential responses of foreign governments to changes in U.S. international tax policies also allows Musgrave to disregard how foreign governments might react to her preferred policy of current taxation of foreign profits with an unlimited credit for foreign taxes. Enactment of such a policy by the United States could encourage foreign governments to make sure that their tax rates on investments from the United States at least equals the U.S. tax rate (if the FTC were limited) and to set rates higher if there were no FTC limitation. U.S. multinationals would have no incentive to arrange their affairs to minimize foreign taxes, a benefit from the perspective of global economic efficiency. But, even within Musgrave's own framework, foreign taxes are simply a cost, from the perspective of the well-being of U.S. citizens and residents; substituting foreign tax payments for higher profits of U.S.-owned companies is a net loss to U.S. persons. This means that from the U.S. perspective, lower foreign taxes should be viewed as a benefit, so long as locating profits in low-tax foreign jurisdictions is not so attractive as to encourage companies to shift investment income out of the United States.<sup>121</sup> This suggests that the United States should be more vigilant in policing corporate efforts to shift taxable profits away from the United States than efforts to reallocate profits among foreign locations to achieve tax savings. From the perspective of national welfare, a certain level of avoidance of foreign

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not be possible politically in the United States to tax U.S. source business income earned by a foreign-owned corporation at a rate lower than the rate applicable to U.S. corporations, and our commitment to nondiscrimination prohibits a higher rate. Therefore, adjusting the rate of tax on inbound investment here requires also lowering or raising the tax on domestic investment by U.S. companies.

<sup>121</sup> See Hines, *Reconsideration*, note 80, at 400.

taxes by both U.S. multinationals and U.S. portfolio investors may be a good thing.

Finally, Musgrave fails to take into account the possibility of improving national welfare through cooperation with other nations. Her failure to explore the potential for enhancing national well-being through bilateral or multilateral agreements is not troubling in evaluating Musgrave's recommendations for achieving worldwide economic efficiency, where her recommended unilateral action (CEN) is identical to her desired multilateral outcome. But this omission raises serious questions about her conclusions regarding "national neutrality," in particular, her assertion that the best policy from a national perspective is to allow only a deduction for foreign taxes.<sup>122</sup>

At least since the 1920's, the international tax policy of the United States has been premised on the idea that we can improve our lot through multilateral cooperation and agreement. In 1918, we unilaterally took the first step toward relief from double taxation of international income by rejecting our prior policy of allowing only a deduction for foreign taxes and enacting a foreign tax credit.<sup>123</sup> The policy we established then was grounded in the view that international income should be taxed once but not twice.<sup>124</sup> From that moment until now, we have participated in, and often led, efforts to achieve similar results on a cooperative bilateral and multilateral basis. In the 1920's, through the auspices of the League of Nations (and subsequently through the United Nations and OECD), we acted to obtain broad acceptance of the notion that double taxation of income from foreign investments should be alleviated either through foreign tax credits or exemption of foreign source income.<sup>125</sup> This has become standard policy throughout the world.

All of the available evidence suggests that these policies were pursued because U.S. policymakers regarded it as in our nation's best interests, not because they had accepted the enhancement of worldwide economic efficiency as the appropriate policy norm.<sup>126</sup> Not all capital-exporting nations agreed that crediting foreign income taxes or exempting foreign income was to their benefit; the United Kingdom, for example, was very slow to accept the idea that it should allow foreign tax credits and did not enter into bilateral tax treaties until the 1940's.<sup>127</sup>

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<sup>122</sup> Musgrave, U.S. Taxation, note 76, at 128, 134, 153, 162.

<sup>123</sup> Revenue Act of 1918, ch. 18, 40 Stat. 1057.

<sup>124</sup> See Graetz & O'Hear, note 2, at 1043-44, 1048-49.

<sup>125</sup> See *id.* at 1061 n.181, 1074-80.

<sup>126</sup> *Id.* at 1082.

<sup>127</sup> *Id.* at 1072.

In addition to the economic benefits that our international tax policy has produced, it also has served important U.S. political interests as the United States became a world power, both politically and economically after the First World War. After the Second World War, international tax policy helped facilitate U.S. private investments abroad in furtherance of our nation's desires for the economic rebuilding of Europe and Japan. By looking only at private rates of return and U.S. tax collections to measure national welfare, economists fail to count any political benefits.

In recent years, this multilateral income tax regime also has facilitated foreign investments into the United States, as I discussed earlier.

I find it difficult to believe that our national well-being—Americans' standards of living—would have been improved with the isolationist policy toward foreign investment implied by allowing only a deduction for foreign taxes.<sup>128</sup> Put simply, while I recognize the difficulties of measuring the effects of international tax policy, indeed of tax policy generally, on national welfare, I reject the simple formula of "national neutrality" that suggests allowing only a deduction for foreign taxes is the best policy if the goal is to enhance national, rather than worldwide, welfare.

### *C. Economic Efficiency as the Sole Value*

The focus in the international income tax literature on economic efficiency to the exclusion of all other values is antithetical to the analysis of tax policy generally, and of income tax policy especially. When assessing our domestic income tax policy or arguing for any substantial change in that policy, the debate generally is guided by a coherent, if controversial, set of multiple principles. There is great dispute over the meaning of these norms and about the priority to be accorded to each, but since Adam Smith, it has been commonplace to say that a tax system should be fair, economically efficient, and reasonably easy to administer and comply with.<sup>129</sup>

There has long been heated dispute over what constitutes a fair system of taxation. The most vigorous policy debate during the past 25 years has been over the choice between income and consumption taxation, with the question whether it would be fair to replace the income

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<sup>128</sup> The Treasury Subpart F Study also generally analyzes the effects of international tax policy on national welfare from the national neutrality perspective of Musgrave, but is careful to conclude only that it sees no reason to tax foreign income at a rate lower than that applicable to domestic income, thereby not taking a position on the choice between a credit and deduction for foreign taxes to maximize national welfare. Treasury Subpart F Study, note 30, at 36-37, 41, 97.

<sup>129</sup> Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations* 945-47 (Regnery Publishing, Inc. ed. 1998) (1776).

tax with a tax on consumption the most contentious issue. Indeed, the decision to impose an income tax in the first instance was grounded in considerations of equity.<sup>130</sup> Put somewhat crudely, the fundamental claim is that income is a better measure of ability to pay than the alternatives, notably consumption or wages.

Recently, the literature also has debated the validity of the traditional division of analysis of a tax system's fairness into horizontal and vertical equity components: requirements, respectively, of similar treatment of persons or families similarly situated and of a distribution of tax burdens based generally on people's ability to pay.<sup>131</sup> Some commentators have suggested that horizontal equity adds nothing.<sup>132</sup> And there have been longstanding disagreements both over how best to distinguish among people based on ability to pay and about the necessity of a progressive distribution of the tax burden.<sup>133</sup> Of late, these disagreements have been reflected in opposing views over the appropriate mix of tax bases, including whether fairness demands the taxation of income or wealth at all and about the need for progressive tax rates.<sup>134</sup>

The appropriate tradeoff between concerns for fairness, on the one hand, and for economic efficiency, on the other, also has long been hotly contested.<sup>135</sup> But, however heated the arguments on each side and uneasy the conclusions, claims that fairness should be irrelevant in the formation of the nation's tax policy or in evaluating or shaping the income tax are extremely rare.

The United States decided to make income taxes a central feature of the U.S. tax system because the American people were convinced that fairness demanded it. The Sixteenth Amendment, adopted in 1913,<sup>136</sup> permitting the taxation of income, was motivated by a quest for equity, in particular by the view that taxing investment income, as well as wages, was essential to a fair system of taxation.<sup>137</sup> For more than eight decades individual and corporate income taxes have produced more than half the revenue of the federal government.<sup>138</sup>

<sup>130</sup> Graetz & O'Hear, note 2, at 1043.

<sup>131</sup> See, e.g., Richard A. Musgrave, *The Theory of Public Finance* 90-115, 160-83 (1959).

<sup>132</sup> See, e.g., Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 *Nat'l Tax J.* 139 (1989). Cf. Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 *Fla. Tax Rev.* 607 (1993). But see Richard A. Musgrave, *Horizontal Equity, Once More*, 43 *Nat'l Tax J.* 113 (1990).

<sup>133</sup> See, e.g., Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 *U. Chi. L. Rev.* 417 (1952).

<sup>134</sup> See, e.g., Graetz, *U.S. Income Tax*, note 58, chs. 13, 14, 15.

<sup>135</sup> See, e.g., Arthur Okun, *Equality and Efficiency: The Big Tradeoff* (1975).

<sup>136</sup> U.S. Const. amend. XVI.

<sup>137</sup> Graetz & O'Hear, note 2, at 1043.

<sup>138</sup> Michael J. Graetz & Deborah H. Schenk, *Federal Income Taxation, Principles and Policies* 16-17 (3d ed. 1995).

If economic efficiency were the sole goal of tax policy, we would tax wages or consumption, but not income. Having decided to impose an income tax, it is mysterious why concern for fairness should disappear simply because goods or services or labor or capital, have crossed national boundaries.<sup>139</sup>

To the contrary, the original motivation for the unilateral adoption by the United States of a foreign tax credit was grounded in concerns for fairness. T.S. Adams, the fountainhead of our system of international income taxation and responsible for the 1918 enactment of the FTC, expressed surprise that it was adopted at all:

In the midst of war, when the financial burden upon the United States was greater than it had ever been, I proposed to the Congress that we should recognize the *equities* . . . by including in the federal income tax the so-called credit for foreign taxes paid . . . I had no notion . . . that it would ever receive serious consideration.<sup>140</sup>

Adams explained the injustice he was trying to correct in the classic language of horizontal equity:

There is something in the legislative mind which recognizes that if one taxpayer is being taxed twice while the majority of men similarly situated are being taxed only once, by the same tax, *something wrong or inequitable* is being done which, other things being equal, the legislator should correct if he can.<sup>141</sup>

The enactment of the foreign tax credit was intended to ensure that the tax burden on investment and business income did not become too high (labeled “double taxation”) simply because the income was earned abroad rather than in the United States. The FTC also was advanced to ensure that foreign source income of individuals and businesses not escape taxation altogether.<sup>142</sup>

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<sup>139</sup> The Treasury Subpart F Study claims to treat concerns with fairness on a par with concerns about economic efficiency. It finds these to be in perfect harmony by endorsing a policy of capital export neutrality on efficiency grounds and claiming that fairness demands taxation of worldwide income on “the equitable principle that the tax burden should be imposed equally on all income, without regard to its source.” Treasury Subpart F Study, note 30, at 82. It then notes that, “[a] more detailed analysis of equity concepts . . . is beyond the scope of this study.” *Id.* at 82-83 n.3. As the text that follows indicates, a number of dimensions of equity are thereby left unexamined by Treasury.

<sup>140</sup> Thomas S. Adams, *International and Interstate Aspects of Double Taxation*, 22 *Nat'l Tax Ass'n Proc.* 193, 198 (1929) (emphasis added).

<sup>141</sup> *Id.* at 197 (emphasis added).

<sup>142</sup> Graetz & O'Hear, note 2, at 1098-99, n.307.

Even T.S. Adams's principal intellectual adversary in matters of international tax policy, the influential economist Edwin R.A. Seligman, who along with Sir Joseph Stamp of Great Britain was the principal author and architect of a widely-cited report of "four economists" prepared in 1923 for the League of Nations,<sup>143</sup> argued strongly in favor of giving prime importance to considerations of fairness in taxing international income.<sup>144</sup> As a policy matter, and contrary to Adams, Seligman argued for granting exclusive power to tax to nations where the supplier of capital resides.<sup>145</sup> Seligman thought little generally of the claims of source countries. He viewed fairness as demanding that taxes based on ability to pay be imposed on worldwide income, and he regarded it as a mistake for capital-exporting residence countries to defer to source countries by allowing a tax credit for foreign taxes.<sup>146</sup> Although he emphasized the taxation of individuals in this regard, Seligman also favored residence-country taxation of businesses, but not for the reasons of worldwide economic efficiency advanced in its behalf today.<sup>147</sup> In the early debates over U.S. international income tax policy, T.S. Adams and Edwin Seligman disagreed vigorously about what policy best satisfies the requirement of fairness, but they did not disagree that fairness was an essential attribute of international income taxation.

#### *D. Inter-nation Equity*

The unlimited FTC, which was in place from 1918 until 1921, also offended Adams' sense of fairness. In this case, however, he was concerned about fairness among nations rather than taxpayers. He complained of a violation of what (due to Peggy Musgrave<sup>148</sup>) is now described as inter-nation equity: "[The unlimited FTC] is subject to this . . . rather grave abuse: If foreign taxes are higher than our rate of

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<sup>143</sup> *Id.* at 1074-75. The other two economists were Professor G.W.J. Bruins of the Netherlands and Professor Luigi Einaudi of Italy.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* at 1074-78.

<sup>146</sup> See, e.g., Edwin R.A. Seligman, *Untitled Response to Speech by T.S. Adams and Discussion*, 8 *Am. Econ. Rev.* 42 (Supp. 1918); see also E.R.A. Seligman, *Note on Sir Josiah Stamp's Note*, transmitted on June 1, 1922, E.R.A. Seligman Papers, Columbia University, box 44, United Nations folder (proposing a test of "economic allegiance" for allocating taxes among nations).

<sup>147</sup> *Id.*

<sup>148</sup> Peggy B. Musgrave, *International Tax Base Division and the Multinational Corporation*, 27 *Pub. Fin.* 394 (1972); Richard A. Musgrave & Peggy B. Musgrave, *International Equity*, in *Modern Fiscal Issues* 63 (Richard M. Bird & John F. Head eds., 1972); see, e.g., Nancy H. Kaufman, *Fairness and the Taxation of International Income*, 29 *Law & Pol'y Int'l Bus.* 145 (1998). Much of the international tax policy literature, including governmental analyses (for example, the Treasury Subpart F Study, note 30) contains no discussion of inter-nation equity.

taxes, that credit may wipe out taxes which *fairly* belong to this country.”<sup>149</sup>

Here Adams’ comment emphasizes the core entitlement of the U.S. Treasury to the income tax revenues from domestic production. His comment reflects the widespread view that each nation has the right to tax income produced domestically, a right routinely exercised through source-based taxation of income, confirmed in the original League of Nations model income tax treaties,<sup>150</sup> and reconfirmed by the more than 1700 bilateral income tax treaties now in effect.<sup>151</sup> The claim of source countries to tax income produced within their borders is analogous to a nation’s long-recognized claim of sovereignty over natural resources within its boundaries.<sup>152</sup>

The idea that the source country has a fair claim to the income produced within its borders is also grounded in the view that foreigners, whose activities reach some minimum threshold, should contribute to the costs of services provided by the host government, including, for example, the costs of roads and other infrastructure, police and fire protection, the system for enforcement of laws, education, and the like. The services a nation provides may contribute substantially to the ability of both residents and foreigners to earn income there. Taxing that income is one way for the source country to be compensated for its expenditures on the services it provides.<sup>153</sup> One need not thoroughly embrace the benefit theory of taxation—the idea that the expenses of government should be paid by those who benefit in proportion to the benefits they receive—which is fraught with difficult problems of measurement and allocation, to recognize a country’s legitimate claim to tax income produced within its borders.

In the consumption tax context, the widely-accepted general practice is to impose such taxes on a destination basis, in other words to allocate the tax to the nation where the consumption occurs. Although credit-method value-added taxes are the common form of such

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<sup>149</sup> Internal Revenue Act of 1921: Hearings on H.R. 8245 Before the Senate Comm. on Fin., 67th Cong. 73 (1921) (emphasis added) (statement of Dr. T.S. Adams, Tax Advisor, Treasury Dep’t), in 95A Internal Revenue Acts of the United States 1909-1950: Legislative Histories, Laws, and Administrative Documents (Bernard D. Reams, Jr. ed., 1979).

<sup>150</sup> See Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Erosion, League of Nations Doc. C.562. M.178. 1928 II (1928).

<sup>151</sup> See, e.g., U.S. Model Income Tax Convention, Sept. 20, 1996, art. VII, Tax Treaties (CCH) ¶ 214 (reserving the right to tax business profits attributable to a permanent establishment in the United States.)

<sup>152</sup> The UN General Assembly has confirmed this right repeatedly. See, e.g., Tremors of World Financial Crisis Felt by Assembly, UN Chronicle, Mar. 22, 1999, at 53 (describing a resolution recognizing Palestinian sovereignty over natural resources in the occupied Palestinian territory).

<sup>153</sup> The economic analyses routinely ignore the potential benefits financed by taxes when they evaluate the economic efficiency of various international tax policies.

consumption taxes, consumption taxes may be imposed in a manner quite similar to income taxes.<sup>154</sup> The deep connections between consumption and income taxes render the longstanding GATT distinction between indirect and direct taxes archaic, if it was ever meaningful.<sup>155</sup> Moreover, recognizing the links between income and consumption taxes may suggest claims of inter-nation equity heretofore largely unanalyzed, in particular claims to share in income taxes by nations that supply a market for goods and services produced elsewhere from capital supplied from other nations. In other words, countries that supply only a market for goods and services may have a claim to income tax revenues in competition with those of both residence and source countries.<sup>156</sup>

The important point for present purposes is that any claim that is *fair* or *just* for a particular nation (or for nations generally) to obtain revenues from the productive activity that takes place within its borders cannot be grounded in a norm of economic efficiency. Indeed, such claims conflict with a central feature of worldwide economic efficiency and capital export neutrality, viz, indifference as to which nation collects the taxes on international income. As has often been pointed out, worldwide economic efficiency implies a policy solely of taxation by country where the suppliers of capital reside and no taxation by the country where the income-producing activity is conducted, the source country.<sup>157</sup> The virtually universal exercise by source countries of their right to tax income produced within their borders is a rejection, as a practical matter, of the worldwide efficiency norm.

### *E. Nondiscrimination and Reciprocity as Fairness-Based Norms*

Taking the demands of fairness seriously in the formation and implementation of tax policy is always a daunting challenge, filled with controversy and inevitably subject to compromise. Difficulties multiply in the international context where new issues must be confronted. As I have indicated, the foreign tax credit was a response to concerns about unfair “double taxation” or unfairly burdensome taxation of in-

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<sup>154</sup> E.g., Graetz, U.S. Income Tax, note 58, at 212-43; Alvin C. Warren, Jr., How Much Capital Income Taxed Under An Income Tax Is Exempt Under a Cash Flow Tax, 52 Tax L. Rev. 1 (1996).

<sup>155</sup> Michael J. Graetz, International Aspects of Fundamental Tax Restructuring: Practice or Principle?, 51 Univ. of Miami L. Rev. 1093, 1097-98 (1997).

<sup>156</sup> Such ideas may be implicit in calls for allocating international income tax revenues to countries where consumption occurs. See, e.g., Reuven S. Avi-Yonah, International Taxation of Electronic Commerce, 52 Tax L. Rev. 507, 544-45 [hereinafter Electronic Commerce]; Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573, 1670-75 (2000) [hereinafter Globalization].

<sup>157</sup> See, e.g., Blueprints, note 30, at 89-90.



come earned internationally.<sup>158</sup> The income tax treaty requirement of nondiscrimination against foreigners was developed virtually simultaneously to guarantee fair treatment by the source country for foreigners and foreign businesses.<sup>159</sup> The fundamental idea that everyone, including foreigners (once they are in the country legally), is entitled to equal treatment before the law (including the income tax law and tax treaties) is grounded in concern for fairness and mutual respect. Whether the nondiscrimination requirement of existing tax treaties also furthers worldwide economic efficiency is, at most, a secondary consideration.<sup>160</sup>

The idea of fair play between sovereign people of different nations also introduces a concern for “reciprocity” between nations as an element in securing fairness or justice in international taxation. A requirement of “reciprocity” is familiar in discussions of international relations, including international tax policy.<sup>161</sup> I cannot discuss the idea in any detail here, but I believe that ideas of fair play, of reciprocity, are quite useful in explaining, for example, recent multilateral efforts to curb “harmful tax competition.”<sup>162</sup> In my view, the requirements of reciprocity may be more pronounced in cases of geographic proximity and more attenuated between rich and poor nations (such as those within and without the OECD).

#### *F. Redistribution Among People of Different Nations*

Achieving fairness in international income taxation is complicated further by the question whether the use of the tax law to redistribute income should stop at the nation’s borders. Interrogation of this question, so far, has been largely absent from the international income tax literature, having generally been left to political philosophers.<sup>163</sup> At a minimum, questions of international redistribution introduce two concerns: first, the issue of a worldwide entitlement to a minimal level of resources at least to prevent starvation, and perhaps malnutrition; second, the question of whether rich nations have any obligation to reduce misery to an “acceptable” level worldwide. The responsibility of

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<sup>158</sup> See text accompanying notes 138-146.

<sup>159</sup> Graetz & O’Hear, note 2, at 1068 (The 1921 resolutions of the International Chamber of Commerce, for example, would have required nondiscrimination among residents, citizens, and foreigners.)

<sup>160</sup> E.g., Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 *Tax L. Rev.* 131 (2001).

<sup>161</sup> E.g., John G. Herndon, Jr., *Relief From International Income Taxation: The Development of International Reciprocity for the Prevention of Double Income Taxation* (1932).

<sup>162</sup> OECD, note 74.

<sup>163</sup> See e.g., Rawls, note 60, at 115-19. But see Avi-Yonah, *Globalization*, note 156, at 1648-50 (urging international redistribution as a basis for source-based taxation).

rich nations to ensure any baseline of resources for all humanity is a controversial idea. And few observers contend that our obligations to people abroad are similar to those within our borders. As with efficiency, a national rather than worldwide perspective seems appropriate. Concerns for the economic opportunities of foreigners, indeed for their liberty, do not correspond to the commitment to equal opportunity we aspire to at home. But accepting that the international obligations required by justice, or by simple humanity, are less than those domestically does not render them nonexistent.

If fairness demands some transfer of resources across national borders, the question remains what role income taxation should play. Again, this is an issue that I cannot plumb here, but to the extent that private investment has any substantial role to play in this regard, the taxation of capital income may become a matter of central importance. To take but one possibility, fairness between richer and poorer nations may imply that rich nations should be net exporters of capital.<sup>164</sup> This could suggest that the international tax policy of rich nations should promote foreign investment, either generally (for example, by deferring to source countries) or alternatively, at least in less developed nations.<sup>165</sup>

### *G. Fairness for Corporations?*

In the international context, one must ask how the demands of fairness relate to the taxation of corporations. From the time when the international income tax rules were first formulated until quite recently, questions about international income taxation were essentially questions about the taxation of corporations, since corporations accounted for virtually all international flows of capital. As Figure 4 shows,<sup>166</sup> the growth of international portfolio investments both directly by individuals and through financial intermediaries has changed the international investment picture dramatically, but this is quite a recent phenomenon.

We know that all taxes ultimately are borne by individuals, so that a requirement for fairness in taxation is properly regarded fundamentally as a requirement of fairness among individuals. The traditional tax fairness concepts of horizontal and vertical equity have their pri-

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<sup>164</sup> This suggestion has been offered, among others, by Gary Hufbauer at a conference at Brooklyn Law School in October, 2000. See Gary C. Hufbauer, Commentary, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 *Brook. J. Int'l L.* (forthcoming May 2001).

<sup>165</sup> Tax policy, of course, would have to be coordinated with other policies such as foreign policy and debt forgiveness.

<sup>166</sup> See page 306.

mary salience when analyzing tax burdens on individuals. Clearly vertical equity, distinguishing among individuals based upon ability to pay, does not demand distinctions among corporations similar to those among individuals. The income of a single corporation may be owned by or attributable to individuals with markedly different levels of income and different abilities to pay taxes.

The extensive studies in the 1990's by the ALI and the Treasury of integration of the corporate and individual income taxes have taught us that equivalent policies can be implemented by changing taxation either at the corporate or shareholder level.<sup>167</sup> The ability to accomplish roughly equivalent outcomes by granting corporations a deduction for dividends, excluding dividends from shareholders' incomes, or granting shareholders a credit for corporate taxes demonstrates this point.<sup>168</sup> The principal disagreement between the two studies, however, with the Treasury study favoring dividend exclusion and the ALI study favoring the shareholder-credit method of integration, essentially turned on a difference of opinion about the demands of fairness—in particular, of vertical equity—in the taxation of income earned by corporations.<sup>169</sup>

When income is taxed only when realized, as it is everywhere, and the undistributed profits of corporations are not attributed and taxed currently to shareholders, vertical equity does, however, demand separate taxation of corporate income. Otherwise, corporations will serve as tax shelters, a place for people with capital to come together and avoid the individual income tax. This is why a corporate tax is a necessary adjunct to an individual income tax, and why many nations, including ours, impose income taxes directly on corporations, although with some uncertainty about just how this tax burden is transferred to individuals.<sup>170</sup> Most economists believe a corporate income

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<sup>167</sup> Graetz & Warren, note 97, at 18-20.

<sup>168</sup> *Id.*

<sup>169</sup> Beginning in the 1970's, many nations, including most countries in Europe, moved toward a partially integrated corporate and individual income tax system through shareholder credits for some portion of corporate income taxes. But in recent years, apparently due to concerns with the taxation of international income, some of these countries—notably, Australia, Germany, and the United Kingdom—have retreated back toward a classical corporate income tax system.

<sup>170</sup> Most economists now regard an income tax on corporations as a tax on capital income, borne by suppliers of capital, but the burden of actual corporate income taxes, at least in part, may be borne by consumers and/or workers. It is standard practice in government analyses either to assume the U.S. corporate income tax is split 50-50 by owners of capital and consumers or to treat the incidence of the tax as uncertain. For analysis of incidence of the corporate tax in an open economy, see Jane Gravelle & Kent Smetters, *Who Bears the Burden of the Corporate Tax in the Open Economy* (NBER Working Paper No. W8280, available at [www.nber.org](http://www.nber.org) (concluding that the incidence is borne by domestic capital or is exported)).

tax principally burdens owners of capital, and if this is true, the corporate tax plays an important role in the allocation of tax burdens between labor and capital income.<sup>171</sup> In my view, in a classical corporate tax system, vertical equity also suggests that the corporate income tax rate be reasonably close to the top individual marginal rate, although others disagree.<sup>172</sup>

The challenge for U.S. tax policy is to maintain a close proximity between the top individual tax rate, the corporate tax rate, and the tax rates of other developed nations. As I have argued in detail elsewhere, accomplishing all these tasks offers support for initiating a 10%-15% value-added tax to finance an income tax exemption of about \$100,000 for families and a reduction in both the corporate and top individual income tax rate to 25%.<sup>173</sup>

From the inception of the individual income tax, U.S. policymakers have been concerned with the use of foreign corporations to undermine the vertical equity of the individual income tax structure. Such concerns also motivated the enactment of the foreign personal holding company rules in 1938<sup>174</sup> and (along with horizontal equity concerns) the PFIC regime added nearly five decades later in 1986.<sup>175</sup> Thus, equity (in addition to concerns about economic efficiency) offers a reason for us to be concerned about foreign source income of corporations (as well as of individuals) escaping both U.S. and foreign income tax.

While the issues are not nearly as straightforward as with vertical equity, I also believe that horizontal equity—the requirement of similar treatment of taxpayers similarly situated—has a role to play in the taxation of corporate income. The metaphor here, frequently advanced by both business representatives and members of Congress, is the “level playing field.” To be sure, the idea of a “level playing field” (like the idea of “double taxation”) and exactly what it means for tax

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<sup>171</sup> Let us not forget, however, that an unintegrated corporate tax imposes an excess burden on new equity investments in corporations. See generally Graetz & Warren, note 97.

<sup>172</sup> The first time I met Boris Bittker, nearly 30 years ago, at a conference at the University of Miami, he was commenting on a paper by Norman Ture railing against the existence of a tax on corporate income. In Bittker’s wry style he pointed out that Ture’s paper indicated he was delivering it on behalf of Norman B. Ture, Inc. Bittker remarked that he was certain that Ture had not incorporated because of his need to access the capital markets but rather because the corporate tax could be an opportunity as well as a burden. In those days the corporate tax provided two opportunities to reduce individual taxes: through greater pension benefits than unincorporated businesses and a substantially lower tax rate on income accumulated at the corporate level.

<sup>173</sup> Graetz, U.S. Income Tax, note 58, at 262-66, 293-314.

<sup>174</sup> Joint Comm. on Tax’n, Tax Evasion and Avoidance, 75<sup>th</sup> Cong., 1<sup>st</sup> Sess. 1-2 (1937).

<sup>175</sup> H.R. Rep. No. 99-841, at II-641, reprinted in 1986-3 C.B. (vol. 4) 641; S. Rep. No. 99-313, at 37 (1986), reprinted in 1986-3 C.B. (vol. 3) 37.

policy are far from self-evident. We should be wary not to personify corporations simply because we treat them as “legal persons,” or, in the language of the Code, “taxpayers.” Nor, on the other hand, should we ignore the importance to justice of equal treatment before the law.

As I have suggested, I regard the familiar requirement of “nondiscrimination” in international tax law (and its cousin “national treatment” in international law more broadly) as grounded in concerns for fairness, rather than economic efficiency. Many areas of the tax law incorporate the idea that horizontal equity—or “nondiscrimination” if you prefer—demands equal treatment of corporations in identical circumstances. For example in 1932, when shifting from an overall foreign tax credit limitation to a per-country limitation, the House Ways and Means Committee expressed its concern about companies earning foreign source income in countries with no income tax (or with a rate significantly lower than the U.S. rate) in the language of horizontal equity. Using as an example two companies operating in Argentina, the Committee complained about “preferential treatment to some taxpayers deriving income from more than one foreign country,” and explicitly suggested that fairness demanded equal treatment of the Argentine income.<sup>176</sup> The Committee was silent about any tax-based incentives for Argentine investments. Today, in contrast, analysis of the choice between per-country and overall tax credit limitations is typically about the relative effects of these limitations on capital export neutrality.<sup>177</sup>

To be sure, economists are concerned with the inefficiencies that might result, but inefficiencies—tax-motivated changes in investment location decisions, for example—will occur only if disparities are apparent before the relevant conduct, the decision to invest, occurs. Inequities, on the other hand, may occur even in the absence of inefficiencies, for example, when two companies in identical circumstances are treated differently by the country where the investment is made after the relevant investments have been made or other relevant transactions have been consummated. To be sure, the real economic unfairness, if any, will fall on the individuals who bear the economic burdens of the corporate-level tax. But, because the legal issues are resolved at the corporate level, the corporations are entitled to equal treatment before the law. Fairness—fair play—requires it.

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<sup>176</sup> H.R. Rep. No. 72-708, at 23-24 (1932); see also William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income From 1909 to 1989: How a Tilted Playing Field Developed*, 43 *Tax Notes* 1379, 1382 (June 12, 1989).

<sup>177</sup> See, e.g., Andrew B. Lyon & Mathew Haag, *Optimality of the Foreign Tax Credit System: Separate vs. Overall Limitations*, mimeo, January 2000, available at <http://www.bsos.umd.edu/econ//Lyon>.

Indeed (although this comment surely will seem heresy to many of my economist and lawyer friends in the academy) claims on behalf of adopting policies of both CEN and CIN seem to contain claims about fairness. As I described earlier, Edwin Seligman's support for equal treatment of foreign and domestic source income (CEN) was explicitly grounded in fairness claims—both horizontal and vertical equity—rather than economic efficiency.<sup>178</sup> And in a December 2000 study, Treasury describes President Kennedy's urging the Congress in 1962 to adopt a policy of capital export neutrality as grounded in concerns for fairness, in this case equal treatment of domestic and foreign income earned by U.S. multinational companies.<sup>179</sup> Likewise, while "competitiveness" is the rallying cry of the business community on its behalf, CIN's demand of equal treatment of income earned within a nation's borders, whether earned by citizens or foreigners (or a corporation owned by nationals or foreigners) may, in substantial part, be motivated by fairness concerns. Consider the following statement, which is typically characterized as a requirement of capital import neutrality, but which also suggests nondiscrimination and national treatment: All investments in the United States should pay the same taxes regardless of whether a U.S. person (company) or foreign person (company) makes the investment. In other words, U.S. and foreign-owned business and investments in the United States should be treated equally.<sup>180</sup> While potential economic inefficiencies are the primary concern of advocates of CEN and CIN, issues of fairness are implicated in this criterion as well.

A few years back, the topic du jour of international tax policy was the allegedly low level of taxes paid to the United States by foreign-owned businesses doing business in the United States. President Clinton ran for office in 1992 claiming he could raise \$45 billion by equalizing the taxes of foreign- and U.S.-owned businesses, although after he was elected President the number had dwindled to less than 10% of that amount,<sup>181</sup> but the public had been stirred. About the same time, Sam Donaldson devoted a segment of his prime-time TV show to the low level of taxes being paid to our Treasury by Japanese-owned companies.<sup>182</sup> Neither Clinton nor Donaldson expressed con-

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<sup>178</sup> See note 145 and accompanying text.

<sup>179</sup> Treasury Subpart F Study, note 30, at 82-83, also claims that fairness demands equal taxation of domestic and foreign income; see also note 21.

<sup>180</sup> This may be one reason why the OECD limited its definition of harmful tax competition to "ring-fencing," a limitation that cannot be explained by any reference to economic efficiency. OECD, note 74, at 27.

<sup>181</sup> Michael J. Graetz, Tax Policy at the Beginning of the Clinton Administration, 10 Yale J. Reg. 561, 567 (1993).

<sup>182</sup> Primetime Live: No Yen for Taxes (ABC television broadcast, Apr. 9, 1992).

cern with the potential misallocation of capital caused by a low level of tax on foreign companies doing business in the United States. Even if they uttered the phrase "competitive advantage," they were beating the drums of fairness.

It is, in fact, not entirely self-evident what business representatives mean when they complain of a "competitive advantage" enjoyed, say by a French company not subject to tax in its home country on an investment in a third country with a low income tax rate, when the United States would impose additional income tax on a similar investment by a U.S. company.<sup>183</sup> Business representatives simply may be asserting that they will have to charge more for their products under the view that at least some part of the corporate tax is passed on to consumers in prices. Alternatively, they may be concerned that the additional U.S. tax burden increases their cost of capital relative to that of the French company—in the rhetoric of business, that the U.S. company faces a higher "hurdle" rate. Or they may be urging both effects. They are surely also claiming that it is unfair to require their company to pay more taxes simply because it is incorporated in the United States rather than abroad. One may or may not credit such claims, but for my point here all that matters is that the competitive advantage claim asserts unfairness, even if it is also about tax-induced distortions to economic decisionmaking.

#### *H. Summary of Discussion of Fairness*

To be sure, thinking about fairness in international taxation complicates both analysis and policymaking. It is frequently controversial even in the domestic context to achieve agreement about the appropriate level or redistributive goals of the income tax, or to assess under what circumstances equity demands equal treatment. When the relevant comparisons are between citizens, residents, and foreigners, the difficulties multiply. Multinational corporations add further complications and controversy. Questions of the appropriate measurement of the tax base and level of tax also become more complex when income is earned transnationally. What, for example, constitutes "double taxation" and at what levels is it unfair? What is the proper role and scope of a requirement of nondiscrimination?

In the international context, we must also pay attention to questions of fairness among nations. Each nation's claims of entitlement to share in the income of its residents as well as income produced within

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<sup>183</sup> Such a difference in taxes may occur because France often imposes no tax on investment abroad, under circumstances where the United States may collect residual tax, for example, due to the foreign tax credit rules or subpart F.

its borders—and the circumstances under which nations are willing to forgo their share—must be taken into account. Reciprocity has both substantive and procedural dimensions. Unilateral actions by sovereign nations often must be given force and responded to, but some level of international coordination and cooperation is essential.

But, despite the difficulties, deciding to tax income reflects a decision to place issues of fairness at the heart of tax policy debates. That commitment cannot be ignored simply because income traverses national borders. As with domestic income taxation, a quest for economic efficiency can never be more than a partial explanation for international tax policy decisions. As one economist put it: “Everything is economics, but economics is not everything.”<sup>184</sup>

### *I. Foreign Policy and International Taxation*

So far, I have argued that basing U.S. international income tax policy solely on the principle of worldwide economic efficiency is wrong both because it fails to give adequate priority to the goals and interests of the American people and omits from consideration important demands of fairness, of justice. But the process of international tax policymaking is further complicated by other considerations, including foreign policy.

For the well-being of its citizens and residents, the U.S. government necessarily takes into account—through its foreign policies—circumstances elsewhere in the world. This nation’s attitudes and policies toward other nations depend on economic, political, and social relationships, as well as our history. History, for example, best explains our current relationship with the Philippines. Our alliances for defense constitute a classic example of U.S. foreign policy at work. Another example is U.S. actions to affect the flow of foreign oil. Sometimes we act simply out of altruism.

Foreign policy concerns have long played an important role in U.S. international tax policy. In 1921 Congress enacted a special exemption for businesses operating in U.S. possessions to encourage economic development there.<sup>185</sup> That law became the model for the special tax advantages enacted in 1942 for Western Hemisphere Trade Corporations.<sup>186</sup> In 1922 Congress passed the China Trade Act, which adopted a complicated structure providing benefits to “China Trade

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<sup>184</sup> Sijbren Cnossen, *Must the Corporation Tax be Harmonized?*, in *Taxation in the United States and Europe: Theory and Practice* 191 (Anthony Knoester ed., 1993); see also Peter A. Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries* 46 (1996) (quoting Cnossen, *supra*).

<sup>185</sup> Revenue Act of 1921, ch. 136, § 262, 42 Stat. 227, 271.

<sup>186</sup> IRC § 109 (1942).



Corporations” to stimulate investments in China by U.S. corporations.<sup>187</sup> In 1950 the U.S. permitted oil-exporting countries to base their income tax on posted prices, a move intended both to encourage foreign investments by U.S. oil companies and to transfer U.S. revenues to oil-producing nations.<sup>188</sup>

This nation’s post-war policies of using both public and private capital to rebuild the economies of Europe and Japan prompted a number of changes in U.S. international tax rules following World War II, including rules governing the calculation of the limitation on the foreign tax credit. Encouraging investments abroad by U.S. corporations and individuals was intended not only to stimulate economic development in countries devastated by the war, but also to spread capitalism and democracy through economic interdependencies and political alliances.<sup>189</sup> Similar goals have been advanced more recently for U.S. investments in Eastern Europe, the former Soviet Union, and China.

In 1962, Congress enacted subpart F rules favoring investments in developing countries.<sup>190</sup> Today almost one-third of the stock of U.S. outbound foreign direct investment is in developing countries.<sup>191</sup>

The income tax also has denied foreign tax credits for companies participating in a boycott of Israel<sup>192</sup> and investing in South Africa during apartheid.<sup>193</sup> The former was enacted to express our distaste for the boycott and to reaffirm this nation’s special relationship with Israel. In the latter case, humanitarian concerns of U.S. citizens provided a national interest in discouraging private investments in South Africa.

There are many other potential uses of international tax policy to advance U.S. foreign policy. In the late 1970’s, for example, when keeping the supply of mideast oil flowing headed the U.S. foreign policy agenda, some analysts suggested that U.S. oil companies should be entering into management service contracts with oil-producing nations rather than making equity investments.<sup>194</sup> To achieve such an outcome, U.S. policymakers could have readily fashioned international tax rules to favor management contracts and disfavor equity investments. Instances where government should make these kinds of distinctions may be rare, but when they are warranted, international income tax laws may facilitate the desired policies.

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<sup>187</sup> China Trade Act of 1922, § 26, 42 Stat. 856.

<sup>188</sup> Bergsten et al., note 50, at 168.

<sup>189</sup> For a good summary of U.S. post-war policy, see *id.* at 309.

<sup>190</sup> Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1008; *id.* at 356.

<sup>191</sup> UN Report, note 9, at 147.

<sup>192</sup> IRC §§ 908(a), 999.

<sup>193</sup> IRC § 901(j); Rev. Rul. 90-53, 1990-2 C.B. 343.

<sup>194</sup> The example is from Bergsten, et al., note 50, at 160-64.

Likewise, if we were to take redistribution internationally as an appropriate function of international tax policy, distinctions among priorities for such redistribution surely would be influenced by foreign policy. For example, we might limit the foreign tax credit in a way to encourage investment of U.S. capital abroad in countries that are “appropriate” objects of redistribution. If, for example, we concluded that South Africa and Russia—for quite different reasons—are now appropriate objects for redistribution, we might treat “competition” by such countries for investments of private U.S. capital as “benign,” not “harmful.” We then might exempt from U.S. tax income earned in these countries or allow deemed foreign tax credits for taxes not imposed by those nations. We might also encourage, rather than discourage, transfer pricing to shift income (and thereby tax revenues) to those countries. Other countries, such as Iraq for example, would not be treated favorably, as it is not a place to which we want to redistribute assets (for well-known foreign policy reasons).

Some of the tax rules enacted for foreign policy reasons have worked reasonably well, others poorly, but surely this would also be true of other means of implementing foreign policy, including government spending and direct regulation of foreign investments. It is a legitimate concern that the tax law promote the foreign policy of the nation, not just the foreign policies of U.S. businesses, but this is no reason to forgo using tax law as a way to implement U.S. foreign policy. Indeed, tax policy may be a superior instrument of foreign policy when stimulating or inhibiting investments of private U.S. capital or transfers of technology or other knowledge to another country is important to this nation’s foreign policy interests. Only the view that the tax law is always a bad way to do things other than raise revenue — the perspective of tax-expenditure religionists—would rule out the tax law as an implement of U.S. foreign policy.

In assessing the role of international tax policy as an instrument of U.S. foreign policy, we should keep in mind the relative inadequacy and costliness of other foreign policy options, including economic sanctions, military blockades, and war. In many instances cutting off (or increasing) foreign aid might serve as well or better than changes in international tax rules, but such tinkering may not be a viable policy option, given the relatively small size of current U.S. foreign aid.<sup>195</sup> Moreover, using direct foreign aid as a stimulus to change the domestic policies of another nation might be regarded by third-party nations

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<sup>195</sup> In 1997, for example, the total U.S. foreign aid budget was \$12.3 billion. Foreign Operations and Export Financing and Related Programs Appropriations Act, 1997, H.R. 3540, 104<sup>th</sup> Cong. (1997). In contrast, foreign tax credits claimed by businesses and individuals on their 1997 tax returns totaled nearly \$29 billion, more than twice as much. IRS, Statistics of Income Bull. 170 tbl. 1, 184 tbl. 13 (Winter 2000-2001).

as more intrusive on their sovereignty than limiting (or enhancing) tax advantages for private investments. One need not believe that what is good for U.S.-based multinationals is necessarily good for the United States, nor that U.S.-based multinationals will always act consistently with U.S. foreign policy, to accept a role for international tax policy as an instrument of U.S. foreign policy.

Foreign policy objectives may influence decisions about which countries to enter or cancel tax treaties with and the appropriate parameters of treaty concessions. The procedure for ratifying tax treaties confirms the legitimate role of foreign policy objectives in international taxation. Like other U.S. treaties, tax treaties are within the jurisdiction of the Senate Committee on Foreign Relations. The exclusion of the House of Representatives altogether from the tax treaty-making process contrasts sharply with the constitutional priority given that body in tax lawmaking generally and tends to support the idea that tax treaties are connected to foreign policy as well as to tax policy generally.

The essential point is this: The advantages (or disadvantages) of foreign investments by U.S. citizens and companies may be political as well as economic. Evaluating U.S. international tax policy by a metric such as worldwide economic efficiency, which looks only to rates of return and tax dollars collected and fails to take into account political benefits and burdens of foreign investments, is a mistake.

### *J. Compliance Costs and Administrability*

Even when treated as a separate goal, rather than just a facet of economic efficiency, simplicity always seems to be the forgotten stepchild of income tax policy. Routinely lip service is offered to the idea that the tax law ought to be as simple to comply with and administer as possible; then, after a nod and a wink, vaulting complexity overleaps itself. Analyzing international tax policy solely through the competing lenses of CEN and CIN relegates simplicity to a footnote.

But wasting valuable resources through unnecessary costs of complying with a complex tax law is economically inefficient. And the Service cannot fairly administer a law its personnel cannot comprehend. Only cursory contact with the details of U.S. international income tax rules confirms their overwhelming complexity. The economists Marsha Blumenthal and Joel Slemrod have estimated that nearly 40% of the income tax compliance costs of U.S. multinationals is attributable to the taxation of foreign source income, even though

foreign operations account for only about 20% of these companies' economic activity.<sup>196</sup>

In addition, each year more and more individuals have investments in mutual funds that purchase securities in foreign countries. The number of taxpayers claiming foreign tax credits on individual tax returns has increased more than ten-fold from 234,000 in 1975 to 2,334,000 in 1997.<sup>197</sup> The average foreign tax credits claimed on the returns of individuals with incomes of less than \$100,000—60.2% of the total—is \$339.<sup>198</sup> This trend seems likely to accelerate. The complexity that claiming FTCs on portfolio investments adds to individual returns is not warranted by any offsetting policy consideration.

The time has come to make simplification of international tax rules a priority. We can simplify without being simplistic: Complex international business transactions and investment arrangements cannot be governed by a simple law, but there is no justification for the level of complexity U.S. individuals, businesses, their advisors, and the Service now confront.

### *K. International Cooperation and Conformity*

Conformity with international practices sometimes is advanced as an independent principle for making international income tax policy.<sup>199</sup> This I think is a mistake. As I have said, I believe the United States should shape its international tax policy to serve the best interests of the nation, broadly defined. A wide range of principles must be taken into account, including what is fair, economically efficient, reasonably simple to comply with and administer, and advances the nation's foreign policy interests.

Often our national interests can be enhanced through international cooperation, cooperation that also may produce gains for other nations. And when a cooperative solution proves impossible or impractical, our national interests may best be promoted by bringing our rules into closer conformity with those of foreign countries. The flexibility that companies enjoy in determining the source of income and their country of residence may mean that the international tax policies and rules of other nations may constrain our ability to depart dramatically from international practice and still achieve our policy goals.

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<sup>196</sup> Marsha Blumenthal & Joel B. Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications*, 2 *Int'l Tax & Pub. Fin.* 37 (1995).

<sup>197</sup> Jeff Curry, Maureen Keenan Kahr & Sarah E. Nutter, *Individual Foreign-Earned Income and Foreign Tax Credit, 1996*, 19 *Statistics of Income Bull.* 1, 130 (Summer 1999).

<sup>198</sup> *Id.*

<sup>199</sup> See, e.g., Rosanne Altshuler, *Recent Developments in the Debate on Deferral*, 87 *Tax Notes* 255 (Apr. 10, 2000); Treasury Report on Subpart F, note 30, at viii.

This constraint may be especially important as a practical matter in taxing income from direct investments by corporations.

Because the developed countries account for more than two-thirds of the world's inward direct investment, more than 90% of the world's outward direct investment, and also the bulk of inbound and out-bound portfolio investments, these nations comprise the most significant universe for seeking cooperation and perhaps conformity.<sup>200</sup> But the developing countries have recently become more important, accounting for 37% of global inflows in 1997, compared to just 17% in 1990.<sup>201</sup> This no doubt reflects the increasing mobility of capital and perhaps lower income tax rates in some developing countries. It makes clear the need to include developing nations both in multilateral policy discussions and as bilateral tax treaty partners. Whatever one thinks about the substance of the OECD efforts to combat what it has labeled "harmful tax competition," its effort to introduce non-OECD nations into OECD policy discussions should be applauded.

Caution, however, is warranted in assuming that conforming our nation's tax system with that of other nations—even developed nations with effective income taxes—will inevitably improve our national welfare. International harmonization of tax systems, like other changes in policy, will tend to produce winners and losers. Recent evidence, for example, suggests that European harmonization of capital income taxes might increase the welfare of citizens and residents of the United Kingdom, while producing large outflows of capital and significant diminution of tax revenues and welfare in the nations of continental Europe.<sup>202</sup>

National interests and social, economic, and political conditions vary from country to country, often along important dimensions. International conformity and cooperation therefore should never be an end in itself and need not serve generally as a bedrock principle informing U.S. international tax policymaking. Rather, cooperation and sometimes conformity are properly regarded as possible means to achieve improvement of our national welfare and the development of a simpler and more just tax system

### *L. Enforceability*

Collectability is an essential attribute of any tax. Enacting rules that cannot be enforced is pointless. In the international tax arena,

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<sup>200</sup> UN Report, note 9, at xviii.

<sup>201</sup> *Id.*

<sup>202</sup> Enrique G. Mendoza, *The International Macroeconomics of Taxation and the Case Against European Tax Harmonization* (NBER Working Paper 8217), available at <http://papers.nber.org/papers/w8217>.

considerations of enforceability have always shaped the law and always will. Source-based taxation of income, for example, has long been justified, at least in part, on the ground that the country of source is in the best position to collect income tax.<sup>203</sup>

Direct and portfolio investments pose different challenges for income tax enforcement. Modernization of tax administration and certain aspects of the income tax law are, however, essential in both cases. For direct investment, today's task is to insist upon adequate information and to modernize longstanding income tax concepts that have become outdated as transnational business has modernized and transformed. (I review some of these outdated concepts in Section II.) In the case of portfolio investment, the largest problem seems to be outright evasion; taxpayers too often simply do not report income earned abroad.

Underreporting of transnational portfolio income is apparently quite substantial. For example, in March, 1994, the U.S. Treasury, for the first time in 50 years, conducted a comprehensive survey of out-bound portfolio investments from the United States.<sup>204</sup> As a result of this survey, the Department of Commerce revised its 1993 estimates of portfolio interest upward by \$6.1 billion, from \$17.2 billion to \$23.3 billion, and its estimate of portfolio dividends upward by \$4.1 billion, from \$6.8 to \$10.9 billion.<sup>205</sup> A similar 1997 Treasury survey reduced the reported U.S. balance of payments deficit by more than \$10 billion due to increased interest and dividends received by U.S. residents from foreign securities.<sup>206</sup> The 1993 estimate of U.S. holdings of portfolio stock was increased from \$302.8 billion to \$543.9 billion.<sup>207</sup> The magnitude of these adjustments suggests massive gaps in tax reporting of interest, dividends, and capital gains.

The Treasury surveys of foreign portfolio holdings by U.S. citizens and residents were part of an internationally coordinated effort of 29 countries under the auspices of the International Monetary Fund, undertaken because reported worldwide liabilities held by foreigners

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<sup>203</sup> Graetz & O'Hear, note 2, at 1056-59.

<sup>204</sup> U.S. Treasury Dep't, 1994 Benchmark Survey of U.S. Ownership of Foreign Securities (1998); see also U.S. Treasury Dep't, Report on U.S. Holdings of Foreign Long-Term Securities as of December 31, 1997 and December 31, 1999, at 1 (Apr. 2000).

<sup>205</sup> Christopher I. Bach, U.S. International Transactions, Revised Estimates for 1974-96, Survey of Current Business (1997).

<sup>206</sup> *Id.*

<sup>207</sup> *Id.*

greatly exceeded reported foreign assets.<sup>208</sup> Most industrialized nations participated in the surveys.<sup>209</sup>

The success of the Treasury surveys in uncovering many billions of dollars of interest and dividend income and holdings of foreign securities offers considerable encouragement about the potential to use information reporting requirements to assist tax enforcement. This new information about aggregate portfolio investments abroad essentially resulted from summing information discovered and accumulated about individual investments.

When source-based countries forgo imposing income tax, as so many now do, for example, with portfolio interest, other enforcement mechanisms become essential. Over the past three decades, the United States has demonstrated the power of information reporting in lieu of withholding in improving the collection of income taxes on domestic interest, dividends, and capital gains. A cooperative multilateral information-reporting effort might prove quite fruitful in improving enforcement of residence-country taxes on portfolio income.

The agreement by the countries of the European Union to expand information reporting of cross-border income flows is an encouraging development.<sup>210</sup> It demonstrates the willingness of countries to collaborate to limit tax evasion, even when they are unwilling to impose low-rate withholding taxes, as had been long urged by E.U. officials.<sup>211</sup> And, despite the gaps in coverage, it shows both the potential benefits and necessity of international cooperation in improving tax

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<sup>208</sup> International Monetary Fund, Results of the 1997 Coordinated Portfolio Investment Survey (Jan. 31, 2000). The Treasury surveys were conducted first in March 1994, again in 1997, and planned for every three to five years thereafter as a joint project of the Treasury Department and the Board of Governors of the Federal Reserve. In addition to data from the Treasury International Capital (TIC) reporting system, which requires reporting of all major purchases and sales of foreign securities on a monthly basis (but which has significantly undermeasured U.S. holdings), surveys were made of all custodians of securities (including those where foreign branches of U.S. financial service companies hold the securities). Detailed data was collected from individuals only when they did not entrust their securities to a U.S. custodian. U.S. investors who hold more than \$20 million of foreign securities were surveyed, with the bulk of assets reported by those who pool assets for investment, such as managers of mutual funds, insurance companies, and pension funds.

<sup>209</sup> See U.S. Treasury Report, note 204, at 1, for a list of countries.

<sup>210</sup> At a meeting of EU finance ministers in Brussels, 12 of the 15 EU countries agreed to exchange information to combat tax evasion. The other three—Luxembourg, Austria, and Belgium—agreed to impose a 15% withholding tax on interest paid to nonresidents from other EU countries. Tom Buerkle, EU Resolves Dispute over Tax Evasion, *Int'l Herald Tribune* (Nov. 28, 2000), available at [www.iht.com/articles/2728.html](http://www.iht.com/articles/2728.html). Some observers, including Reuven Avi-Yonah, for example, regard withholding as essential. Avi-Yonah, *Globalization*, note 156, at 1578.

<sup>211</sup> Commission Proposal for a Council Directive to Ensure a Minimum of Effective Taxation of Savings Income in the Form of Interest Payments Within the Community, COM (1998) 295 final.

enforcement. Although U.S. portfolio investments are widespread throughout the world, two-thirds of such investment is in 10 countries, with five countries (the United Kingdom, Canada, Japan, the Netherlands, and Germany) attracting more than \$100 billion each of such investments.<sup>212</sup>

The European move toward more information reporting, especially in the face of the bank secrecy laws of certain member countries, offers an important policy opportunity for the United States. In the 1980's, when this nation was anxious for foreign purchases of U.S. debt in order to help finance federal deficits, Congress repealed our withholding tax on portfolio interest and allowed bearer bonds to be issued to foreigners.<sup>213</sup> As a result, the U.S. government is currently unable to provide other countries with any information about the owners of these bonds. To protect against tax evasion by U.S. residents, however, these bonds contain a stamp indicating that they may not be sold to U.S. persons. Of course, the Eurobond market also provides bearer bonds, so that U.S. persons who want bearer bonds (without paying withholding taxes) may purchase bonds abroad. Today, fiscal surpluses are permitting the federal government to reduce the national debt held by the public, and national economic policy seems likely to produce an ongoing reduction of such debt in the years ahead. Since combating tax evasion on portfolio investment is clearly in our national interest (and in the interest of the European nations), the time seems ripe to seek a multilateral agreement eliminating bearer bonds and simultaneously otherwise improving mechanisms for information exchange on portfolio investments (especially when no substantial withholding tax is collected at source).

As the next Section illustrates, however, we should not be misled into believing that solving the problems of enforcing international income tax rules is simply a matter of greater cooperation, of more and better exchanges of information. Today, the mobility of capital and technological innovations pose substantial challenges for collecting income taxes, challenges that can be addressed only by modernizing archaic core concepts for enforcing the international taxation of business income.

### III. OUTDATED CONCEPTS

As I suggested earlier, in the case of direct investment, many of the core concepts designed to enforce international income tax arrangements have become outdated. These fundamental rules for accom-

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<sup>212</sup> U.S. Treasury Report, note 204.

<sup>213</sup> Tax Reform Act of 1984, Pub. L. No. 98-369, § 127, 98 Stat. 494, 648 (1984).



plishing and enforcing international tax policy were put in place during the formative period—1918 through 1928—for international income taxation, a time when the world economy was very different. Recent years have witnessed, for example, the rise of e-commerce, the expanded use of financial derivatives, the invention of e-money, the increased mobility of capital, a rise in the use of tax-haven financial centers and more sophisticated cross-border legal and financial arbitrage, all of which have helped render archaic (or easily manipulated) the longstanding core concepts used worldwide to implement international income tax arrangements and policies.<sup>214</sup> International income tax law is now composed of legal concepts and constructs that no longer reflect the economic realities of international business, if they ever did. The continuing insistence of the international tax regime in treating different divisions of an integrated multinational business as separate entities, whenever their legal status implies such separation, is but one illustration of the problem.<sup>215</sup> Legal constructs, which are largely elective and easily manipulated, play too great a role in determining international tax consequences of business arrangements. I treat this subject only very briefly here. These issues have been treated at length elsewhere in the international tax literature, and many of the key concepts are the regular grist of meetings and conferences of international tax professionals. Some have moved to the top of the agenda of OECD working groups. Thus, the comments that follow sketch only the outlines of a rather deep iceberg. I limit my comments to the fundamental concepts of source of income and residence of taxpayers, the basic building blocks for measuring income and allocating tax revenues among countries. Discussion of these (and related) issues in the international tax literature—much like the reluctance to move away from reliance on CEN as the sole normative goal of international tax policy—reflects a resistance to surrendering the existing concepts and categories. That these rules have served reasonably well in the past makes the international tax community reluctant to consider abandoning or even reconceptualizing the existing concepts and categories. Ultimately, however, this may be exactly what is required.

#### A. *Rules for Determining the Source of Income*

New forms of doing business and flexibility in fashioning transactions to determine the characterization of income today threaten to

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<sup>214</sup> Vito Tanzi, *Globalization, Technological Developments and the Work of Fiscal Termites*, 26 *Brook. J. Int'l L.* (forthcoming May 2001).

<sup>215</sup> H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 *Brook. J. Int'l L.* (forthcoming May 2001).

undermine the basic rules for determining the source of various categories of income. Readily manipulated distinctions, for example, between sales and licenses or interest and rents, play a critical role in the allocation and taxation of international income. In the late 1970's, the American Law Institute conducted a thoroughgoing review of the source rules and concluded that, while a bit of tinkering might improve things, all was reasonably well.<sup>216</sup> Rereading the excellent work of the ALI today underscores just how fast and fundamental have been the changes in the ways companies do business. For example, recently, a number of commentators have suggested that the use of financial derivatives has rendered the ALI's judgment obsolete.<sup>217</sup> Reconsideration of the source rules for business and portfolio interest, dividends, capital gains, and related derivative income is necessary in light of recent financial developments.

Moreover, many of the basic source rules themselves turn on the legal nature of a transaction rather than its economic substance.<sup>218</sup> Examples include distinctions between sales and licenses and between rents on a financial lease and interest. In addition, a number of source rules turn simply on the residence of the payor, and as the subsequent Section shows, corporate residence today is itself a problematic category. Finally, source rules sometimes are used to promote a particular kind of economic activity; the U.S. rules for determining the source of income from products manufactured in the United States and sold abroad are an example.<sup>219</sup>

If the source rules are to serve as a way of allocating income equitably among nations and enhancing national economic well-being and/or fairness among taxpayers, they should be overhauled to be better linked to the location of real economic activity, the location of customers, workers, or assets.<sup>220</sup> Moving in this direction demands that greater attention be given to the economic role of intangible assets. Valuing such assets is, of course, not practical and their allocation to various locations tends to be illusory. Sales may reflect the value of many customer-based intangibles and labor costs may reflect

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<sup>216</sup> ALI, *Federal Income Tax Project: International Aspects of United States Income Taxation (Proposals of the American Law Institute on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons)* (1978).

<sup>217</sup> Jeffrey M. Colón, *Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads*, 1999 U. Ill. L. Rev. 775; Gregory May, *Flying on Instruments: Synthetic Investments and Withholding Tax Avoidance*, 73 *Tax Notes* 1225 (Dec. 9, 1996).

<sup>218</sup> Hugh Ault and David Bradford have suggested that source is only a legal concept, not an economic one. See Ault & Bradford, note 34, at 12.

<sup>219</sup> See U.S. Treasury Dep't, *Report to the Congress on the Sales Source Rules* (1993).

<sup>220</sup> For further development and analysis of the ideas in this section, see David Noren, *Commentary*, 54 *Tax L. Rev.* 337 (2001).

workforce-in-place intangibles, but the location of research and development also must be taken into account for such rules to reflect reasonably the real economic activity underlying the production of income. The need to redesign source rules to connect better to real economic activity is linked to recent efforts to shore up the rules designed to protect against the manipulation of the source of income through transfer prices among related companies.

Much of the attention of international tax policymakers in the past decade, indeed during the past three, has focused on difficulties in enforcing the requirement that related-company prices be equivalent to those that would occur in arm's-length transactions between unrelated companies. Many have questioned whether arm's-length pricing is the theoretically appropriate way to allocate profits jointly produced, but whatever its theoretical merits, arm's-length allocation, which was introduced in the 1920's by the League of Nations<sup>221</sup> has always been a difficult fiction to enforce. Determining a related-company price for the right to use intangible assets and proprietary knowledge has become increasingly more difficult and hotly contested as an increasing proportion of intercompany transfers have come to involve intangibles, such as technology applications and know-how, which are rarely, if ever, transferred to an unrelated third party except when an entire business or line of business is sold. After many fits and starts in recent years over the substantive rules, as well as the procedures for determining such prices and the penalties for making "mistakes," the international tax community, including most first-world governments, the OECD, and many businesses, now seem to be embracing the fairy tale that the transfer-pricing problem is pretty much under control.<sup>222</sup> This, however, is no doubt only a temporary lull until the next round of transfer pricing abuses captures the attention of Congress or other policymakers.

The major alternative to the arm's-length pricing fiction is apportionment of income among related companies based on a formula turning on sales, labor costs, or assets, or some combination of those three plus perhaps a fourth factor relating to research and development expenditures. Despite the genuine economic importance to the production of income of assets, sales, and labor, experience with formula apportionment in U.S. state income taxes is not encouraging.<sup>223</sup> Because different states' formulas weigh the factors

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<sup>221</sup> League of Nations, Report on Double Taxation, Doc. E.F.S. 73 F. 19 (1923).

<sup>222</sup> The rules sometimes rely on adjusting income periodically based on actual income. See generally OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995).

<sup>223</sup> Charles E. McLure, Jr., U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles, 14 Tax Notes Int'l 859 (Mar. 10, 1997), and literature cited therein;

differently, typically to the advantage of the local treasury, some income is taxed more than once by multiple jurisdictions, although some income may escape taxation altogether.

Formulary apportionment was considered and rejected by the League of Nations in 1927 and 1928, principally because tinkering with the variety of methods of apportionment then in place throughout the world would have upset the fragile compromise that permitted the League to issue the model income tax treaties of 1928.<sup>224</sup> In 1976 formulary apportionment passed the U.S. Senate but was not accepted by the conference committee. Formulary apportionment remains a potential solution to transfer pricing difficulties. I am not aware, however, of any serious attempt to develop a formulary system for international income taxation on a revenue neutral basis for the United States and its major trading partners, nor am I aware of a formulary recommendation that gives appropriate weight to the role of intangible assets in producing income. While not easy, such an effort should now be made in conjunction with exploring the potential use of such formulas (or other profit-splitting techniques) as a basis for determining the source of business income more generally.<sup>225</sup>

Finally, the "permanent establishment" concept, which has served reasonably well since the 1920's to set the threshold for countries to impose source-based taxation of business income, is also facing new pressures, from electronic commerce, new financial techniques, and new forms of business arrangements and combinations. Litigated controversies seem to be increasing. Some commentators have offered proposals for revising the permanent establishment idea, while others would abandon it altogether.<sup>226</sup> Some minimum threshold of business activity necessarily is required as a prerequisite to source-based taxation of business income. At a minimum, modernization of the permanent establishment concept seems essential. It is also worth exploring whether a threshold amount of sales, assets, labor, or research and development within a nation could better serve to establish both the

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Charles E. McLure, Jr. & Joann M. Weiner, *Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income*, in *Taxing Capital in the European Union* (Sijbren Cnossen ed.) (forthcoming).

<sup>224</sup> Graetz & O'Hear, note 2, at 1086-89.

<sup>225</sup> See, e.g., Noren, note 220.

<sup>226</sup> See, e.g., Richard L. Doernberg & Luc Hinnekens, *Electronic Commerce and International Taxation* (1999) OECD, *The Economic and Social Impact of Electronic Commerce: Preliminary Findings and Research Agenda* (1999); Avi-Yonah, *Electronic Commerce*, note 156, at 535; Frances M. Horner & Jeffrey Owens, *Tax and the Web: New Technology, Old Problems*, 50 *Bull. Int'l Fisc. Doc.* 516, 517 (1996); Charles E. McLure, Jr., *Alternatives to the Concept of Permanent Establishment* (forthcoming); Charles E. McLure, Jr., *Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws*, 52 *Tax L. Rev.* 269, 417 (1997).

source of business income and as a threshold for the imposition of tax. Indeed, multilateral agreement to impose source-based taxation on a uniform formulary apportionment of sales, assets, R & D, and labor costs might eliminate the need for the permanent establishment concept altogether.

### *B. Corporate Residence*

Analyses of the taxation of international income, particularly discussions that would ground such taxation in a norm of worldwide economic efficiency (or CEN) not only typically insist on the primacy of taxation of the worldwide income of the nation's residents, but also often proceed as if the idea of residence is obvious and self-enforcing. In the case of corporations, however, the idea of residence—an idea central to any discussion of principles and policies relating to international taxation of foreign direct investment—seems both outdated and unstable.

One basic difficulty is jurisdictional. The United States, for example, has no claim to tax foreign persons on their foreign source income, but asserts jurisdiction to tax U.S. persons on income earned anywhere in the world. Thus, the residence of a corporation becomes critical for determining whether the United States has jurisdiction to tax its foreign source income. In addition, there are a number of instances when the source of income is determined by reference to residence, for example, where the source of income turns on the residence of a corporate payor.<sup>227</sup>

A tax regime based on residence or nationality can be somewhat difficult to implement in the case of individuals, as recent efforts to curb tax-motivated shedding of U.S. citizenship have demonstrated.<sup>228</sup> But in the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied by legal niceties. It is no accident that we call corporations doing business around the world “multinationals.”

The separate legal status and taxation of corporations has long been a feature of U.S. law.<sup>229</sup> The 20th century corporate income tax predates the modern individual income tax. The Code treats corporations organized in the United States under federal or state law as U.S. persons.<sup>230</sup> This allows companies considerable flexibility whether to

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<sup>227</sup> See, e.g., § 861(a)(1) (interest); § 861(a)(2) (dividends).

<sup>228</sup> IRC §§ 877, 2107, 2501(a)(3).

<sup>229</sup> See Treasury Subpart F Study, note 30, at app. H (containing a history). Only the income tax in place briefly during the Civil War attributed the income of corporations to its owners. *Id.* at 102.

<sup>230</sup> IRC §§ 7701(a)(4), (a)(5).

subject their business operations abroad to residence-based taxation in the United States. Other nations sometimes look to more than the simple act of incorporation—for example, to the place of actual management<sup>231</sup>—in determining residence of corporations, but flexibility in establishing a corporation's residence is a universal phenomenon.

The chore of limiting such flexibility to impose residence-based taxes fills many pages of the Code, regulations, and tax treaties. In general, the thrust of these efforts is to impose residence-based taxation whenever the foreign corporation is substantially owned or controlled by U.S. persons (including other corporations).<sup>232</sup> In the case of multinational corporations, this means that major tax consequences turn on whether the parent corporation is a U.S. or foreign entity.

Perhaps there was a time when national identity exerted sufficient pull that a corporation controlled by U.S. individuals would find incorporation of the parent entity elsewhere unthinkable, but that time seems to have passed. The choice of a German parent in the Daimler-Chrysler merger, which was at least partially driven by tax considerations, is the most publicized and scrutinized example.<sup>233</sup> But the use of Bermuda-based parents of such companies as Global Crossing and Tyco may be at least equally threatening to U.S. residence-based corporate taxation. In March 2000, Lindy Paull, Chief of Staff of the Joint Committee on Taxation, and Jonathan Talisman, Assistant Treasury Secretary for Tax Policy, expressed concern to Congress about the legal loophole that allowed property and casualty insurers to stop paying income taxes simply by moving the parent corporation to Bermuda.<sup>234</sup> Senator Daniel Moynihan, then the ranking Democrat on the committee, always one to see broader implications, wondered aloud whether “we are entering an era of corporate expatriation” with companies moving their headquarters overseas to avoid taxes.<sup>235</sup>

Additional flexibility in determining corporate status and residence was ushered in a few years ago with the “check-the-box” regula-

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<sup>231</sup> Joseph Isenbergh, *International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income* 83 (1990).

<sup>232</sup> See, e.g., Richard L. Reinhold, *What is Tax Treaty Abuse? (Is Treaty Shopping an Outdated Concept?)*, 53 *Tax Law.* 663 (2000).

<sup>233</sup> Hearings Before the House Comm. on Ways and Means, June 30, 1999 (statement of John H. Loffredo, Vice President and Chief Tax Counsel, DaimlerChrysler Corp.), available in 1999 TNT 126-47, Jul. 1, 1999, LEXIS, TNT File. Among the tax considerations at issue apparently were the German rules regarding corporate expatriations, which might have resulted in large capital gains taxes if a U.S. company were the parent. Some commentators have suggested that the U.S. subpart F rules were also an important factor. Albertina M. Fernandez, *The US Deferral Privilege: Should Subpart F be Repealed?* 86 *Tax Notes* 1055 (Feb. 21, 2000).

<sup>234</sup> Hearings of the Senate Finance Committee, Mar. 8, 2000, available in 2000 TNT 52-28, Mar. 16, 2000, LEXIS, TNT File.

<sup>235</sup> *Id.*

tions.<sup>236</sup> As the furor over Notice 98-11<sup>237</sup> and its progeny dramatically illustrated, the check-the-box development has produced much debate over the extent to which and when the United States should be concerned with techniques for reduction of foreign income taxes by U.S.-owned foreign entities.

Likewise, efforts to distinguish “real” corporate residents from false claimants when nationals of third countries seek to take advantage of benefits of bilateral income tax treaties have spawned a variety of “limitation on benefits” or “treaty shopping” clauses since the 1970’s.<sup>238</sup> These clauses attempt to restrict the benefits of tax treaties to corporations (or other entities) that are owned, at least in substantial part, by residents of the treaty country.<sup>239</sup>

Treasury also has issued regulations that limit the ability of U.S. corporations to expatriate tax free, but tax-free mergers with and acquisitions by foreign entities generally are permitted.<sup>240</sup> I cannot review the relevant rules here, but they seem to have something of a finger-in-the-dike quality about them. In any event, permitting corporate expatriations only through mergers is not obviously wise policy. Companies and their advisors have developed a number of techniques to minimize the “exit tax” that may be imposed when a taxable expatriation occurs, techniques that may render Treasury’s regulations largely ineffective.<sup>241</sup> Start-up companies, which expect to earn foreign source income, are completely free to choose their residence (although in many instances the ability to use start-up losses against other U.S. source income may argue for a U.S. residence).

A number of commentators have suggested that the recent evidence that corporations prefer a foreign residence implies a need to reexamine whether the U.S. international tax law has become unduly inhospitable to corporate headquarters and incorporation.<sup>242</sup> Business representatives have urged a reexamination of subpart F on similar grounds.<sup>243</sup>

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<sup>236</sup> Reg. § 301.7701-1 to -3; see generally, Treasury Subpart F Study, note 30, at 68-70.

<sup>237</sup> 1998-1 C.B. 433.

<sup>238</sup> See Reinhold, note 232, at 664.

<sup>239</sup> U.S. Model Treaty, note 151, art. 22, Tax Treaties (CCH) ¶ 214.

<sup>240</sup> Reg. § 1.367; see generally Robert J. Staffaroni, *Size Matters: Section 367(a) and Acquisitions of U.S. Corporations by Foreign Corporations*, 52 Tax Law. 523 (1994); Willard B. Taylor, *Corporate Expatriations—Why Not?*, 78 Taxes 146 (2000); David R. Tillinghast, *Recent Developments in International Mergers, Acquisitions and Restructurings*, 72 Taxes 1061 (1994).

<sup>241</sup> Taylor, note 240, at 149-52.

<sup>242</sup> See, e.g., *id.* at 146.

<sup>243</sup> See, e.g., NFTC Foreign Income Project, note 41, ¶ 57; cf. Treasury Subpart F Study, note 30, at vii.

It is precarious to turn significant U.S. tax consequences on the status of a corporation as a resident or nonresident, given the difficulty of assessing the “true” residence of corporations, except in the case of closely-held companies where the residence of the owners easily can be determined. Linking corporate residence to the residence of its owners simply does not seem practical in the context of multitiered multinationals. On the other hand, insisting that a corporation’s residence is the same as that of its managers or officers seems difficult to justify.

The fragility and manipulability of the residence of corporations suggests to me that U.S. international tax policy, to the extent possible, should reduce the tax consequences of determinations of residence for corporations. There are several policy implications that flow from this judgment. First and foremost, it implies priority of taxation of business income at source. In the case of corporations, we probably should stop talking as if our policy is worldwide taxation of corporate residents and as if any departure from such policy, such as taxing active business income of foreign corporations only when repatriated, is an aberration.<sup>244</sup>

In the case of direct investment, the need to collect tax on U.S. source corporate income deserves emphasis, and policymakers should focus on techniques for deflecting such income, including the deflection of passive and mobile income to other countries, as well as erosion of the U.S. tax base through deductible payments. In today’s economy, accomplishing these tasks is Herculean. We should try to minimize the tax consequences that turn on a corporation’s “residence.” This necessarily would put additional pressure on determinations of source, and make the linkage of such determinations to the location of real economic activity (the locations of sales, labor, property, and research and development), as suggested in the previous Section, even more pressing.

### III. UNSATISFACTORY POLICY

Adherents of CEN have clear policy priorities: They would eliminate “deferral”—taxation by the United States of active business income of foreign corporations controlled by U.S. corporations or persons when repatriated to the United States rather than when earned. As I have indicated, elimination of deferral was proposed to Congress in 1962 by President Kennedy, suggested again in December 2000 by Treasury (along with reliance on CEN as a basis for U.S. in-

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<sup>244</sup> For a good example of such talk, see generally Treasury Subpart F Study, note 30, at x.



ternational tax policy), and frequently endorsed by other CEN proponents.<sup>245</sup> On the other hand, support for the other two policy changes implied by CEN—elimination of cross-crediting of foreign taxes and repeal of the foreign tax credit limitation—is scarce. The former is regarded as impractical (although the 1986 Tax Reform Act's basket system might be regarded as a move in the direction of CEN); the latter unwise. No one urges an unlimited foreign tax credit, because it would both undermine the ability of the United States to collect taxes on U.S. source income and invite other nations to impose high taxes on U.S. companies as a way to shift revenues from our treasury to theirs. Although CEN advocates insist that their policy is "worldwide" taxation of residents,<sup>246</sup> a "pure" CEN policy is not in the cards.

Enthusiasts of CIN, on the other hand, endorse a territorial system of international income taxation, a system that would grant the exclusive power to tax income to countries of source, with no tax on income earned abroad by countries where the suppliers of capital reside. But, although about one-half of the OECD countries exempt from tax at least some foreign active business income,<sup>247</sup> nations with substantial capital exports routinely retain residence taxation of passive and portfolio income.

Viewed through the twin lenses of CEN and CIN, U.S. international tax policies (and those of our major trading partners) can reasonably be described as a "compromise," and, as I have stressed earlier,<sup>248</sup> a "compromise" between CEN and CIN can justify virtually any policy outcome. Debating CEN versus CIN as a guide to international tax policymaking is a dead end. We need to change the conversation about international tax policy, and take a fresh look at our international tax rules. And in doing so, we should avoid fruitless policy debates where one side insists that any departure from worldwide taxation of U.S. residents, including corporate residents, is an unfortunate violation of CEN, while the other side demands that only territorial taxation of income will implement CIN.

Instead, we can now ask the straightforward, but difficult to answer, question: What international tax policy is in the best interests of the people of the United States, taking into account political as well as economic considerations, and the demands of fairness as well as of

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<sup>245</sup> See, e.g., text accompanying note 45; Treasury Subpart F Study, note 30, at 87; Peroni, note 37, at 977, 986-94; Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 SMU L. Rev. 455 (1999).

<sup>246</sup> E.g., Treasury Subpart F Study, note 30, at ix-xi.

<sup>247</sup> E.g., OECD, Taxing Profits in a Global Economy: Domestic and International Issues 183 (1991).

<sup>248</sup> See text accompanying notes 35-57.

efficiency, recognizing that nations believe that they have rights (or at a minimum, fair claims) to the tax revenues attributable to the economic activities that take place within their borders, and keeping in mind that the United States is now a large importer, as well as exporter, of capital? We should minimize the costs of compliance and administration and acknowledge that an unenforceable tax can be neither efficient nor fair.

Providing policy answers to this question will inevitably be difficult and controversial. First, disputes will occur over what policies the norms imply—over what fairness, for example, demands—as well as about the priorities and appropriate trade-offs among the norms when they entail conflicting policies. In my view, fairness considerations merit priority in the taxation of individuals, while concern for our national economic well-being should enjoy primacy in taxing corporations' business income. Second, the consequences of alternative policies remain uncertain. We simply do not have adequate factual knowledge to make confident predictions about the effects of different policies. But both of these circumstances—normative disputes and empirical uncertainty—are commonplace conditions of tax policymaking. Asking the right questions will nevertheless improve policy debates and potentially produce better law.

Before turning to some specific policy suggestions, let me illustrate how changing the question can change the policy analysis. First, how should we think about the avoidance of foreign taxes by U.S. multinational corporations?<sup>249</sup> As I have discussed, if the goal is to maximize worldwide economic efficiency, there is no difference between foreign and U.S. taxes. On the other hand, in terms of our national welfare, U.S. taxes finance goods and services for the use of U.S. citizens and residents, but foreign taxes are simply costs, which (net of any specific benefits they purchase for U.S. citizens and residents) reduce the economic wherewithal of the U.S. persons who pay them.

From the perspective of CEN, which abhors tax-induced distortions in the location of investments, any tax-induced shift in the allocation of resources is bad, whether the culprit is U.S. or foreign taxes. In contrast, from the perspective of national welfare, we may be indifferent about the avoidance of foreign taxes due to a shift in resources from one foreign country to another. Indeed, paper transactions to reduce foreign taxes, as opposed to shifts in real economic resources, should increase our national welfare, at least until techniques for foreign tax avoidance stimulate owners of capital to locate assets abroad

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<sup>249</sup> For the purpose of this discussion, I simply assume that the parent corporation is owned and managed by U.S. individuals and managed and incorporated in the United States.

rather than in the United States. Thus, for example, when foreign taxes can be reduced simply by "checking the box," the United States may benefit so long as this ability does not cause U.S. resources to move offshore. In contrast, if one views CEN as the fundamental ground for policymaking (either for reasons of economic efficiency or fairness), any ability to reduce foreign taxes is problematic.

From the perspective I am urging here, the essential difficulty is empirical. A number of economists have demonstrated, for example, that business decisions, including the location of productive activities, are sensitive to tax burdens, but we do not know at what level tax differentials will stimulate individuals and businesses to move their capital or labor abroad.<sup>250</sup>

Second, consider the distinction between direct investments by corporations and portfolio investments by individuals. Capital export neutrality implies identical policies for both: taxation by the residence country only, or alternatively, current taxation of worldwide income with an unlimited per item foreign tax credit for taxes levied by source countries. But recasting the international tax policy questions the way I have urged here implies a sharp distinction between the taxation of foreign direct investments of multinational corporations and foreign portfolio investments of individuals. With regard to the former, the impact on our economic well-being occurring from both outbound and inbound investments is primary; foreign policy and other political considerations also may be important; issues of fairness are secondary. On the other hand, in taxing individuals' foreign portfolio investments, issues of fairness take on greater importance.

Moreover, the reasons for investing abroad tend to be different in the two cases. Portfolio investors seek diversification and higher rates of return. Portfolio capital is considerably more mobile than direct investment and its liquidity often makes it quite volatile, as it was during the Asian, Latin American, and Mexican economic crises in the 1990's.<sup>251</sup> Direct investments, in contrast, typically are made by corporations when the company's ownership-specific advantages, such as proprietary know-how or technologies, compensate for the additional costs of establishing facilities in a foreign country and for any disadvantages of the firm vis-a-vis local competitors, and when the company enjoys greater benefits from exploiting such ownership advantages internally rather than contracting with unrelated third par-

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<sup>250</sup> See, for example, the sources cited at note 13.

<sup>251</sup> See UN Report, note 9, at 14-16.

ties.<sup>252</sup> Foreign direct investment typically involves a long-term commitment to a business endeavor in a foreign country.<sup>253</sup>

The claims of source countries to tax the income also seem different in the two cases. Direct investment seems more likely to impose costs on the host country and to benefit from host country governmental expenditures than does portfolio investment. Thus, the source country's claim to tax income seems stronger with direct investment.

The analysis I have offered here thus suggests that international tax policies concerning foreign direct investments by corporations and foreign portfolio investments of individuals should be determined separately, recognizing the crucial need (and difficulty) to establish and police the boundaries between them.<sup>254</sup> I shall now explore briefly some policy proposals that should be seriously examined for direct and portfolio investments. In advancing these policy ideas, I am not now urging adoption of the ideas that I shall discuss. My effort here is preliminary, and more work is needed both to estimate the consequences of such policy changes and to detail the rules needed for their implementation.

I assume here that any changes I discuss can be adopted on a revenue neutral basis. Thus, for example, if changes in the taxation of outbound foreign direct investment would increase U.S. corporate revenues, corporate tax rates could be reduced.<sup>255</sup> This means that the suggestions that follow need not affect the relative tax burdens of labor and capital income.

### A. *Inbound Investment*

As I mentioned earlier, the principal determinants of how attractive the United States is to direct investments from abroad relate to non-tax economic conditions, such as our flexible labor markets.<sup>256</sup> In terms of tax policy, foreign corporations are treated similarly to domestic corporations so the U.S. corporate income tax also plays an important role. I have detailed elsewhere my own ideas for U.S. tax reform, which would lower the U.S. corporate tax rate to 25%.<sup>257</sup> The changes I recommend—enacting a 10-15% value-added tax to finance a \$100,000 per family exemption from the individual income tax and

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<sup>252</sup> See *id.* at 89; Dunning, note 92 at 79-80.

<sup>253</sup> See World Investment Report, note 101, at 90.

<sup>254</sup> One trick in drawing such a distinction will be in providing appropriate rules for venture capital investments abroad, a topic that has barely made it onto the international tax policy radar screen.

<sup>255</sup> Or other offsetting changes could be enacted. For example, the rule that limits foreign tax credits for the corporate alternative minimum tax could be repealed or revised.

<sup>256</sup> See text accompanying note 27.

<sup>257</sup> Graetz, U.S. Income Tax, note 58, at 303-14.

reduction of both the top individual and corporate tax rates to 25%—would enhance the attractiveness of the United States as a location for foreign investments. I have also long supported integration of the corporate and individual income taxes, which many industrial nations have embraced but from which some now seem to be retreating.<sup>258</sup>

As I have stated previously, in my view, the nation with a primary claim to the taxation of active business income is the host country, the country of source. Thus, from the perspective of the United States, I would emphasize the collection of taxes on U.S. source business income, whether earned by foreigners or residents. As I suggested in the preceding section, effective source-country taxation now seems to require substantial changes in numerous international tax concepts, such as those dealing with transfer pricing, permanent establishments, and income effectively connected to a U.S. business, as well as the more general rules for determining the source of various categories of income.<sup>259</sup>

With regard to portfolio investments into the United States from abroad, the major attraction is a strong U.S. economy and stock market. The general tax reform I have described above should be a positive factor in that regard. In the case of portfolio investments, principally for reasons relating to national welfare and fairness discussed more fully in Section C below, I regard the principal claim to taxation to be that of the residence country. And I endorse our treaty policies of reducing (or eliminating) withholding taxes. As I have discussed earlier, the problem of evasion of taxes on portfolio income is serious, and the United States should join a multilateral effort to enhance information reporting of portfolio income. Such an effort obviously will require the United States to be a supplier as well as a recipient of information, so I recommend the elimination of bearer bonds for sale to foreigners. If that deflects a certain amount of portfolio investment elsewhere, it is a price worth paying.

### *B. Foreign Direct Investment*

As I noted earlier, CEN enthusiasts from time to time have endeavored to tax currently the income of foreign corporations controlled by U.S. persons or companies, thereby reversing the longstanding U.S. policy of taxing foreign active business income only when repatriated.<sup>260</sup> In my view, however, none has yet made a convincing case that this would increase the well-being of U.S. citizens and residents.

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<sup>258</sup> See generally Graetz & Warren, note 97.

<sup>259</sup> See text accompanying notes 178-203.

<sup>260</sup> See text accompanying notes 18-19 and note 245.

My concern is that the principal effect of such a shift in U.S. policy to a substantially more burdensome policy followed by none of our major trading partners—a significant departure from international practice—would be to encourage incorporation of businesses outside the United States and efforts to move U.S. corporate residents abroad.<sup>261</sup> Making the United States a less hospitable place for corporate incorporation, headquarters, or management does not seem likely to enhance our national welfare.

In contrast, because of the dominance of CEN as a basis for U.S. international tax policymaking, political leaders have given little attention to the potential benefits of moving toward an exemption system. Any movement away from foreign tax credits toward exemption has been viewed as abandoning CEN in favor of CIN. We have been paralyzed by fear of abandoning taxation of “worldwide income” in favor of a “territorial” system. In practice, however, exemption systems used by other nations and our foreign tax credit system are quite close.<sup>262</sup> And U.S. companies with excess foreign tax credits essentially enjoy exemption on any additional marginal foreign source income. The right question to ask is whether we, as a nation, would be better served by explicitly exempting from U.S. tax some specific categories of foreign direct income.

A number of other industrial countries, including, for example, France and the Netherlands, exempt foreign source active business income from tax.<sup>263</sup> Indeed, about one-half of OECD countries have some type of exemption system, while the other half use foreign tax credits.<sup>264</sup>

From time to time, analysts have suggested that the U.S. system of international taxation and U.S. economic welfare could be for example, substantially improved by moving to an exemption system.<sup>265</sup> For example, a recent paper co-authored by a leading international economist at Treasury suggests that moving to an exemption system, with appropriate anti-abuse rules, could both increase U.S. revenues and

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<sup>261</sup> See text accompanying notes 190-203 for a discussion of the insubstantiality of our rules regarding corporate residence.

<sup>262</sup> See Hugh J. Ault, *Comparative Income Taxation: A Structural Analysis* 381-82 (1997).

<sup>263</sup> *Id.* at 384-85.

<sup>264</sup> *E.g.*, OECD, note 247, at 183.

<sup>265</sup> See, *e.g.*, Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, *Ariz. L. Rev.* (forthcoming); Harry Grubert & John Mutti, *Dividend Exemption Versus the Current System for Taxing Foreign Business Income* (1999) (unpublished manuscript on file with the Tax Law Review); Hufbauer, note 94, at 135-36. Not enough detailed work on how an exemption system would work in the United States has been done to assess the validity of these assertions, although a Brookings Institution International Tax Policy Forum Conference on Territorial Income Taxation held in Washington, D.C. in April, 2001, while this Article was in press, made some important progress in this regard.

improve economic efficiency.<sup>266</sup> Moreover, there is credible economic evidence that exempting foreign source active business income would not precipitate any substantial outflow of capital from the United States.<sup>267</sup>

The greatest potential simplification of our system for taxing international income could be achieved by exempting all foreign source income. But the risks of such a change to the nation's economic well-being may be too great. Such a broad exemption would create a substantial incentive to move mobile and portfolio capital abroad, creating an unacceptable risk to both the U.S. Treasury and U.S. residents. Exempting dividends from active business income, however, may not entail such significant risks, and surely an exemption for income earned in countries with real income taxes imposed at tax rates roughly comparable to the U.S. rate would pose no such threat. A presidential task force in 1971 proposed an elective exemption from U.S. taxation of income derived from the active conduct of a trade or business by U.S. corporations and their foreign subsidiaries and branches in countries where the tax rate is sufficiently high to produce tax credits that would largely offset U.S. tax liabilities (that is, where the foreign rate is at least 75% of the U.S. rate).<sup>268</sup>

Some proponents of exemption have claimed great simplification advantages for an exemption system, and an exemption of all active business income earned abroad does seem to offer much potential for simplification. Under a system that exempts foreign business income only in countries with comparable income taxes, important simplification benefits might also occur for companies operating almost exclusively in countries with tax rates roughly comparable to ours. Such an exemption would cover income earned in the vast majority of countries where substantial active business income is earned by U.S. companies. But further work is needed to assess the simplification potential of this more limited exemption system.

In an exemption system, we would need to retain rules to distinguish foreign and domestic source income and to separate active business income from passive income. Anti-abuse rules along the lines of subpart F and the foreign personal holding company rules also would have to be retained. Look-through rules would be necessary to protect against mischaracterization of income and source. If exemption

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<sup>266</sup> See Grubert & Mutti, note 265.

<sup>267</sup> Roseanne Altshuler & Harry Grubert, *Where Will They Go If We Go Territorial? Dividend Exemption and The Location Decisions of U.S. Corporations* (paper prepared for Brookings Institution International Tax Policy Forum Conference on Territorial Income Taxation, Washington, D.C., Apr. 2001).

<sup>268</sup> *Business Taxation: The Report of the President's Task Force on Business Taxation* 44 (1970).

were limited to active business income from relatively high tax countries, we also would have to maintain a foreign tax credit regime for income not eligible for exemption, although such a foreign tax credit could be considerably simpler than the one we now employ, since companies would have excess foreign tax credit limitations, and there would be no need to provide rules to deal with excess credit situations. We could greatly simplify or eliminate the basket system, for example, and substantially simplify the rules for allocating deductions, such as for taxes, interest, and research and development between foreign and domestic sources. Transitional issues of moving to an exemption system also would have to be addressed.

The essential task today—as it has been since the foreign tax credit was first enacted nearly nine decades ago—is to prevent double taxation of income earned abroad, while also guarding against foreign source income going untaxed anywhere.<sup>269</sup> Double taxation would inhibit U.S. citizens and companies from making productive investments abroad, while zero taxation might unduly tempt them to shift investments away from the United States.<sup>270</sup> Surely these goals can be accomplished at lower cost and with less complexity than today's law. The current rules for taxing foreign source business income are unduly complex. They impose unnecessary costs of compliance on businesses and are difficult, if not impossible, for the Service to enforce in an evenhanded manner. A number of proposals have been offered for simplification of the U.S. rules for taxing foreign source income.<sup>271</sup> But we also should investigate seriously the advantages and disadvantages of replacing the foreign tax credit with an exemption of active source business income or at least an exemption of such income earned in countries with tax rates comparable to ours.

The U.S. business community is split on the question of exempting foreign source income. Whether a company supports or opposes exemption tends to turn on what proportion of its foreign source income is due to royalties or interest (which could be subject to increased U.S. taxes under an exemption system). Nevertheless, we should take a hard look at exempting from U.S. tax foreign source direct income from the conduct of an active foreign business (perhaps limited to treaty countries or countries with income taxes comparable to ours) to determine whether the simplification and economic advantages claimed on its behalf could be realized.

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<sup>269</sup> See Graetz & O'Hear, note 2, at 1033, 1038-39.

<sup>270</sup> At least since the 1930's, for example, special rules have been required to inhibit the movement offshore of passive income and portfolio assets.

<sup>271</sup> E.g., Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 *Tex. L. Rev.* 130 (1996); David R. Tillinghast, *International Tax Simplification*, 8 *Am. J. of Tax Pol'y* 187 (1990).



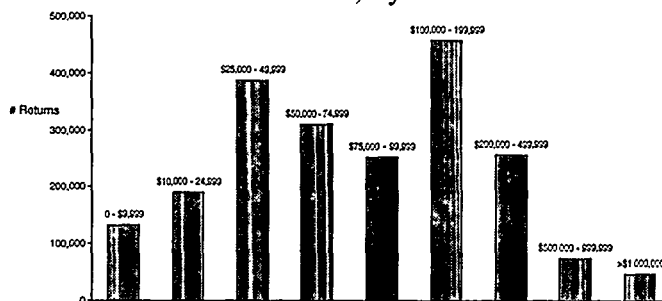
### C. Foreign Portfolio Income of Individuals

The amount of portfolio income—interest, dividends, and capital gains—earned by U.S. individuals from foreign sources has increased dramatically in recent years. Some of these investments are made by individuals directly, but much of the recent increase is through mutual fund investments. Pension funds, tax exempt organizations, and 401(k) plans also earn a significant amount of foreign portfolio income. As I indicated earlier, such investments generally are made to achieve diversification and a higher rate of return, and they tend to substitute for domestic investment, thereby conforming to the economists' simple models discussed earlier.<sup>272</sup> Moreover, portfolio income tends to be quite volatile; there is considerable evidence that portfolio investments have retreated from host countries when financial crisis strikes.<sup>273</sup> Unlike foreign direct investments, where measuring the benefits to the United States is difficult, the effect on our national welfare from portfolio investments by individuals abroad does seem to be captured by the standard economic analysis, which takes into account only rates of return plus domestic taxes paid.

This suggests that our national economic welfare might be enhanced by allowing a deduction rather than a credit for foreign taxes imposed on portfolio investments of individuals. The foreign tax credit system was designed in a very different era when little foreign portfolio income was earned by U.S. citizens. As Figures 8 and 9 show, now relatively small amounts of foreign tax credits are being claimed on increasing numbers of individual tax returns.<sup>274</sup>

FIGURE 8

#### Numbers of Individual Income Tax Returns With a Foreign Tax Credit or a Form 1116, by Income Bracket



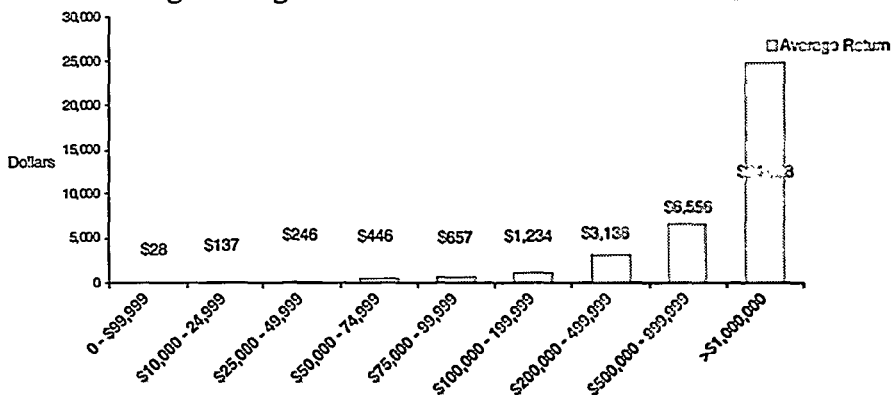
Source: Jeff Curry, Maureen Keenan Kahr & Sarah E. Nutter, *Individual Foreign-Earned Income and Foreign Tax Credit, 1996*, 19 IRS Stat. Income Bull. 1 (Summer 1999).

<sup>272</sup> See text accompanying note 99.

<sup>273</sup> UN Report, note 9, at 14-16.

<sup>274</sup> In 1997, Congress simplified the foreign tax credit for individuals with only foreign portfolio income by eliminating the limitation if the credits claimed are less than \$300 for an individual or \$600 for a married couple filing jointly. IRC § 904(j).

FIGURE 9  
Average Foreign Tax Credits at Selected Incomes, 1996



Source: Jeff Curry, Maureen Keenan Kahr & Sarah E. Nutter, *Individual Foreign-Earned Income and Foreign Tax Credit, 1996*, 19 IRS Stat. Income Bull. 1 (Summer 1999).

Generally, due to tax treaty agreements, the source-based taxes on this income are low or zero. Much interest and capital gains escapes source-based taxes altogether, and dividends from treaty countries tend to be taxed at rates ranging from 5-15%, although higher statutory rates (for example, 30% in the United States)<sup>275</sup> may apply in the absence of treaties. A 10% withholding rate on dividends in U.S. treaties is common and a rate of 5% is imposed in a number of recent treaties.<sup>276</sup> Thus, foreign taxes on portfolio income typically are imposed at a level comparable to the taxes of many U.S. states and are often lower (although foreign taxes, of course, are imposed in addition to state taxes).

In the case of an individual's portfolio income, the claim to tax the income by the residence country predominates. Not only does the residence country's claim seem stronger, but taxation by the country of residence is the only way to impose a progressive income tax based on an individual's ability to pay. In the case of portfolio investment by individuals, considerations of fairness are paramount. Lower taxes on foreign portfolio investments than for domestic portfolio investments of individuals violate both vertical and horizontal equity norms. There seems to be no good reason to tax individuals who are diversifying their risks by investing abroad more favorably than individuals who invest domestically. Moreover, individuals' portfolio investments abroad do not seem to produce any significant political or economic advantages to the United States. Although further analysis is necessary to evaluate the effects on national well-being of such a change,

<sup>275</sup> IRC §§ 871(a), 881(a).

<sup>276</sup> See Richard L. Doernberg & Kees van Raad, *U.S. Tax Treaties* (1999).

we should explore the possibility and consequences of allowing only a deduction for foreign taxes on such portfolio income. A deduction system would be simpler than the credit system, and might well increase our national welfare.<sup>277</sup> Because our treaties commit us to allowing credits for foreign taxes, such a change should not be taken unilaterally, certainly not by Congress overriding current treaty obligations. The potential damage to our standing and relationships in the international community from proceeding in that manner would almost certainly outweigh any potential gains.

In evaluating this idea, we must consider the potential effects on inbound portfolio investment if our shift from a credit to a deduction were replicated by other nations. In addition, since a credit would continue to be available for foreign taxes on income from portfolio investments by foreign corporations, anti-abuse rules to police the boundary would be required, rules that might offset somewhat the potential simplification advantages of such a change. Finally, consideration of such a substantial change in the taxation of portfolio income of individuals requires a fresh look at the taxation of mutual funds (which sometimes currently already fail to obtain foreign tax credit benefits for their investors) and of other financial intermediaries through which individuals invest abroad, a reexamination that is now essential in any event.<sup>278</sup> If the United States were to seriously consider allowing only a deduction for foreign income taxes on individuals' portfolio investments, the ultimate effect might be to stimulate a worldwide reduction, or perhaps even elimination, of withholding taxes on dividends. This would be a positive change, so long as the enforcement issues discussed earlier are adequately addressed through improved information reporting. In any event, as I have previously discussed, the important problems of enforcement of residence-based taxes on portfolio income demand significantly enhanced information reporting on a multilateral basis.<sup>279</sup>

#### *D. Earned Foreign Source Income of Individuals*

The taxation of wages earned abroad also merits reexamination in light of the increasing mobility of workers. Contrary to the practice of

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<sup>277</sup> See text accompanying notes 48-51 for a discussion of national neutrality. Certain other countries allow only a deduction for foreign taxes on portfolio income, Belgium, for example. See Working Party No. 2 of the Comm. on Fiscal Affairs, OECD, *Taxation of Cross-Border Portfolio Investment: Mutual Funds and Possible Tax Distortions*, at 38 (1999).

<sup>278</sup> See generally *id.*

<sup>279</sup> Reuven Avi-Yonah has proposed a 40% refundable withholding tax on portfolio income, but he seems to agree that exchanges of information will suffice for all but tax haven countries. See Avi-Yonah, *Globalization*, note 156, at 1668-69.

other nations, which typically tax only residents, the United States taxes citizens on their worldwide income. Thus, citizens of other nations working abroad for a full year generally are not taxed on their earned income by their home country. The United States, however, imposes tax on the worldwide income of citizen nonresidents, allowing a foreign tax credit for income taxes imposed by other nations. Taxing citizens has led, in recent years, to tax-motivated expatriations by U.S. citizens in an effort to avoid U.S. taxes on capital income (and taxes on gifts and bequests), conduct that Congress acted to stop.<sup>280</sup>

Currently the Code provides special benefits for foreign earned income, exempting approximately \$78,000 of wages earned abroad and allowing a tax credit for foreign income taxes on wages above that amount.<sup>281</sup> The Code also provides a special housing allowance for U.S. citizens working abroad.<sup>282</sup>

Although such benefits for foreign earnings are longstanding, no good social or economic policy reasons have ever been offered for those provisions. They have remained in the law at the behest of and to benefit U.S. multinational companies. Surely a better system for taxing wages earned abroad is possible. One alternative would be to exempt income earned in countries with tax rates comparable to ours by a person resident abroad for the full taxable year. Kees von Raad of the Netherlands has suggested a system for allocating the worldwide income of nonresidents and residents who work abroad for a substantial part of a year. He proposes that the nation of residence (or, in the case of the United States, citizenship) compute the individual's worldwide income based on its own tax rules, apply its tax rate to the worldwide income and then impose tax in proportion to the ratio of domestic income to worldwide income.<sup>283</sup> If such an approach were used multilaterally, it could be used by countries of source as well as residence to impose a single level of tax on earned income. An alternative would be to enact a simplified foreign tax credit system for foreign earned income of individuals. In any event, a fairer regime is surely possible.

#### IV. CONCLUSION

The effort—which has been surprisingly successful—to reduce international income tax policymaking to advancing CEN or responding

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<sup>280</sup> See IRC §§ 877, 2107, 2501(a)(3).

<sup>281</sup> IRC §§ 901(a), 911(a)(1), (b)(2)(D), (d)(6).

<sup>282</sup> IRC § 911(a)(2), (c).

<sup>283</sup> Kees van Raad, *Non-Discriminatory Income Taxation of Non-Resident Taxpayers by Member States of the European Union: A Proposal*, 26 *Brook. J. Int'l L.* (forthcoming May 2001).

somehow to the insoluble conflict between CEN and CIN is understandable, given the difficulties and uncertainties of fashioning international tax policy taking into account the multiple principles I have discussed here. But an effort to take seriously each of the relevant norms frees us to think anew about policy alternatives, to consider U.S. international tax policy proposals quite differently from the confinements of a commitment to CEN or CIN or to a compromise between them. Moving forward from here requires much further analysis, empirical investigation, and discussion (not necessarily by me), but if we are to have satisfactory international tax policy for the years ahead, it is a task that should begin.