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How I Learned to Stop Worrying and Love Double Taxation

Herwig J. Schlunk

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*Herwig J. Schlunk**

INTRODUCTION

In the current U.S. federal income tax regime, some of the income generated by economic activity conducted in corporate form is taxed twice: first when it is earned by the corporation and again when it is distributed to the owner of an interest in such corporation. This "double taxation" has long been the subject of scorn, and numerous proposals have been put forward to end it.[1] Most recently, President George W. Bush loudly joined the chorus of double taxation's detractors. He proclaimed that such taxation is "unfair" and "doesn't make any sense," and proposed legislation—centered on an exclusion of dividends from individual income taxation—that would have been its death knell.[2]

I have no particular quarrel with the President's assessment of double taxation as such taxation is currently practiced in the United States. That is, when the effect of double taxation either is, or in any event is perceived to be, to incrementally burden capital (narrowly

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1 *See* U.S. DEP'T OF THE TREASURY, REPORT ON INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE (1992); Michael J. Graetz & Alvin C. Warren, *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767 (1999).

2 Remarks Following a Cabinet Meeting and an Exchange with Reporters, 39 WEEKLY COMP. PRES. DOC. 30, 32 (Jan. 6, 2003), *available at* http://www.gpoccess.gov/wcomp/v39no2.html. The day after President Bush's remarks, two bills were introduced in the House that proposed the exclusion of dividends. *See* H.R. 178, 108th Cong. (2003); H.R. 49, 108th Cong. (2003). Congress did not enact the President's dividend exclusion, but rather, a temporary reduction in the rate of tax imposed on dividend income. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 301, 117 Stat. 752, 758 (2003).

defined to exclude human capital) or, more correctly, to incrementally burden corporate equity capital—for no better reason than that corporate equity capital is corporate equity capital—such double taxation can well be viewed as being unfair because it discriminates against corporate equity capital for no particularly defensible reason. Moreover, such double taxation can well be viewed as senseless because a whole host of financial arrangements can readily be substituted for much or even most corporate equity capital.

But the mere fact that double taxation as it is currently practiced in the United States may be unfair and senseless is not an indictment of double taxation in general. That is, there is nothing inherent in the concept of double taxation that necessarily leads to the imposition of an incremental tax burden solely on some nonhuman capital. Once this is understood, it turns out that there is nothing wrong with, and much right with, certain types of double taxation.[3] In fact, as I will demonstrate below, circumstances can and do arise in which it is not the presence, but rather the absence, of double taxation that is unfair and senseless! Given that these circumstances invariably exist in the "real world," it follows that the President's energies would be better spent trying to reform the United States' double tax regime, rather than trying to dismantle it.

This Article is divided into three Parts. The first Part is devoted to an example demonstrating that, while double taxation may be gratuitous in a purely domestic context, it invariably becomes necessary in a multinational context. The second Part formalizes and generalizes the example, and concludes that double taxation is not only necessary in a multinational context, but also in any multi-period domestic context. The third Part contains a few policy prescriptions that, I fervently hope, will guide future administrations.

I. AN EXAMPLE

A. *Integrated Domestic Taxation*

Consider a country called LowTax that is inhabited by an even number of identical individuals. All such individuals face an identical business opportunity. The opportunity requires an initial capital outlay of 1500,[4] which can be financed at a 10% interest rate, and which

3 *See* Herwig Schlunk, *I Come Not to Praise the Corporate Tax, But to Save It*, 56 TAX L. REV. 329 (2003) (discussing some defensible reasons for imposing an incremental "corporate" income tax, and illustrating how to design a "corporate" income tax regime based on one of them).

4 Figures represent monetary units.

is used as follows: 1000 to build a factory, and 500 to build a road to the factory. Once these investments have been made, the opportunity requires the capital and labor of two individuals, as well as an annual expenditure of 250 for the purchase of raw materials and an annual expenditure of 20 for the purchase of security services. From these various inputs an output is manufactured that, when sold, generates annual gross receipts of 600.

If two individuals form a joint venture to pursue this business opportunity, their joint venture will generate an aggregate annual return—"net income"—of 180. Consequently, each joint venturer's share of such return—that is, the "net income" generated by the capital and labor she devotes to the joint venture's business activity—will be 90. If, as I further posit, each joint venturer invariably annually spends 10 on personal security services (alarm systems and the like), and 20 on automobile maintenance services (necessitated by driving on poorly maintained dirt roads), her "ultimately disposable income"—that is, the annual income that she has available for the purchase of consumption goods and services other than security services and automobile maintenance services—will be 60.[5]

TABLE 1.1. LOWTAX JOINT VENTURE OPPORTUNITY

	With No Government Benefits	With Government Benefits	With Benefits *and* Taxes
ENTIRE VENTURE			
Gross Receipts	600	600	600
Interest Expense (Factory)	−100	−100	−100
Interest Expense (Road)	−50	−50	−50
Raw Materials	−250	−250	−250
Security Services	−20	0	0
Annual Return or "Net Income"	180	200	200
EACH PARTICIPANT			
Share of "Net Business Income"	90	100	100
Security Services	−10	0	0
Automobile Maintenance Services	−20	−20	−20
Individual Income Tax	0	0	−20
Ultimately Disposable Income	60	80	60

Suppose that LowTax decides to provide certain "benefits" to its businesses and residents. Specifically, LowTax decides to provide police protection. Suppose that if LowTax provides such police protection, each joint venture will be able to forego its annual expenditure on security services and, moreover, each resident will likewise be able to forego her annual expenditure on security services. As illustrated

5 *See infra* Table 1.1, column 1.

in column 2 of Table 1.1, LowTax's provision of police protection will directly cause the joint venture's net income to increase to 200. In addition, it will (partly indirectly and partly directly) cause each joint venturer's ultimately disposable income to increase to 80.

Unfortunately, LowTax will generally incur a cost when it bestows benefits on its businesses and residents. The amount of this cost will depend on how efficiently LowTax can produce and deliver the benefits in question. I assume, for purposes of this example, that LowTax can provide the benefits at exactly the same cost as the private sector. Thus, LowTax incurs a cost of 20 when providing police protection to a joint venture, and a cost of 10 when providing police protection to a joint venturer.

LowTax must find a way to cover these costs. In general, this means that LowTax will need to impose a tax. Suppose that LowTax chooses to impose an *income* tax. To balance its budget, LowTax might impose a 20% tax on the "net business income" of each resident. This tax will generate 20 of revenue from each resident (20% tax imposed on 100 of taxable income), and hence will provide LowTax with exactly the amount of revenue it requires. As illustrated in column 3 of Table 1.1, and following directly from the assumption that LowTax provides benefits at exactly the same cost as the private sector, the effect of the tax is to completely offset the windfall in ultimately disposable income that LowTax appeared to bestow upon its residents. Thus, under these assumptions, there is no free lunch.

Consider now a neighboring country called HighTax that is, except with respect to its tax and benefits policy, in every way identical to LowTax. HighTax has an even number of residents who are all faced with a business opportunity that is identical to the one facing LowTax's residents. Thus, HighTax's residents will also pair up to form joint ventures, each of which will require an initial capital outlay of 1500, financed at a 10% interest rate, and used to build a factory (1000) and a road to the factory (500), as well as the capital and labor of its two joint venturers, raw materials costing 250 annually, and security services costing 20 annually. From these various inputs, the joint venture will manufacture an output that, when sold, generates annual gross receipts of 600.

Under these assumptions, each joint venture will generate an aggregate annual return of 180, which will provide each joint venturer with an annual return—her "net business income"—of 90. If, as I further posit, each joint venturer invariably annually spends 10 on personal security services and 20 on automobile maintenance services, her "ultimately disposable income"—that is, the income she has avail-

able for the purchase of consumption goods and services other than security services and automobile maintenance services—will be 60.[6]

TABLE 1.2. HIGHTAX JOINT VENTURE OPPORTUNITY

	With No Government Benefits	With Government Benefits	With Benefits *and* Taxes
ENTIRE VENTURE			
Gross Receipts	600	600	600
Interest Expense (Factory)	−100	−100	−100
Interest Expense (Road)	−50	0	0
Raw Materials	−250	−250	−250
Security Services	−20	0	0
Annual Return or "Net Income"	180	250	250
EACH PARTICIPANT			
Share of "Net Business Income"	90	125	125
Security Services	−10	0	0
Automobile Maintenance Services	−20	0	0
Individual Income Tax	0	0	−65
Ultimately Disposable Income	60	125	60

As did LowTax, HighTax decides to provide certain benefits to its businesses and residents. However, it decides to provide more benefits than did LowTax. In addition to providing police protection, HighTax decides to build and maintain roads. Suppose that the provision of police protection has exactly the same effects in HighTax as it had in LowTax. Thus, each joint venture is able to forego its annual expenditure on security services, and each joint venturer is likewise able to forego her annual expenditure on security services. Suppose that the provision of roads has the following effects: each joint venture is able to forego the initial investment of 500 that was used to build a road to its factory, and each resident is able to forego her annual expenditure on automobile maintenance services. Thus, as illustrated in column 2 of Table 1.2, HighTax's provision of police protection and road services will directly cause each joint venture's net income to increase to 250. In addition, it will (partly indirectly and partly directly) cause each joint venturer's ultimately disposable income to increase to 125.

But, as did LowTax, HighTax will generally incur a cost when it bestows benefits on its businesses and residents. I assume, as I did in the case of LowTax, that HighTax can provide the benefits it chooses to provide at exactly the same cost as the private sector. Thus, HighTax incurs a cost of 20 when providing police protection to a joint venture, a cost of 10 when providing police protection to a joint

6 *See infra* Table 1.2, column 1.

venturer, a cost of 50 when providing road services to a joint venture, and a cost of 20 when providing road services to a joint venturer.

Of course, HighTax must find a way to cover these costs. It, too, chooses to enact an income tax. To balance its budget, HighTax might impose a 52% tax on the "net business income" of each resident. This tax will generate 65 of revenue from each resident (52% tax imposed on 125 of taxable income), and hence will provide HighTax with exactly the amount of revenue it requires. As illustrated in column 3 of Table 1.2, and again following directly from the assumption that HighTax provides benefits at exactly the same cost as the private sector, the effect of the tax is to completely offset the windfall in ultimately disposable income that HighTax appeared to bestow upon its residents.

B. Integrated Multinational Taxation

Suppose, now, that into this balkanized world come two additional individuals—*J*, who chooses to reside in LowTax, and *K*, who chooses to reside in HighTax. Since neither *J* nor *K* can find a joint venture partner in her country of residence (since all other individuals in each country are already paired up), *J* and *K* form the first cross-border joint venture.

Suppose first that *J* and *K* form the *J-K* joint venture in LowTax, and that such joint venture conducts all of its business activity in LowTax. In this case, in keeping with its policy of providing police protection to its businesses, LowTax will provide police protection to the *J-K* joint venture. This incremental provision of police protection will impose a cost of 20 on LowTax. In addition, in keeping with its policy of providing police protection to its residents, LowTax will provide police protection to *J*. This incremental provision of police protection will impose a cost of 10 on LowTax. Finally, in keeping with its policy of providing police protection and road services to its residents, HighTax will provide both police protection and road services to *K*. This incremental provision of police protection and road services will impose a cost of 30 on HighTax. Thus, when all is said and done, LowTax must, to balance its budget, raise additional tax revenue of 30, and HighTax must, to balance its budget, also raise additional tax revenue of 30.

I assume that neither LowTax nor HighTax is willing to undertake a wholesale overhaul of its income tax system simply to raise the additional revenue it requires. In particular, neither country is willing to change the way in which it taxes any individual who is paired up in a wholly domestic joint venture. Rather, each country seeks a way to

integrate the taxation of *J* and *K*, the two individuals not paired up in a wholly domestic joint venture, into its existing tax system. More mundanely, LowTax seeks a straightforward and more or less principled way to impose aggregate taxes of 30 on *J* and *K*, and HighTax similarly seeks a straightforward and more or less principled way to impose aggregate taxes of 30 on *J* and *K*.

Note that there is no particularly principled reason for either country to give *J* any special tax treatment. From LowTax's vantage, *J* is a LowTax resident who is involved in a joint venture that is engaged in business activity that is conducted entirely in LowTax. Thus, *J* looks exactly like every other resident of LowTax, and should be taxed accordingly. If so, LowTax will tax *J* at its usual 20% rate on her net business income of 100, and will thus collect 20 of tax revenue from her. Similarly, from HighTax's vantage, *J* is a LowTax resident who is involved in a joint venture that is engaged in business activity conducted entirely in LowTax. Thus, *J* looks exactly like every other resident of LowTax, and should be taxed accordingly, namely not at all.

After taking the taxes imposed on *J* into account, it becomes necessary for LowTax and HighTax to find a way to collect taxes of 10 and 30, respectively, from *K*. Note that the fact that *both* countries must collect tax from *K* is not, in and of itself, problematic. That is, *K* is the only person in the world who actually has sufficient contacts with both countries to justify such dual taxation: *K*'s income is derived from business activity conducted in LowTax (and is, therefore, directly enhanced by the business benefits that LowTax provides); *K* is a resident of HighTax (and her quality of life is therefore directly enhanced by the non-business benefits that HighTax provides). What is problematic is finding a way to coordinate LowTax's and HighTax's tax regimes so that each country imposes on *K* a tax burden that *exactly* covers the cost of the benefits provided to *K*.

Since the *J*-*K* joint venture's business activity is conducted in LowTax, LowTax has the first bite at the apple of *K*'s income. What should LowTax do? Note that LowTax cannot tax *K* as a resident, not because it is impractical to do so, but rather because doing so would result in the collection of too much revenue. That is, tax revenue collected from *K* would amount to 20 (a 20% tax imposed on 100 of net business income), when only 10 is actually required. Thus, LowTax must devise a mechanism that will impose a lesser tax burden on *K*. Two such mechanisms are frequently employed in the "real world." The first mechanism involves imposing tax at a reduced "nonresident" tax rate. Thus, LowTax could balance its budget by imposing a 10% nonresident tax rate on all of *K*'s net business income (a 10% tax imposed on 100 of income yields 10 of tax). The second

mechanism involves imposing the usual "resident" tax rate, but on a reduced tax base. Thus, LowTax could balance its budget by imposing its usual 20% tax rate, but only on 50% of *K*'s net business income (a 20% tax imposed on 50 of income yields 10 of tax).[7]

TABLE 2.1. TAX COLLECTIONS FROM *K*

	LowTax	HighTax
Necessary Revenue from *K*	10	30
LowTax Taxes *K* at 10% rate	10	—
HighTax Ignores LowTax Taxes	—	52
HighTax Allows Deduction for Taxes	—	46.8
HighTax Allows Foreign Tax Credit	—	42
HighTax Excludes Foreign Income	—	0
LowTax Taxes *K* on 50% of Income	10	—
HighTax Taxes *K* on 50% of Income	—	26

Suppose, first, that LowTax decides to impose a 10% tax on all of *K*'s net business income. In the "real world," HighTax typically responds in one of four ways. At one extreme, HighTax can ignore LowTax's imposition of tax and simply tax *K* as it taxes any other resident, that is, at its full 52% tax rate on *K*'s entire 100 of worldwide net business income (computed without allowing any deduction for LowTax tax payments or accruals).[8] Such an imposition of tax would, however, raise 52 of revenue, which is 22 more than HighTax requires. At the other extreme, HighTax could allow *K* to exclude her LowTax source income from HighTax taxation.[9] In that case, however, HighTax would raise no revenue at all, and thus would face a revenue shortfall of 30.[10]

7 The first mechanism is adopted in most tax treaties. *See, e.g.*, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL §§ 10–12 (1992) (recommending that the source country impose tax at reduced rates of 5% to 15% on dividends paid to nonresidents, 10% on interest paid to nonresidents, and 0% on royalties paid to nonresidents). The second mechanism is adopted by most states for the purpose of taxing the income of multistate enterprises. JEROME HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION 653–54 (5th ed. 1988); *see also infra* Table 2.1.

8 This extreme requires a truly unusual confluence of improbables. Thus, if *K* were a U.S. resident, it would require that: (1) the United States has no tax treaty with LowTax; (2) the United States allows no deduction for taxes paid to LowTax (e.g., the Internal Revenue Code might be called off because the payments are illegal under U.S. law); and (3) the United States allows no foreign tax credit for the taxes paid to LowTax (e.g., because the Internal Revenue Code does not treat the payments as "income" taxes).

9 *See, e.g.*, I.R.C. § 911 (2000) (allowing U.S. residents to exclude from U.S. income taxation certain amounts of "foreign earned income").

10 *See supra* Table 2.1.

In between these extremes are the two most typical responses. First, HighTax could tax *K* as it taxes any other resident, but allow *K* a deduction for the taxes *K* is required to pay to LowTax.[11] Thus, *K* would be taxed at HighTax's 52% rate, but only on 90 of net income (100 of worldwide net business income reduced by 10 of tax required to be paid to LowTax). If HighTax adopts this response, it would raise revenue of 46.8, which exceeds its requirements by 16.8.[12] Alternatively, HighTax could tax *K* as it taxes any other resident, but allow *K* a foreign tax credit for the foreign taxes that *K* is required to pay with respect to her foreign source income.[13] In the instant case, *K* would be taxed at HighTax's 52% tax rate on 100 of worldwide net business income, and, thus, would incur a tentative tax liability of 52. However, *K* would be entitled to reduce this tentative tax liability by the amount of foreign taxes that she is required to pay to LowTax, namely 10. Thus, *K* would ultimately pay 42 of taxes to HighTax. Again, HighTax's tax collections would exceed its revenue requirements, this time by 12.[14]

Finally, suppose that LowTax adopts the alternative mechanism that provides it with the correct amount of revenue: it taxes *K* at its full 20% tax rate, but only on that fraction of *K*'s net business income—in this case, 50%—that it deems to be earned in LowTax.[15] In such case, HighTax might, as an alternative to the four foregoing mechanisms, adopt its own income allocation scheme. Assuming that it does, and assuming that the two income allocation schemes are identical, so that both LowTax and HighTax agree that 50% of *K*'s net business income should be allocated to LowTax and that 50% of *K*'s net business income should be allocated to HighTax, HighTax would impose its 52% tax on 50% of *K*'s net business income. Thus, HighTax would collect tax revenue of 26 (a 52% tax imposed on 50% of *K*'s 100 of worldwide net business income). Unfortunately, just like all the other alternatives, this strategy is imperfect: it leaves HighTax with a revenue shortfall of 4.[16]

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11 *See* I.R.C. § 164(a)(3).

12 *See supra* Table 2.1.

13 *See* I.R.C. § 901.

14 *See supra* Table 2.1.

15 In general, states allocate income earned by a multistate enterprise to one state or another on the basis of a formula (differing from state to state) that takes into account the enterprise's sales, payroll, and property in the various states. *See, e.g.*, IDAHO CODE § 63–3027 (Michie 2000); MO. REV. STAT. § 32.200 (2001). In the example, I do not base my 50% allocation on any such formula, but simply on fiat: it is the allocation necessary to balance LowTax's budget.

16 *See supra* Table 2.1.

Not surprisingly, similar difficulties are encountered if the *J-K* joint venture is formed in HighTax, and conducts all of its business activity in HighTax. In such case, in keeping with its policy of providing police protection and road services to its businesses and residents, HighTax will provide police protection costing 20 and road services costing 50 to the *J-K* joint venture and police protection costing 10 and road services costing 20 to *K*. Thus, HighTax incurs 100 of incremental expenditures. In addition, in keeping with its policy of providing police protection to its residents, LowTax will provide police protection costing 10 to *J*. Taking these costs into account, HighTax must impose additional taxes of 100 to balance its budget, and LowTax must impose additional taxes of 10 to balance its budget.

Assuming again that neither country is willing to undertake a wholesale overhaul of its existing tax system, the question each faces is how to integrate *J* and *K* into its tax system. In particular, HighTax needs such integration to be accomplished in a way that raises 100 of revenue, and LowTax needs such integration to be accomplished in a way that raises 10 of revenue.

The taxation of *K* should be straightforward. HighTax has no good reason to tax *K* differently than it taxes any other resident involved in a joint venture that is engaged in business activity conducted entirely within HighTax. Thus, HighTax should tax *K* at a 52% rate on her 125 of net business income and, hence, should raise 65 of revenue from *K*. Similarly, LowTax has no good reason to tax *K* differently than it taxes any other nonresident lacking LowTax source income, namely not at all.

After taking the foregoing taxes imposed on *K* into account, HighTax and LowTax must find a way to impose taxes of exactly 35 and 10, respectively, on *J*. Again, there can be no question that both HighTax and LowTax are entitled to tax *J*'s income: HighTax's entitlement stems from the fact that *J*'s income is derived from business activity conducted in HighTax; LowTax's entitlement stems from the fact that *J* is a LowTax resident. Rather, the question is whether HighTax and LowTax can coordinate their tax regimes so as to collect *exactly* the right amount of tax.

I begin by considering HighTax's strategy, since HighTax has the first bite at the apple of *J*'s income. Obviously, HighTax cannot tax *J* as if she were a resident, since doing so would result in too much revenue: revenue would total 65 (a 52% tax imposed on 125 of net business income), when only 35 is required. Thus, HighTax must resort to a mechanism that will impose a lesser tax burden on *J*. As already noted, the two most prevalent mechanisms are to impose tax on *J* at a reduced "nonresident" tax rate, and to impose tax on *J* at

HighTax's full 52% tax rate, but only on a fraction of *J*'s net business income. If HighTax adopts the former mechanism, its nonresident tax rate would need to be 28%, since a 28% tax imposed on *J*'s 125 of net business income would yield 35 of tax revenue. If HighTax adopts the latter mechanism, it would need to impose its 52% tax rate on 54% of *J*'s net business income, since a 52% tax imposed on 54% of 125 of net business income would yield 35 of tax revenue.[17]

TABLE 2.2. TAX COLLECTIONS FROM *J*

	LowTax	HighTax
Necessary Revenue from *J*	10	35
HighTax Taxes *J* at 28% Rate	—	35
LowTax Ignores HighTax Taxes	25	—
LowTax Allows Deduction for Taxes	18	—
LowTax Allows Foreign Tax Credit	0	—
LowTax Excludes Foreign Income	0	—
HighTax Taxes *J* on 54% of Income	—	35
LowTax Taxes *J* on 46% of Income	11.5	—

Suppose, first, that HighTax adopts the strategy of taxing *J* at a 28% reduced nonresident tax rate. As already noted, LowTax has four more or less standard responses. First, at one extreme, it could ignore HighTax taxes and simply tax *J* on all 125 of her worldwide net business income. However, applying LowTax's 20% tax rate to *J*'s 125 of income would result in tax collections of 25. Such tax collections would exceed LowTax's revenue requirements by 15. Second, at the other extreme, LowTax could exclude *J*'s income from LowTax taxation on the basis that the income is not LowTax source income. But that strategy would result in no tax collections from *J*, and so would leave LowTax with a revenue shortfall of 10.[18]

Third, in between these extremes, LowTax could tax *J* as it taxes any other resident, but allow *J* a deduction for the taxes *J* is required to pay to HighTax. Thus, *J* would be taxed at LowTax's 20% tax rate on 90 of income (125 of worldwide net business income reduced by 35 of tax required to be paid to HighTax). If LowTax adopts this strategy, it raises revenue of 18, and accordingly has a surplus of 8. Finally, LowTax could tax *J* as it taxes any other resident, but allow *J* a foreign tax credit for the taxes *J* is required to pay to HighTax. In this case, *J* would be taxed at LowTax's 20% tax rate on all 125 of her worldwide net business income, and so would incur a tentative tax liability of 25. However, *J* would be entitled to reduce this tentative

17 *See infra* Table 2.2.

18 *See supra* Table 2.2.

tax liability by the amount of foreign taxes she is required to pay to HighTax. In practice, *J* would generally not be entitled to reduce her tentative tax liability by *all* of the taxes she is required to pay to HighTax, since a reduction of 35 applied to a liability of 25 would produce a negative tax payment, that is, a tax refund. So LowTax would generally limit *J*'s tax credit to the amount of tax that LowTax would normally impose on *J*'s foreign source income.[19] In the instant case, *J* has 125 of HighTax source income, so her foreign tax credit would be limited to 25 (LowTax's 20% tax rate imposed on 125 of income results in 25 of tax). But this credit would still be sufficient to wipe out *J*'s entire LowTax tax liability. Thus, when all is said and done, LowTax would collect no tax from *J*, and thus would face a revenue shortfall of 10.[20]

Now, suppose that HighTax adopts the alternative mechanism that provides it with the necessary amount of revenue: it taxes *J* at its full 52% tax rate but only on that fraction of *J*'s net business income—in this case, 54%—that it deems to have been earned in HighTax. In such case, LowTax might also adopt an income allocation scheme. Assuming that it does, and assuming that the two allocation schemes are identical, so that both HighTax and LowTax agree that 54% of *J*'s net business income should be allocated to HighTax and 46% of *J*'s net business income should be allocated to LowTax, LowTax would impose a 20% tax on 46% of *J*'s net business income. Thus, LowTax would collect tax revenue of 11.5 (a 20% tax imposed on 46% of *J*'s 125 of worldwide net business income). Again, the desired result proves elusive; LowTax would achieve a revenue windfall of 1.5.[21]

C. *Double Taxation to the Rescue*

Why is it that LowTax and HighTax find it impossible to implement tax regimes that collect *all* of the necessary revenue, but *only* the necessary revenue? The answer, perhaps surprisingly, is that both LowTax and HighTax have what are called integrated income tax regimes! Such regimes, by their very nature, conflate the taxes imposed on business activity with the taxes imposed on consumption activity. Thus, a country with an integrated income tax regime cannot directly impose on businesses a tax that exactly corresponds to the cost of government benefits that such country provides to businesses. And it cannot directly impose on individuals a tax that exactly corresponds to

19 *See* I.R.C. § 904.

20 *See supra* Table 2.2.

21 *Id.*

the cost of government benefits that such country provides to individuals in their non-business capacities.

This defect, while present in the purely domestic context, does not, under my current assumptions, take on a huge amount of importance there. Thus, if, as is trivially true in my example, the business benefits (indirectly) provided to each individual increase as her amount of net business income increases, and if the non-business benefits provided to each individual increase as her amount of "individual income"—defined as the excess of her net business income over her share of the cost of governmentally provided business benefits—increases, then an "integrated" income tax can be designed that, when imposed on each individual's taxable income—defined as her net business income—will yield tax revenue exactly equal to the cost of the business and the non-business benefits provided to such individual.

In the multinational context, however, the ability to successfully employ such an integrated income tax regime vanishes. That is, an individual with multinational contacts will continue to (indirectly) receive business benefits that increase as her amount of net business income increases, and she will continue to receive non-business benefits that increase as her amount of "individual income"—still defined as the excess of her net business income over her share of the cost of governmentally provided business benefits—increases. But she will receive the business benefits and the non-business benefits from different countries. Thus, neither country can simply impose its integrated income tax on her taxable income, still defined as her net business income. Rather, the country providing the business benefits must impose a tax *designed solely to cover the cost of its business benefits.* And the country providing the non-business benefits must impose a tax *designed solely to cover the cost of its non-business benefits.* Gladly, there is a straightforward way for each country to do this. Each country must impose a tax on each individual's net business income that reflects the cost of the business benefits it (indirectly) provides to such individual. And each country must impose a tax on each individual's individual income—as ever defined as the excess of her net business income over her share of the cost of governmentally provided business benefits—that reflects the cost of the non-business benefits it provides to such individual. Of course, following such a strategy amounts to enacting a double tax regime.

To illustrate, I return to the dilemma faced by LowTax and HighTax in the face of the *J-K* joint venture. Suppose that LowTax replaces its integrated income tax regime, which imposes a 20% tax on each individual's net business income, with a double tax regime that imposes a 10% "corporate" income tax on each individual's net

business income (collected, for the sake of administrative convenience, from the business) *and* an 11% "individual" income tax on each individual's "individual income," defined as her net business income less her share of the corporate income tax. And suppose that HighTax replaces its integrated income tax regime, which imposes a 52% tax on each individual's net business income, with a double tax regime that imposes a 28% "corporate" income tax on each individual's net business income (collected, for the sake of administrative convenience, from the business) *and* a 33% "individual" income tax on each individual's "individual income," defined as her net business income less her share of the corporate income tax. As illustrated in Table 3.1, in the purely domestic context, the double tax regimes perfectly replicate the prior integrated income tax regimes.

TABLE 3.1. TAXATION OF JOINT VENTURE UNDER A CLASSICAL TAX REGIME

	JV Conducted in LowTax	JV Conducted in HighTax
ENTIRE VENTURE		
Gross Receipts	600	600
Interest Expense (Factory)	−100	−100
Interest Expense (Road)	−50	0
Raw Materials	−250	−250
Net Income of Joint Venture	200	250
"Corporate" Income Tax	−20	−70
After-Tax Business Income	180	180
EACH PARTICIPANT		
"Individual Income"	90	90
"Individual" Income Tax	−10	−30
Automobile Maintenance Services	−20	0
Ultimately Disposable Income	60	60

But, of course, the double tax regimes actually do much more than merely replicate the results of the prior integrated income tax regimes. In the multinational context, i.e., in the case of the *J-K* cross-border joint venture, it is now easily possible for each country to collect exactly the right amount of tax. To do so it must simply adhere to the following obvious set of "international tax" rules:

(1) Each country must impose its "corporate" income tax on all of the net business income generated by a business conducted within

such country's borders, whether or not the owners of such business reside in such country;[22]

(2) Each country must exempt from its "corporate" income tax all of the net business income generated by a business conducted outside of such country's borders, even if the owners of the business reside in such country;[23]

(3) Each country must impose its "individual" income tax on all of the after-corporate-tax net business income received by its residents, whether or not such income is received from a business conducted within such country's borders;[24] and

(4) Each country must exempt from its "individual" income tax all of the after-corporate-tax net business income received by its nonresidents, even if such income is received from a business conducted within such country's borders.

As illustrated in Tables 3.2 and 3.3, an application of these rules indeed produces the required tax collections for LowTax and HighTax.

22 Similar rules have been proposed elsewhere. *See, e.g.*, Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, 89 GEO. L.J. 543, 591 (2001) (arguing that foreign corporations doing business in the United States should be subjected to U.S. corporate income taxation, but perhaps at a reduced rate—reflecting her belief that, contrary to the assumption underlying my example, the revenues collected by the U.S. corporate income tax greatly exceed the cost of governmentally provided business benefits).

23 *Id.* at 588. Roin would likewise exempt foreign source income from U.S. *corporate* income taxation. *Id.* In addition, Roin would impose a reduced rate of *individual* income tax on the foreign source non-dividend business income of individuals. *Id.* at 593. Since such income is, under the current U.S. tax regime, only taxed in the hands of individuals, the cost of any business benefits associated with the generation of this income is currently collected directly from individuals. Obviously, such income, when foreign-sourced, cannot have been enhanced by any domestically provided business benefits. Thus, imposing a reduced individual income tax burden on such income reflects the same notion motivating my rule: namely, that a charge for business benefits should only be collected by the country providing the business benefits.

24 *Id.* at 592. Roin would likewise impose the individual income tax on an individual's share of after-corporate-tax foreign corporate income. *See id.* at 592.

TABLE 3.2. TAX COLLECTIONS FROM LOWTAX JOINT VENTURE

	LowTax	HighTax
Corporate Income Tax	20[25]	0
Individual Income Tax Paid by *J*	10[26]	0
Individual Income Tax Paid by *K*	0	30[27]

TABLE 3.3. TAX COLLECTIONS FROM HIGHTAX JOINT VENTURE

	LowTax	HighTax
Corporate Income Tax	0	70[28]
Individual Income Tax Paid by *J*	10[29]	0
Individual Income Tax Paid by *K*	0	30[30]

II. GENERALIZING THE EXAMPLE

A. *On the Relationship Between Income Taxes and Benefits Taxes*

It is beyond the scope of this Article to engage in an extended philosophical discussion of the purposes of taxation. Suffice it to say that a sovereign imposes taxes to collect revenue, and it collects revenue to enable it to purchase various goods and services. Perhaps not in the short run, but certainly in the long run, all monies collected are spent: what comes in goes out again. Moreover, what a sovereign spends is not in general spent for its own "personal" benefit. In that part of the modern world that concerns me in this Article, sovereigns are not individuals indulging extravagant tastes in lavish palaces. Rather, sovereigns are somewhat amorphous entities—that is, governments—and like other entities, are incapable of personal consumption in their own right. Thus, what a sovereign spends it spends on others. Or, to fit the terminology in the heading to this section, the goods and services purchased by a sovereign are purchased *for the benefit of* others. If the sovereign is benevolent, and I take it as a given that all of the relevant sovereigns would, if they were sentient, view them-

25 Ten percent corporate income tax imposed on 200 of net business income.

26 Eleven percent individual income tax imposed on 90 of after-corporate-tax net business income.

27 Thirty-three percent individual income tax imposed on 90 of after-corporate-tax net business income.

28 Twenty-eight percent corporate income tax imposed on 250 of net business income.

29 Eleven percent individual income tax imposed on 90 of after-corporate-tax net business income.

30 Thirty-three percent individual income tax imposed on 90 of after-corporate-tax net business income.

selves as benevolent, the "others" that it intends to benefit are broadly all of those persons that are its subjects. But a sovereign's subjects are neither more nor less than the persons within its taxing jurisdiction. Thus, the persons benefited by the sovereign's purchase of goods and services are those who either pay taxes or could be made to pay taxes.[31] But that just means that any tax imposed by a benevolent sovereign, *including an income tax*, is, at least when viewed in the aggregate, a benefits tax. The revenue it generates is entirely used to purchase goods and services that provide benefits to those persons who pay or could be made to pay the tax; the tax itself would not be imposed but for a desire to provide such benefits.

What applies in the aggregate may or may not apply on the level of any one subject.[32] Thus, it is generally neither meaningful nor correct to say that the taxes a sovereign collects from any one subject are used, dollar-for-dollar or yen-for-yen, to purchase goods and services that (directly? exclusively?) provide benefits to such subject. Of course, some *part* of the taxes may be so used. Thus, even more crassly than in the example in Part I, the sovereign might use part of the taxes it collects from one of its subjects to pay the salary of a policeman who will be posted at such subject's door. However, most of the goods and services purchased by the sovereign will provide benefits that are not and indeed cannot be targeted in such a narrow way. Rather, such goods and services are so-called public goods and services: goods and services that benefit most or even all of the sovereign's subjects. These include not just police protection and adequate roads, as in the example in Part I, but also an educational system, a legal system, a social safety net, a national defense, and so on.

The tax problem that confronts the sovereign is how to allocate the cost of such goods and services, or equivalently, the payment for the benefits such goods and services provide, among its subjects. At least three "reasonable" possibilities exist. First, the sovereign could allocate the cost in that manner that it believes will induce its subjects to maximize their aggregate output of goods and services. That is, it could attempt to impose a tax that is "efficient." Second, the sover-

31 Note that, under my view, development grants made to foreign countries are not made for the altruistic purpose of simply benefiting such countries, but rather for the selfish purpose of benefiting the sovereign's own subjects, perhaps stimulating commerce, perhaps by promoting global stability, etc.

32 *See* PETER ANDREW HARRIS, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES 13 (1996) (discussing some of the difficulties of viewing an income tax as a benefit tax). In spite of these difficulties, Harris ultimately concludes that something very much like a benefits view is not only justifiable, but actually necessary, in multinational contexts. *See id.* at 445–56.

eign could allocate the cost in that manner that it believes will maximize the utility of its subjects as measured by some social utility function. That is, it could attempt to impose a tax based primarily on considerations of welfare. Third, the sovereign could allocate the cost in that manner that it believes best reflects how its subjects would demand and consume the goods and services it purchases and provides, if it did not otherwise provide them. That is, it could attempt to impose a tax that treats such goods and services as either productive inputs or consumer goods and services, as the case may be, and that treats its subjects as persons who must purchase such goods and services in order to enjoy their benefits. I will assume that the sovereign follows the third approach. Accordingly:

Proposition 1: A sovereign can reasonably attempt to impose a tax that reflects its assessment of its subjects' demand for and consumption of the goods and services it provides.

How can the sovereign measure any given subject's demand for and consumption of the goods and services it provides? One way is to try to assess the marginal cost "imposed by" the subject on the sovereign. That is, the sovereign could (theoretically) determine the cost of the goods and services it would provide, based on the relevant political process, to all of its subjects other than the given subject in a world without the given subject. And it could determine the cost of the goods and services it actually provides. The excess of the latter over the former is the marginal cost "imposed by" the given subject on the sovereign. Of course, this excess is likely to be very small: the sovereign will rarely feel compelled by the addition of any given subject to dramatically increase the amount of goods and services it provides. Nonetheless, the excess is unlikely to be zero. That is, population growth will almost invariably lead a sovereign to increase the aggregate amount of goods and services it provides. Thus, although not necessarily measurable, population growth *of even one subject* will at least statistically lead to an increase (albeit a very small one) in the aggregate amount of goods and services the sovereign provides.

I believe that more can be said. I maintain that, in general, the marginal cost imposed by any subject on the sovereign, at least on average, will be greater the greater is such subject's wealth. For example, it surely costs the sovereign more to provide police protection to Bill Gates than to me: he has a mansion and numerous other properties to protect; I have but a single modest house. And it surely costs the sovereign more to provide adequate roads to Bill Gates than to me: his business sends fleets of trucks onto the roads, transporting his

software to various retail outlets; I merely drive one automobile back and forth to my place of employment. And it surely costs the sovereign more to provide a legal system to Bill Gates than to me: he is continuously involved in litigation; I am not currently involved in any. Moreover, it arguably costs the sovereign more to provide an educational system to Bill Gates than to me: he demands a large educated workforce and a large educated customer base; I simply demand a few educated colleagues. And it arguably costs the sovereign more to provide a social safety net to Bill Gates than to me: he demands employees who will forego the incremental wages that would be necessary but for the fallback of such a safety net; I am content to sleep better at night in the knowledge that a safety net exists for me and my family. And it arguably costs the sovereign more to provide national defense to Bill Gates than to me: his manufacturing facilities might well be a target for terrorists or other hostile persons; my house almost surely is not.

Of course, and unfortunately, it would not be particularly practical for a sovereign to impose a tax on every subject in the amount of the marginal cost imposed by such subject on the sovereign. The reason is that the aggregate of such marginal costs across all of the sovereign's subjects would be far less than the actual cost of the goods and services the sovereign provides. Thus, a marginal cost analysis really provides nothing more than a clean *lower bound* for the amount of taxes that should be imposed on any given subject. Accordingly:

Proposition 2: The lower bound of the tax a sovereign should impose on any subject, to reflect such subject's demand for and consumption of the goods and services the sovereign provides, increases (on average) as the subject's wealth increases.

A second way for the sovereign to measure any given subject's demand for and consumption of the goods and services it provides is to directly determine the benefit such subject derives from those goods and services. That is, the sovereign can acknowledge that it is a monopolist providing a highly desirable package of goods and services. Like any monopolist, the sovereign can charge each "purchaser" of such package any price so long as such price does not more than offset such purchaser's "consumer surplus." Focusing now on a given subject, what is her consumer surplus? It is the total amount that she would be willing to pay not to lose the sovereign's package of goods and services. To determine this amount, it is helpful to perform the following thought experiment. Imagine that the sovereign

ceases to tax and spend: it simply disappears.[33] How much would the subject pay to keep that from happening? My intuition tells me that she would pay nearly the entire amount of her wealth. The reason is that the result of the sovereign's disappearance would almost surely be anarchy, a return to the state of nature. And in the state of nature, most or all of the subject's assets that are valuable in the world where the sovereign provides its package of goods and services, including her human capital, would lose most or all of their value. Accordingly:

Proposition 3: The upper bound of the tax a sovereign can impose on any subject, to reflect such subject's demand for and consumption of the goods and services the sovereign provides, increases (essentially uniformly) as the subject's wealth increases.

Unlike a tax imposed in the amount of the lower bound set forth in Proposition 2, a tax imposed in the amount of the upper bound set forth in Proposition 3 will cover the cost of the goods and services the sovereign wishes to provide. Indeed, it will generally much more than cover such cost. Thus, it is feasible for the sovereign to pursue a taxing strategy that takes this upper bound into account. However, the sovereign will need to abate the tax collections suggested by such upper bound to ensure that its aggregate tax collections equal rather than exceed the cost of the goods and services it wishes to provide. I will take up such abatement in a moment. But first it will be fruitful to convert the suggested wealth-based tax into an income-based tax.

Note that the sovereign's provision of goods and services, and hence its need to collect taxes, is not, in general, a one-time event. Rather, the sovereign *periodically* provides goods and services.[34] And hence it must *periodically* collect taxes. Thus, I will assume that the sovereign establishes a period, such as the taxable year, and for such period both collects a given amount of taxes and provides a corresponding amount of goods and services. How does the upper bound of the tax the sovereign can impose on any subject appear under these assumptions? If the sovereign takes an ex ante perspective, that is, it collects taxes and provides corresponding goods and services at the beginning of the period, the upper bound is the subject's wealth at

33 *Cf.* LIAM MURPHY & THOMAS NEAL, THE MYTH OF OWNERSHIP 16 (2002) ("[T]he benefit of government services must be understood as the difference between someone's level of welfare in a no-government world and their welfare with government in place.").

34 In fact, the sovereign can be better viewed as providing goods and services continuously. However, there is no loss of generality and much gain of simplicity in assuming instead that it provides such goods and services periodically.

the beginning of the period, or W_b. The reason is simple: in the state of nature, the subject would lose more or less exactly this amount. If, instead, the sovereign takes an ex post perspective, that is, it provides goods and services at the beginning of the period but collects taxes to pay for them at the end of the period (which taxes are necessarily grossed-up to reflect the time value of money imposed on its borrowings), the upper bound is the sum of the subject's wealth at the end of the period and the subject's consumption during the period, or $W_e + C$. After all, in the state of nature that would have resulted had the sovereign not provided its goods and services, the subject would not have been able to achieve either her end-of-period wealth or more than a mere fraction of the consumption she enjoyed during the period.

Of course, the sovereign cannot generally tax away and spend *and respend and respend again ad infinitum* the entire amount of any subject's wealth. Indeed, if the goods and services the sovereign provides are actually consumed by the subjects to whom they are provided, the sovereign has no *ongoing periodic* ability to tax and spend more than the return earned by any subject on her wealth. Thus, if the sovereign takes the ex ante approach, it could not on an ongoing periodic basis impose a tax of more than approximately $r*W_b$, where r is the riskless rate of return available in the economy during the period. Alternatively, if the sovereign takes the ex post approach, it could not on an ongoing periodic basis impose a tax of more than $(W_e - W_b) + C$. It should come as no great surprise to any reader that each of these amounts is a measure of *income*: the former is the subject's expected risk-adjusted income during the period in question; the latter is the subject's actual Haig-Simons income during the period in question. Thus, and with all due emphasis:

Proposition 4: The upper bound of the tax a sovereign can impose on any subject on an ongoing periodic basis, to reflect such subject's demand for and consumption of the goods and services the sovereign provides, or more accurately, to reflect such subject's benefit derived from the goods and services the sovereign provides, increases (essentially uniformly) as the subject's income increases.

Recall that the sovereign will not need to impose a tax equal to this upper bound on its subjects, since such a tax would leave it with an undesired budget surplus. Thus, for any given subject, the sovereign should impose a tax that is some fraction (less than one) of the upper bound. Since the upper bound is a subject's income, it follows immediately that a "fair" benefits tax can and should be structured as

an income tax: that is, as a tax that increases as a given subject's income increases. The reason is that only this tax structure will satisfy the two most widely accepted "fairness" norms of taxation: horizontal and vertical equity. That is, only an income tax can ensure that every subject that derives a given amount of benefit from the sovereign's provision of goods and services (which benefit is by virtue of Propositions 3 and 4 equal to such subject's income) will pay the same amount of tax as every other subject that derives the same amount of benefit. And only an income tax can ensure that any subject that derives a greater amount of benefit from the sovereign's provision of goods and services than does some other subject (which benefit is by virtue of Propositions 3 and 4 equal to such subject's income) will pay a greater amount of tax than any other subject.

Conversely, it also follows that any income tax is a "fair" benefits tax, w*hether or not the sovereign that imposed such income tax intended to impose a benefits tax.* That is, whether an income tax is progressive, or proportional, or regressive, it will have as an inherent feature that it will impose on subjects that derive identical amounts of benefit from the sovereign's provision of goods and services identical amounts of tax (since by virtue of Propositions 3 and 4 the amount of any subject's benefit is equal to such subject's income), and it will also have as an inherent feature that it will impose on subjects that derive greater amounts of benefit from the sovereign's provision of goods and services greater amounts of tax (again, since by virtue of Propositions 3 and 4 the amount of any subject's benefit is equal to such subject's income).[35] Thus, I have proven:

Theorem 1: A "fair" tax imposed by a sovereign with respect to the benefits it provides to its subjects can and should take the form of an income tax. Conversely, any income tax imposed by a sovereign can be viewed as a "fair" benefits tax.

I will end this subsection with a quick illustration. Suppose that in Country *X* there are 101 individuals, and that these individuals an-

35 Additional norms must be superimposed on the "fair benefits tax" concept in order for the sovereign to refine the design of its income tax. That is, the benefits tax concept by itself does nothing more than force the sovereign to bound its tax by the income generated by its subjects. Superimposing the fairness norm on this structure then turns the sovereign's tax into an income tax. Superimposing additional norms might then turn the income tax into a progressive, or proportional, or regressive income tax. Thus, for example, superimposing a social welfare norm *might* be thought to lead to a progressive income tax. And superimposing an efficiency norm *might* be thought to lead to a regressive income tax. Such refinements will not affect the arguments that I make in this Article, and are hence beyond its scope.

nually generate pre-tax incomes of 0, 1, . . . 99, and 100, respectively. Thus, the gross domestic product of Country *X* is 5050. Suppose that if Country *X* reverted to the state of nature, each individual would annually generate 5 of (necessarily after-tax) income. Thus, the gross domestic product in the state of nature would be 505. Finally, suppose that the difference between Country *X* as it is and Country *X* in the state of nature is an annual expenditure of 1140 by Country *X*'s sovereign on various goods and services. Which individuals benefit from these goods and services, and how much do they benefit? For the individual with 0 of pre-tax income, her benefit from Country *X*'s provision of goods and services is –5. For the individual with 1 of pre-tax income, her benefit from Country *X*'s provision of goods and services is –4. And so on. Finally, for the individual with 100 of pre-tax income, her benefit from Country *X*'s provision of goods and services is 95. Note that the first five individuals would actually prefer the state of nature to civilization, the sixth individual is indifferent between the state of nature and civilization, and all remaining individuals prefer civilization to the state of nature. Under these facts, the aggregate benefit that the individuals who benefit from civilization realize as a result of Country *X*'s provision of goods and services is 4560.[36] This, then, is the appropriate aggregate income tax base. Thus, *among an infinite number of other possibilities*, Country *X*'s sovereign could fund the goods and services it provides by means of a 25% tax on positive "taxable income" defined as the excess of any individual's pre-tax income over the state of nature baseline of 5.[37] Note that this tax is "fair" in that it exhibits both horizontal and vertical equity. I leave it to the reader to decide whether it also "makes sense."

36 $1 + 2 + \ldots + 95 = 4560$.

37 Of course, in the interest of deterring revolution, one of the goods and services Country *X*'s sovereign may provide is transfer payments to the individuals who generate less income than they would in the state of nature, so that such individuals do not, taking taxes and transfer payments into account, ultimately prefer the state of nature. Alternatively, also in the interest of deterring revolution, one of the goods and services Country *X*'s sovereign may provide is police protection aimed at keeping such low-income individuals in line. Whichever approach it uses, I want to be quite clear that it is appropriate to view the amounts spent on the low-income individuals as being "demanded" not by those individuals, but by the higher-income individuals who ultimately fund the expenditures. Purely as a matter of political reality, no underclass has ever had the political clout to demand anything.

B. *The Occasional Equivalence of an Integrated Income Tax Regime and a Double Income Tax Regime*

Suppose now that a sovereign views itself, not as providing a single package of goods and services to its subjects, but rather as providing two packages of goods and services. That is, the sovereign notes that its subjects engage in two very different types of activities, production or business activities and consumption or non-business activities. It further notes that each of these activities affirmatively benefits from the goods and services it provides.[38] That is, business activities benefit from a police force, roads, schools, courts, a social safety net, national defense, and so on. How? To take just some obvious examples, a police force enables a business to economize on the cost of security guards; adequate roads allow it to economize on the cost of distributing its products; good schools allow it to economize on the cost of training workers; functioning courts allow it to economize on the cost of defending its intellectual property; and an adequate social safety net and a strong national defense enable it to engage in long-term projects that would be unimaginable in an environment without significant social stability.[39] Similarly, non-business activities benefit from a police force, roads, schools, courts, a social safety net, national defense, and so on. How? Again, to take just a few obvious examples, a police force enables an individual to economize on the cost of protecting her residence; adequate roads allow her to economize on the cost of visiting her friends; good schools allow her to economize on the cost of educating her children; functioning courts allow her to economize on the cost of resolving any disputes she might have with her neighbors; and an adequate social safety net and a strong national defense enable her to sleep well at night.[40]

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38 *See* HARRIS, *supra* note 32, at 446. Harris divides government services into those that are "production related" and those that are "consumption related," at least for purposes of analyzing multinational income. *Id.*

39 I include in a social safety net all manner of "redistributive" transfers to low-income individuals. Aside from reducing the likelihood of civil unrest, such transfers provide a significant additional benefit to business activity since these transfers tend to increase aggregate demand for the goods and services produced by businesses: individuals receiving redistributive transfers tend to annually spend the entirety of the resources that are available to them.

40 With respect to the income redistribution implicit in a social safety net, an individual paying for such redistribution may well receive benefits in addition to those flowing from social stability (that is, the ability to sleep well at night). For example, she may receive a psychic benefit—an easing of her conscience—from the knowledge that she has aided the poor. *Cf.* Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413, 476–77 (1996). In addition, the individual will generally receive a tangible benefit from the insurance

How would a sovereign that views itself as providing two packages of benefits, one that aids business activity and one that aids non-business activity, incorporate this view into its tax structure? First, based on some ultimately arbitrary perception of the relative amount of benefit it provides to businesses and to individuals, the sovereign would need to decide how much of its total revenue needs will be satisfied by each of those two constituencies. Then, following the framework developed in the preceding subsection, the sovereign would establish the upper bound of the tax it could impose on any business and on any individual to reflect such business' and such individual's benefit derived from all of the various goods and services it provides. Finally, assuming that the aggregate upper bound of tax that could be imposed on all businesses exceeds the amount of revenue the sovereign has decided to collect from businesses, and assuming likewise that the aggregate upper bound of tax that could be imposed on all individuals exceeds the amount of revenue the sovereign has decided to collect from individuals, the sovereign would need to import other values, such as fairness and efficiency, to actually structure its tax.

I will, for now, ignore the first step in the sovereign's process, and assume that it has simply decided to impose a certain tax burden on businesses and a certain tax burden on individuals. Proceeding to the second step, the sovereign must establish the upper bound of the tax it could impose on any given business. Its analysis will be identical to the analysis elaborated in the prior subsection. Thus, the sovereign will observe that if it disappeared and the state of nature ensued, the business' various assets would become essentially worthless. If this happened, the persons who hold actual or inchoate claims against such assets—the business' employees, landlords, lenders, equity owners and other stakeholders—would see the value of their claims fall to zero. Thus, the stakeholders would be willing to pay any amount up to the value of their claims to keep the sovereign from disappearing. Or, equivalently, the business would be willing to pay any amount up to the aggregate value of its (gross) assets to keep the sovereign from disappearing.

But as in the prior subsection, the upper bound of the tax the sovereign can impose on any business must be tempered by the reality that the sovereign will want to periodically provide goods and services to businesses and hence will want to periodically collect taxes from such businesses. If so, it will not be able on an ongoing periodic basis

aspect of the social safety net: although she may not at the moment be a net recipient of redistributive payments, circumstances may make her such in the future.

to tax away and spend more than the entire amount of income generated by the business' assets. This, then, is the relevant upper bound:

Proposition 5: The upper bound of the tax a sovereign can impose on any business on an ongoing periodic basis, to reflect such business' benefit derived from the goods and services the sovereign provides, increases (essentially uniformly) as the business' income increases.

It is important to emphasize that the notion of a business' income employed in Proposition 5 is *not* the same as the notion of taxable income under the current U.S. corporate income tax. That is, the notion of a business' income in Proposition 5 includes all returns generated by the business and payable to any of its stakeholders. Thus, this notion is essentially congruent with the notion of income under the so-called entity income tax.[41] In particular, and unlike the notion of taxable income under the current U.S. corporate income tax, a business' income would *not* be reduced by payments the business makes to its various stakeholders. Thus, for example, the interest paid by a business to its lenders and the wages paid by a business to its employees would not be deductible.

Once the sovereign has established the upper bound of tax it can impose on any business, it must determine what tax it will actually impose, given the reality that its revenue needs will be only a fraction of the upper bound. To answer this question, it must, as in the prior subsection, import additional norms. Assuming the first of these is "fairness," it again follows that the actual tax must be an income tax. That is, horizontal equity dictates that if two businesses generate identical amounts of income, and thus by definition derive identical amounts of benefit from the sovereign's provision of goods and services, they should each pay the same amount of tax. And vertical equity dictates that if one business generates a greater amount of income than another, and thus by definition derives a greater amount of benefit from the sovereign's provision of goods and services than the other, it should pay a greater amount of tax than the other.

In addition, unlike in the case of the income tax derived in the prior subsection, in the case of this income tax on business activity it is not really possible to be agnostic as to whether such tax should be progressive, proportional, or regressive. That is, the most elementary application of an efficiency norm dictates that such tax *must be* pro-

41 *See* Schlunk, *supra* note 3, at 382. *But see* HARRIS, *supra* note 32, at 455–56 (observing that "business does not receive different levels of government services depending on the form in which their income is distributed").

portional. Why? Suppose that an individual owning a particular set of productive assets can equally well make such assets available to either of two businesses, one large and one small. In either case, her assets will enable the business making use of them to generate identical amounts of incremental pre-tax income. If the larger business is subject to a higher marginal tax rate, the individual will make her assets available to the smaller business. If the larger business is subject to a lower marginal tax rate, the individual will make her assets available to it. Only if both businesses are subject to the same marginal tax rate will the individual make her assets available to one or the other on the basis of non-tax considerations. Since there is no reason for the sovereign to want to have any stake in the individual's choice, it must impose a business income tax that does not encourage or discourage either outcome. Thus, it must impose a proportional business income tax.[42] Thus, I have:

Proposition 6: A fair and efficient benefits tax imposed on business activity must take the form of a proportional business income tax imposed on all businesses.

Once the sovereign has established the structure of the tax it will impose with respect to the benefits it provides to business activity, it must establish the structure of the tax it will impose with respect to the benefits it provides to non-business activity. How does it do that? It follows the reasoning and the template of the prior subsection. Thus, it will impose an income tax on its individual subjects (for only individuals are capable of having non-business capacities). But note that, for this purpose, an individual's "income" must be reduced to the extent that such individual has (indirectly) paid an amount of business income tax. The reason, quite simply, is that an individual would neither be willing nor able to pay all of its pre-business-income-tax income twice to avoid the state of nature. Rather, in her capacity as a stakeholder in a business, she would be willing to pay all of her pre-business-income-tax income. Then, to the extent that the sovereign does not confiscate this entire amount, she would, in her capacity as an individual consumer, be willing to pay such non-confiscated amount. It follows that the appropriate upper bound for the individual income tax is an individual's after-business-income-tax income. Thus:

42 *See* HARRIS, *supra* note 32, at 457. Harris similarly derives the need for a proportional income tax on the business income of nonresidents. *Id.* His argument, however, is based on the norm of ability-to-pay. *Id.*

Proposition 7: A fair benefits tax imposed on individuals by a sovereign that separately imposes a tax with respect to the benefits it provides to businesses will take the form of an individual income tax, where "individual income" is defined as an individual's after-business-income-tax income.

It is now possible to prove:

Theorem 2 (Equivalence): Suppose that a sovereign reigns in a country that is isolated from the rest of the world: the country has no international trade of any sort. And suppose further that all income generated by the sovereign's subjects is generated by business activity. And suppose finally that all business activity is either formally conducted by entities or can be deemed to be so conducted. Then a fair benefits tax imposed with respect to the benefits individuals derive from the sovereign's provision of goods and services can be structured either as an integrated income tax imposed on each individual's income,[43] or as a double income tax pursuant to which a proportional "entity" income tax is imposed on each entity's income and an "individual" income tax is imposed on each individual's after-entity-income-tax income.

The proof is as follows. Suppose, first, that the sovereign has enacted a well-defined and well-behaved integrated income tax regime. In particular, by definition, an individual with more income will pay more tax than an individual with less income. So consider two individuals, J and K, who each engage in business activity (by definition, in an entity) and who thereby (indirectly) generate pre-tax income of B_J and B_K, respectively. If $B_J > B_K$, then $T_J > T_K$, where T_J is the amount of integrated income tax paid by J and T_K is the amount of integrated income tax paid by K. Let 2^*t_e be the lowest marginal income tax rate imposed by the sovereign under its integrated income tax. I assume that $2^*t_e > 0$.[44]

I will now construct a double income tax regime that is equivalent to the sovereign's integrated income tax regime. First, I will impose a

43 The current partnership income tax regime fits this description. *See* I.R.C. §§ 701–777 (2000). A tax regime that is integrated by means of a dividend exclusion does not, however, since the tax rate imposed by such regime on some income is not the *individual* marginal income tax rate.

44 This follows because I treat redistributive transfers as occurring outside of the tax system (they are goods and services provided by the sovereign). Thus, all individuals, even those at the low end of the income scale, can be deemed to pay tax at a positive rate. They might simply, after paying tax, receive transfers that are as great as or greater than the amount of tax they paid.

proportional business income tax at the rate of t_e. Since the integrated income tax regime is assumed to be a well-defined and well-behaved income tax regime, the highest, and a fortiori the lowest, marginal income tax rate must be less than 100%. Thus, $0 < 2*t_e < 1$ and so $0 < t_e < 1$. Accordingly, my business income tax is also a well-defined and a well-behaved income tax.

Second, I will impose a tax on J's individual income, which is equal to her after-business-income-tax income, or $(1 - t_e)*B_J$, in the amount $T_J - t_e*B_J$. Likewise, I will impose a tax on K's individual income, which is equal to her after-business-income-tax income, or $(1 - t_e)*B_K$, in the amount $T_K - t_e*B_K$. I claim that this individual income tax is well-defined and well-behaved. From $0 < t_e < 1$, it follows that $0 < (1 - t_e) < 1$. Since, by hypothesis, $B_J > B_K$, it follows that $(1 - t_e)*B_J > (1 - t_e)*B_K$. In other words, if J generates more business income than K, she will also generate more after-business-income-tax income, in spite of the business income tax. The question is thus whether she will necessarily also pay more individual income tax. Note that $T_J - T_K > t_e*(B_J - B_K)$, since t_e is lower than the lowest marginal income tax rate imposed by the integrated income tax regime. Rearranging terms yields $T_J - t_e*B_J > T_K - t_e*B_K$. Thus, the individual income tax I have constructed is indeed well-defined and well-behaved.

Conversely, suppose that, under the given predicates, the sovereign has chosen to enact a well-defined and well-behaved double income tax regime. And suppose that the business income tax component of such regime imposes tax at the rate of t_e on each entity's business income. Let J and K be two individuals who (by definition) invest their assets in entities and suppose that such entities are able to generate B_J and B_K, respectively, of pre-tax income as a result of such investments. Thus, the entities will pay entity income tax of t_e*B_J and t_e*B_K, respectively, with respect to such income, and will be able to allocate or distribute $(1 - t_e)*B_J$ and $(1 - t_e)*B_K$, respectively, of after-entity-income-tax income, or individual income, to J and K. With respect to such individual income, suppose that the sovereign imposes an individual income tax of t_J on J and an individual income tax of t_K on K.

Needless to say, in order to replicate this double income tax regime with an integrated income tax regime, I must impose an income tax burden of $t_e*B_J + t_J$ on J's integrated income of B_J and an income tax burden of $t_e*B_K + t_K$ on K's integrated income of B_K. The only question is whether this integrated income tax is a well-defined and well-behaved income tax. Thus, suppose that $B_J > B_K$. Since the business income tax component of the double income tax regime is well-defined and well-behaved, it follows that both $t_e*B_J > t_e*B_K$ and $(1 -$

$t_e)*B_J > (1 - t_e)*B_K$. As the individual income tax component of the double income tax regime is also well-defined and well-behaved, the second of these inequalities implies that $t_J > t_K$. Putting pieces together, it follows that $t_e*B_J + t_J > t_e*B_K + t_K$. Thus, the integrated income tax is a well-defined and well-behaved income tax. *QED.*

Of course, in spite of this formal equivalence of an integrated income tax regime and a double income tax regime, an important difference will remain between the two. Specifically, the former imposes a single income tax that is reported on a single income tax return, while the latter imposes two income taxes that are reported on two income tax returns. This difference means that a double income tax regime will almost inevitably be accompanied by incremental administrative costs: additional paperwork, more chances for dispute and error, etc. When these costs are considered, it may cease to be true that a double income tax regime that is ostensibly equivalent to an integrated income tax regime is in fact equivalent to such integrated income tax regime. Accordingly, a sovereign would be well-advised if it hesitates before imposing separate taxes to separately charge its subjects for the goods and services it provides in their business and in their non-business capacities.

I should also add that, even if a double income tax regime were *fully equivalent* to an integrated income tax regime, taking administrative costs into account, it would still be the case that, under the predicates set forth above, no sensible sovereign should actually choose to enact a double income tax regime. The reason is that such enactment would represent nothing more than a triumph of meaningless form over substance: it would impose double income taxation solely for the sake of imposing double income taxation. That is, the double income tax regime constructed above, however theoretically sound it may be, misses the entire point of double income taxation, which is not to tax *all* income twice, but merely to tax *some* income twice. Rational double income taxation, as opposed to such merely formal double income taxation, will thus require relaxation of some of my predicates. In particular, it will require a sovereign to be able to distinguish between different types of income, and it will require a reason for the sovereign to select only certain such types of income for double taxation. These elements will be discussed at length below.

C. *Enter King Midas*[45]

My analysis so far, and hence the demonstrated equivalence of any integrated income tax regime and an alternative double income tax regime,[46] ultimately rests on the fact that all income generated by the sovereign's subjects is generated by local business activity. But suppose it is not. Suppose that the sovereign becomes aware that King Midas has taken up residence in its domain. Midas differs from the sovereign's other subjects in that he is able to produce income without engaging in anything that the sovereign would classify as local business activity. That is, while his activity may be local, the sovereign does not deem it to be business activity. It turns out that this single divergence of "all income" from "all income generated by local business activity" is sufficient to destroy the equivalence between an integrated income tax regime and *any* double income tax regime.

To see this, consider an individual *J*, who generates the same amount of pre-tax income as Midas. *J*, however, generates all of her income by means of local business activity. Suppose, first, that the sovereign imposes tax by means of an integrated income tax regime. In defining the tax base for such regime, it has two choices: it can either include Midas' income in the tax base, or it can exclude Midas' income from the tax base. In the former case, Midas and *J* will pay identical amounts of tax. The justification for this result would be a belief that Midas and *J* derive identical benefits from the sovereign's provision of goods and services: all of their activities, business and non-business alike, are given a refuge from the state of nature, and the value of that refuge is equal to their pre-tax income. In the latter case, *J* would pay income tax, but Midas would not. The justification for this result would be a belief (untenable, in my opinion) that only local business activity derives a benefit from the sovereign's provision of goods and services.

Now suppose that the sovereign enacts a double income tax regime. Its reason for doing so would be a belief that it provides its

45 *See generally* HARRIS, *supra* note 32. Harris' concern is with the allocation of taxing rights between countries. Thus, he derives an ideal "composite" income tax to be applied to multinational income. This composite income tax, which, like the double income tax I derive below is based on benefits principles, is, *as applied to multinational income*, identical to my double income tax. Harris, however, fails to observe that the very derivation of his composite income tax implies that it can and should be extended to the purely domestic context.

46 Under my predicates, any integrated income tax regime is actually equivalent to an infinite number of double income tax regimes. To see this, simply replace the lowest marginal income tax rate under the integrated income tax regime with $\propto {}^{*}t_e$ for any $\propto > 1$.

subjects not with one package of goods and services, but with two: it provides its subjects with a refuge from the state of nature for their business (production) activities and it provides its subjects with a refuge from the state of nature for their non-business (consumption) activities. Note that *J*, but not Midas, benefits from receiving a refuge from the state of nature for her business activity. Thus, *J*, but not Midas, would be subject to the business/corporate/entity income tax component of the sovereign's double income tax regime. So long as the amount of this tax is positive, it follows that *J* would have less after-business-income-tax income than Midas. Furthermore, since after-business-income-tax income would be the tax base for the individual income tax component of the sovereign's double income tax regime, it follows that *J* would pay less individual income tax than Midas. (The justification for this result is that *J*'s non-business activity receives less benefit from the sovereign's provision of goods and services than does Midas' non-business activity.) However, so long as individual marginal income tax rates are less than 100%, she will not pay sufficiently less individual income tax to completely offset the amount of business income tax she indirectly paid. Thus, when all is said and done, *J*'s aggregate (indirect and direct) tax burden under the double income tax regime would be greater than Midas', and Midas' aggregate (indirect and direct) tax burden would be greater than zero. These results are different from those produced by an integrated income tax regime, irrespective of how such regime decides to tax Midas. Thus, the possibility for equivalence has disappeared.

Now suppose that instead of discovering Midas, the sovereign discovers Sisyphus in its domain. Sisyphus differs from the sovereign's other subjects in that he engages in local business activity that generates a significant amount of income, but neither he nor anyone else, other than the sovereign, can consume any of such income. That is, the income generated by Sisyphus, if not immediately taxed, vanishes. Thus, the amount of income generated by Sisyphus' local business activity differs from his individual income (as measured, for example, under Haig-Simons precepts). As was the case with King Midas, this single divergence is sufficient to destroy the equivalence between an integrated income tax regime and *any* double income tax regime.

To see this, consider an individual, *J*, who generates the same amount of pre-tax income as Sisyphus. Suppose, first, that the sovereign imposes tax by means of an integrated income tax regime. In defining the tax base for such a regime, it has two choices: it can either include Sisyphus' income in the tax base, or it can exclude Sisyphus' income from the tax base. In the former case, Sisyphus and *J* will pay identical amounts of tax. The justification for this result

would be a belief that Sisyphus and *J* derive identical benefits from the sovereign's provision of goods and services: all of their activities, business and non-business alike, are given a refuge from the state of nature, the value of that refuge is equal to their pre-tax income, and the fact that Sisyphus is constitutionally unable to enjoy any of his income is unfortunate but beside the point. In the latter case, *J* would pay income tax, but Sisyphus would not. The justification for this result would be a belief (untenable, in my opinion) that only non-business activity ultimately derives a benefit from the sovereign's provision of goods and services.

Now suppose that the sovereign enacts a double income tax regime. Once again, its reason for doing so would be a belief that it provides its subjects not with one package of goods and services, but with two: it provides its subjects with a refuge from the state of nature for their business activities and it provides its subjects with a refuge from the state of nature for their non-business activities. Note that Sisyphus and *J* both derive an identical amount of benefit from receiving a refuge from the state of nature for their business activities. Thus, Sisyphus and *J* would pay identical amounts of tax under the business/corporate/entity income tax component of the sovereign's double income tax regime. But there the identity ends. That is, it is impossible to claim that Sisyphus and *J* derive an identical benefit from receiving a refuge from the state of nature for their non-business activities. Sisyphus receives no such benefit at all. Thus, Sisyphus' individual income for purposes of the individual income tax component of the sovereign's double income tax regime would be zero, and he would pay no individual income tax. *J*, on the other hand, receives an affirmative benefit, in an amount equal to her after-business-income-tax income, from receiving a refuge from the state of nature for her non-business activity. Thus, so long as individual marginal income tax rates are positive, it follows that *J*'s aggregate (indirect and direct) tax burden under the double income tax regime would be greater than Sisyphus', and Sisyphus' aggregate (indirect and direct) tax burden would be greater than zero. These results are different from those produced by an integrated income tax regime, irrespective of how such regime decides to tax Sisyphus. Thus, the possibility for equivalence has disappeared. I have proven:

Theorem 3 (Nonequivalence): If either some of the income generated by a sovereign's subjects is not generated by local business activity, or some of the income generated by the local business activity of a sovereign's subjects is not available for consumption by the sovereign's subjects, then an integrated income tax im-

posed by the sovereign will not be equivalent to any double income tax that is composed of a proportional "entity" income tax imposed on each subject entity's local business income and an "individual" income tax imposed on each individual subject's after-entity-income-tax consumable income.

Of course, King Midas and Sisyphus are mythical figures. But real world analogs for them exist. For example, in a purely domestic context, it is possible to analogize an individual who accidentally discovers treasure with Midas and an individual who suffers an uninsurable casualty loss with Sisyphus. Much more significantly, in a cross-border context, it is possible to analogize any individual who resides in one sovereign's domain but who employs some of her capital and labor in a second sovereign's domain with Midas. To the extent that her capital and labor are employed in the second sovereign's domain, the individual does not engage in business activity in the first sovereign's domain. But, to the extent that her capital and labor employed in the second sovereign's domain generate (after-tax) income that she effectively repatriates, she does engage in non-business (consumption) activity in the first sovereign's domain. Similarly, it is possible to analogize any individual who resides in the second sovereign's domain, but who employs some of her capital or labor in the first sovereign's domain, with Sisyphus. To the extent that her capital and labor are employed in the first sovereign's domain, she is engaged in business activity in such domain. But to the extent that her after-tax business income is effectively repatriated to the second sovereign's domain, she does not engage in any non-business (consumption) activity in the first sovereign's domain.

Given the prevalence of such real world analogs to King Midas and Sisyphus, and given the nonequivalence of integrated income tax regimes and double income tax regimes in the face of such analogs, it is incumbent on every sovereign to choose, with the full knowledge that its choice will have real consequences, whether to impose an integrated income tax regime or a double income tax regime. How should it make this choice? It seems to me that the only principled way to make this choice is on the basis of which tax regime better reflects reality. That is, is it a better reflection of reality to say that the sovereign provides a single package of goods and services to all of its subjects, or is it a better reflection of reality to say that the sovereign provides one package of goods and services to its subjects in their business capacities and one package of goods and services to its subjects in their non-business capacities? Of course, this is not an easy question to answer.

For example, the sovereign might build a road with the primary intention of making it easier for individuals to visit one another (that is, to engage in non-business activity). But the very same road will invariably also make it cheaper for businesses to deliver their products to such individuals (that is, engage in business activity). Conversely, the sovereign might build a road with the primary intention of making it cheaper for businesses to deliver their products to individuals. But the very same road will invariably also make it easier for individuals to visit one another. In both of these cases, the sovereign's *intention* to provide the road primarily to benefit business activity or primarily to benefit non-business activity cannot adequately be captured by an integrated income tax regime, assuming any divergence between individuals engaged in business activity and those engaged in non-business activity. However, the *actual result* of the sovereign's provision of the road—benefits to both business activity and to non-business activity—at first blush can be so captured.

Now consider a device that the sovereign installs in all factories to monitor factories' emissions of noxious gasses. Such a device would be intended to improve the quality of the air breathed by individuals residing in the sovereign's domain, and so to provide non-business benefits. Moreover, since such device might well make it more expensive for businesses to manufacture their products, it would be highly disingenuous to say that amounts spent by the sovereign on the device provide a benefit to business activity. Conversely, the sovereign might install a device in the factories of all businesses that improves such factories' efficiency, but that also increases the factories' emissions of noxious gasses. Such a device would clearly be intended to provide a benefit to the businesses operating in the sovereign's domain. Moreover, since such device might well decrease the utility of individuals living in the sovereign's domain, it would be highly disingenuous to say that amounts spent by the sovereign on the device provide a benefit to non-business activity. In these examples, neither the sovereign's *intention* nor the *actual result* of the sovereign's provision of the device can be adequately captured by an integrated income tax regime, assuming any divergence between individuals engaged in business activity and those engaged in non-business activity.

Finally, consider again a road built by the sovereign, and suppose that the sovereign intends the road to benefit both business activity and non-business activity; suppose, in fact, that the road does benefit both business activity and non-business activity. Does it follow, at more than first blush, that an integrated income tax can be imposed that will adequately capture both the sovereign's *intention* with respect to such road and the *actual result* produced by such road? It does not.

For example, suppose the road is used equally often by every individual engaged in business activity and by every individual engaged in non-business activity. In that case, an individual engaged only in business activity, or only in non-business activity, derives less benefit from the road than does an individual engaged in both business activity and non-business activity. There is no way for an integrated income tax regime to adequately capture this difference.

This final point, albeit viewed in terms of the entire package of goods and services provided by the sovereign, rather than in terms of a single road, is ultimately the decisive one. That is, the sovereign in reality provides a single package of goods and services: neither businesses nor individuals can cherry-pick which goods and services they want to receive and hence to pay for. The sovereign's intention in providing its package of goods and services is—broadly speaking—to benefit both those engaged in business activity and those engaged in non-business activity. And the sovereign's package of goods and services generally does indeed benefit both those engaged in business activity and those engaged in non-business activity. Does it follow that an integrated income tax can be imposed that will adequately capture both the sovereign's intention with respect to the package and the actual result produced by such package? It does not. Exactly as in the case of the road in the prior paragraph, an individual can make use of the sovereign's package in a business capacity, in a non-business capacity, or in both a business capacity and a non-business capacity. To the extent that an individual makes use of the sovereign's package only in a business capacity, or only in a non-business capacity, she derives less benefit from the package than does an otherwise identical individual who makes use of the package both in a business capacity and in a non-business capacity. And there is no way for an integrated income tax regime to adequately capture this difference.

An alternative way of reaching the same conclusion, at least in a world with individuals who have cross-border contacts, is by focusing on the confiscatory power of the sovereign. Harking back to the illustration in Part I, consider *K*, who is a resident of HighTax but who conducts all of her business activity in LowTax. If LowTax's sovereign had a policy of confiscating all of the income generated by business activity conducted in LowTax, *K* would not conduct any business activity there. And so, at the end of the day, LowTax could not in fact confiscate all of the income generated by *K*'s business activity. In other words, the upper bound of tax that LowTax can impose on *K*'s business activity is actually less than the entire amount of income generated by such business activity. But that is just another way of saying that, although *K* manifestly benefits from the goods and services pro-

vided by LowTax, she benefits *less* than does an otherwise identical resident of LowTax who also conducts all of her business activity in LowTax. And so she should pay less tax. Under an integrated income tax regime, however, she would not, absent a special dispensation. I illustrated the inadequacy of such special dispensations in Part I.B., and I will discuss them further in Part II.D.

Now consider *J*, who is a resident of LowTax but who conducts all of her business activity in HighTax. If LowTax's sovereign had a policy of confiscating all of the income generated by its residents, whether or not such income is generated by business activity conducted in LowTax, it would run into a problem with respect to *J*. That is, since HighTax gets the first tax bite at the apple of *J*'s income, LowTax could not, in fact, confiscate *J*'s entire pre-HighTax-tax income. Rather, the upper bound of tax that LowTax can impose on *J* is the entire amount of *J*'s income reduced by the taxes *J* pays to HighTax, and this is, of course, less than the entire amount of *J*'s income. But that is just another way of saying that although *J* manifestly benefits from the goods and services provided by LowTax, she actually benefits less than does an otherwise identical resident of LowTax who also conducts all of her business activity in LowTax. And so she should pay less tax. Under an integrated income tax regime, however, she would not, again absent a special dispensation.

Of course, the mere existence of a compelling theoretical tax relevant difference between individuals is not necessarily a sufficient reason for a real world sovereign to take such difference into account in constructing its tax regime. Rather, the question with respect to any compelling theoretical tax-relevant difference is one of cost and benefit. What is the cost of classifying individuals? What is the benefit from doing so? To return to King Midas and Sisyphus, perhaps they are easy to identify and perhaps they are not, but in general it is unlikely that it would make sense (in a cost-benefit sense) to choose one type of tax regime over another simply on the basis that it more properly taxes these two peculiar individuals. In the case of inbound investors and outbound investors, however, identification should generally be easy. Moreover, in the modern world, with its large and ever-growing amount of international commerce, the number of such investors is large and getting larger. Thus, it seems quite likely that it would make sense (in a cost-benefit sense) to choose one type of tax regime over another on the basis that it more properly taxes such individuals.

D. Constructing an Ideal Income Tax Regime

Two things follow from the foregoing discussion of cross-border investors. First, in the case of an inbound investor, the sovereign should impose an income tax on the investor's local business-generated income in an amount that is less than the aggregate amount of income tax that the sovereign imposes on an identical amount of local business-generated income earned by a resident. Second, in the case of an outbound investor, a sovereign should impose an income tax only on the investor's after-foreign-tax income.[47] I claim that this structure is *implicitly* a double income tax structure. Moreover, given the need to *explicitly* impose this implicit double income tax structure on both inbound and outbound investors, there is no reason not to explicitly impose this double income tax structure more generally on all individuals.[48]

That is, by virtue of Proposition 6, the type of tax that a sovereign should impose on an inbound investor's local business activity is a proportional business income tax. Assuming the sovereign imposes such a tax, it can, at no significant additional administrative cost, and in keeping with the horizontal and vertical equity norms, impose an identical proportional business income tax on the income generated by its own residents' local business activity. In other words, and without implying any congruence to the current U.S. income tax regime, it could impose a "corporate" income tax, or more correctly an "entity" income tax, on all income generated by any business activity conducted by any entity within its borders, where it would further by fiat

47 *See* HARRIS, *supra* note 32, at 466 (noting that "it is correct to include in taxable income foreign income net of foreign (source) taxes").

48 *See supra* note 46 and accompanying text. Harris misses this point. After he constructs an income tax regime applicable to persons with multinational contacts that is essentially identical to the one I derive, he overlooks that this tax regime is, from a domestic perspective, nothing other than a double income tax regime. Moreover, he misses the administrative simplicity that would be gained by actually implementing his regime through overt double taxation. Thus, for example, he constructs an elaborate mechanism to ensure that residents pay the proper amount of tax with respect to foreign source income. *See* HARRIS, *supra* note 32, at 460–70. That mechanism involves: (1) grossing up after-foreign-tax foreign source income by the tax rate generally applied to the domestic income earned by nonresidents (i.e., to use my language, the corporate income tax rate); and (2) allowing a "foreign" tax credit with respect to the domestic tax imposed on such grossed-up income, which tax credit is in the amount of the tax rate generally applied to the domestic income earned by nonresidents (again, to use my language, the corporate income tax rate). The net effect of this complicated two-step is simply to impose what I call the individual income tax on after-foreign-tax foreign source income.

deem all income generated by any business activity conducted within its borders to be generated by an entity.

Assuming the sovereign follows this tack, what is the appropriate individual income tax for it to impose? I already asserted that it needs to impose a tax on an outbound investor in an amount that is determined by the investor's after-foreign-tax income, since this amount fully determines the amount of benefit the outbound investor receives from the sovereign's provision of benefits to her (necessarily exclusively) non-business activity. In keeping with the horizontal and vertical equity norms, the question becomes: what resident receives exactly the same amount of benefit from the sovereign's provision of benefits to her non-business activity as does the outbound investor? And the answer is: any resident who generates an amount of after-entity-income-tax income that is equal to the outbound investor's after-foreign-tax income. The reason, as noted in Proposition 7, is that the individual's after-entity-income-tax income fully determines the amount of benefit she receives from the sovereign's provision of benefits to her non-business activity.

But note what this means. For an individual without any international contacts, the appropriate aggregate income tax burden is produced by imposing an entity income tax on her business-generated income and then by imposing an individual income tax on her after-entity-income-tax income. In other words, the appropriate aggregate income tax burden is produced by imposing, on all individuals without international contacts, the equivalent of a double income tax regime! Thus, I have demonstrated:

Theorem 4 (Necessary Double Taxation): If a sovereign wishes to impose a fair tax burden upon its subjects with international contacts, it must impose the equivalent of a double income tax regime on its subjects without international contacts. The corporate income tax component of such double income tax regime will consist of a proportional tax imposed on business income, which tax is imposed at the same rate as the tax imposed by the sovereign on the business income of inbound investors. The individual income tax component of such double income tax regime will consist of a tax imposed on after-corporate-income-tax income, which tax will be imposed at the same rate (or according to the same schedule) as the tax imposed by the sovereign on the after-foreign-tax income of outbound investors.

Alternatively, separating the various components of this ideal double income tax regime, I have reproduced the tax rules I announced in Part I.C:

(1) A country should impose its "corporate" income tax on all of the income generated by any business activity conducted within such country's borders, whether or not the owners of such business activity reside in such country. The reason is that the country can and does provide benefits to the business activities that generate such income;

(2) A country should exempt from its "corporate" income tax all of the income generated by any business activity conducted outside of such country's borders, even if the owners of such business activity reside in such country. The reason is that the country neither can nor does provide any (significant) benefits to such business activity;

(3) A country should impose its "individual" income tax on all of the after-corporate-income-tax income generated by its residents, whether or not such income is generated by business activity conducted within such country's borders. The reason is that the country can and does provide benefits to the residents who (indirectly) generated such income; and

(4) A country should exempt from its "individual" income tax all of the after-corporate-income-tax income generated by its nonresidents, even if such income is generated by a business activity conducted within such country's borders. The reason is that the country neither can nor does provide any (significant) benefits with respect to such individuals' non-business activity.[49]

One point bears repeating. I have not only demonstrated that double income taxation produces the appropriate results, both for those individuals with international contacts and for those individuals without international contacts, I have also demonstrated that any tax regime that produces the appropriate result is equivalent to a double income tax regime. In particular, by virtue of Theorem 3, an integrated income tax regime cannot produce the appropriate results.

Moreover, an integrated income tax regime that has simply been "tweaked" so that it properly taxes individuals with international contacts can never produce the appropriate results. That is, appropriate results are *not* produced by an integrated income tax regime that contains the following two "small" adjustments: nonresidents are subject

49 I repudiate the reasoning in *Cook v. Tait*, 265 U.S. 47, 56 (1924), that justifies the individual income taxation of nonresident citizens. While it is true, at least in theory, that the United States provides some non-business benefits to such nonresidents, the amount of such benefits is sufficiently de minimis that, in my opinion, taxing such nonresidents as if they were residents cannot be justified.

to a flat rate (proportional) withholding tax on all income they receive from business activity conducted within the sovereign's domain, and residents are entitled to an income tax deduction for any foreign income taxes they pay with respect to business activity they conduct outside of the sovereign's domain. The proof is as follows. Consider two individuals who, under this tweaked integrated income tax structure, each have the same amount of integrated taxable income. One has invested domestically; the other has not and has accordingly had her taxable income reduced by virtue of the deduction for foreign income taxes paid. Both of these individuals would pay an identical amount of domestic income tax. But these two individuals have *not* in fact received an identical amount of benefit from the sovereign's provision of goods and services. That is, the latter individual has received *no* benefits from the sovereign with respect to her business activity; rather she has received and paid for benefits provided by another sovereign. On the other hand, the former individual *has* received benefits from the sovereign with respect to her business activity. Thus, unless the sovereign reaches the conclusion that the appropriate tax with respect to business benefits is zero, the tweaked integrated income tax will not tax these individuals appropriately.[50]

E. Space and Time

In the foregoing discussion, the existence of inbound and outbound investors added a spatial dimension to the question of how to properly levy an income tax. That is, double taxation became necessary because a sovereign provided benefits to individuals based on the spatial location of certain activities of such individuals. Thus, the sovereign provided benefits to the business activities of individuals, but only to the extent that such business activities were conducted within the sovereign's domain. And the sovereign provided benefits to the non-business activities of individuals, but only to the extent that such non-business activities were conducted within the sovereign's domain.

The existence of a spatial dimension to a question frequently portends the existence of an analogous temporal dimension. Thus, one can ask: Does double taxation become necessary if a sovereign provided benefits to individuals based on the temporal "location" of certain activities of such individuals? In particular, to the extent that the sovereign provides benefits to the business activities of individuals, it provides such benefits *when* the business activities are conducted.

50 If the sovereign does reach the conclusion that the appropriate tax with respect to business benefits is zero, it must set its withholding tax rate for nonresidents at zero as well.

And to the extent that the sovereign provides benefits to the non-business activities of individuals, it provides such benefits *when* the non-business activities are conducted.

Before embarking on an analysis of the effects of a potential temporal component in the sovereign's provision of benefits, it is fruitful to analyze the effects of a potential temporal component in the sovereign's imposition of tax. In Part II.B, I proved the Equivalence Theorem (Theorem 2), which states that, under certain predicates including the absence of international contacts, any integrated income tax regime—technically, any income tax regime that is integrated by means of an allocation mechanism (that is, a mechanism under which all business income is allocated to various participants in the business and is taxed directly to such participants)—can be perfectly replicated by a double income tax regime (and vice versa). To prove the theorem, I began with an arbitrary integrated income tax regime and constructed a double income tax regime that is equivalent to it. The resulting double income tax regime consists, naturally enough, of two components: a "corporate" income tax that is imposed on all business-generated income, and an "individual" income tax that is imposed on all after-tax business-generated income. Thus, although my proof did not explicitly mention this fact, the resulting double income tax regime does not allow for the deferral of any portion of the individual income tax that must be imposed on after-tax business-generated income. In particular, all such income, whether allocable to employees (wages), creditors (interest), or equity owners (dividends and/or retained earnings), is immediately taxed to such participants as it was earned.

The double income tax regime under current law does not, of course, share this feature. For example, the individual income tax component of such double income tax regime is subject to various types of deferral. Most significantly, employees can defer compensation income that is deflected into retirement plans and equity owners can defer dividend income to the extent that a corporation retains earnings. Since allowing such deferral is clearly not a necessary feature of a double income tax regime, the result in Theorem 2 remains unaffected. But it is interesting to note that the result in Theorem 2 would generally change in the face of deferral opportunities. Thus:

Theorem 5: Assume the predicates stated in Theorem 2. Then a fair benefits tax that is structured as an integrated income tax imposed on each individual's income will be equivalent to a double income tax pursuant to which a proportional "entity" income tax is imposed on each entity's income, and an "individual" income

tax is imposed on each individual's after-entity-income-tax income if, and only if, all after-entity-income-tax income is subject to an "identical" amount of "deferral."

The proof is straightforward. The economic effect of deferral is to reduce the effective individual income tax rate applied to after-entity-income-tax income. If all after-entity-income-tax income is subject to an identical amount of deferral, the effective individual income tax rate applied to all such income will fall by the same amount. Accordingly, in the proof of Theorem 2, the construction of the individual income tax rate schedule can proceed as before, but with a simple adjustment (that is, a gross-up) to take the alternative effective tax rate into account. Conversely, if different types of after-entity-income-tax income are subject to different amounts of deferral, they are subject to different effective individual income tax rates. Thus, a single quantity of pre-tax business-generated income allocable to a given individual can be subject, under a double income tax regime, to more than one effective income tax rate (combining the uniform proportional business income tax rate with the variable individual income tax rate). Since a single quantity of pre-tax business-generated income allocable to a given individual is always subject to the same (actual and effective) income tax rate under an integrated income tax regime, it follows that the double income tax regime with variable deferral is not equivalent to an integrated income tax regime.

Theorem 5 has tremendous consequences. Since the mere possibility of deferral generally destroys the equivalence of an integrated income tax regime and any double income tax regime, it is worthwhile to ask whether, even in a country satisfying all the predicates for potential equivalence (that is, satisfying all of the predicates of Theorem 2), it is preferable to have an integrated income tax regime or some *nonequivalent* double income tax regime that offers some variable amount of deferral. The question can be phrased more pointedly: Should an ideal income tax regime permit (or even require) deferral opportunities and, if so, why? An answer lies in the purpose of taxation. I have assumed throughout this Article that the sovereign imposes taxes to pay for various goods and services that provide benefits to business and non-business activities. If so, the sovereign's most straightforward approach to taxation is to impose taxes at the time it provides the corresponding benefits. To the extent that business activities and "corresponding" non-business activities are conducted in different tax periods, it follows that a "corporate" income tax and a corresponding "individual" income tax should be imposed in different tax periods. In other words, deferral may be proper.

Is it conceivable that business activities and "corresponding" non-business activities can be conducted in different tax periods? What might that even mean? Consider a business activity conducted in a given tax period. Such business activity generates a certain amount of pre-tax income during the tax period. Assuming that the business activity benefits from the sovereign's provision of goods and services as it generates income, it is appropriate to subject the business activity's pre-tax income to a corporate income tax during the tax period. If so, then the business activity indirectly generates a certain amount of after-corporate-income-tax income during the tax period. This amount of after-corporate-income-tax income should be subject to an individual income tax during such tax period if, and only if, it accurately reflects the conduct of a commensurate amount of non-business activity during the tax period. I submit that it may, or it may not.

Consider a miserly hermit who lives in a hovel and eats cat food, but who nonetheless generates a large (and growing) amount of after-corporate-income-tax income. The hermit does not appear to benefit terribly much *in her individual non-business capacity* from the sovereign's provision of a police force (she has no non-business assets to protect), or roads (she has no friends to visit), or courts (she engages in few consumption activities that could spawn litigation), or schools (she has no friends to converse with), or a social safety net (she has no non-business assets that could be lost in a revolution), or a national defense (she has no non-business assets that could be lost in an invasion). The explanation for this divergence between an individual's after-corporate-income-tax income and her level of non-business activity is, of course, that the former bears no necessary relationship to consumption, while the latter is, by very definition, consumption. It follows that the individual "income" tax component of an ideal double income tax regime should be nothing other than a consumption tax! Thus, I have illustrated:

Theorem 6: An income tax regime that fairly takes into account all of the business and non-business benefits derived by individuals from the sovereign will implicitly or explicitly impose a "corporate" income tax on all business-generated income at the time such income is generated, and will implicitly or explicitly impose an "individual" income tax on all after-business-income-tax income at the time such income is consumed. Thus, so long as not all after-business-income-tax income is consumed as soon as it is generated, a fair income tax regime must be a double income tax regime.

The predicate in the last sentence of Theorem 6 is surely an accurate description of the "real" world. Thus, an appropriate income tax burden in the real world can be imposed *only* by means of a double income tax regime—and *not* by means of an integrated income tax regime—even in the absence of international contacts (and/or in the absence of peculiar individuals, such as King Midas or Sisyphus).

Before turning from the underpinnings of ideal double taxation to its practical implementation, it is worth mentioning a practical consideration bolstering the argument that the individual income tax component of an ideal double income tax regime must be a consumption tax, namely that with respect to outbound investors, the individual income tax component of any double income tax regime is likely to effectively be a consumption tax, whether the sovereign wishes it to be or not. The reason lies in the administrative difficulty attendant with taxing any outbound investor. In general, a sovereign will be able to obtain only very incomplete information as to the income underlying such investor's investment. Indeed, in many cases, the sovereign will be unable to determine, and therefore to tax, anything other than the amount of after-foreign-tax income actually distributed to the investor.[51] In such cases, so long as the investor can arrange to receive her after-foreign-tax income only as and when she wishes to consume such income, she will effectively be taxed only upon consumption. But if an outbound investor can achieve the deferral inherent in a consumption tax, there is no basis in fairness (or for that matter in efficiency) for denying similar deferral opportunities to residents who invest locally. Accordingly, as already noted, the individual income tax component of a double income tax regime should be a consumption tax.

III. Real-Life Policy Prescriptions for the U.S.

At this point, it is important to make clear that I have demonstrated only one claim, albeit a large one: I have demonstrated that, so long as the world either is replete with international contacts, or is a

51 In some cases, the sovereign will have difficulty obtaining any information at all. In other cases, it may be able to discover the foreign taxes paid by the foreign business and the foreign income earned by the foreign business (as measured under foreign law). In such cases, the sovereign must allocate this apples-to-oranges amount of after-foreign-tax income to all the different stakeholders in the foreign business under something akin to the current Code Section 704 partnership income allocation rules. *See* I.R.C. § 704 (2000). It is unlikely that this could be done with even reasonable accuracy. In particular, the investor, in conjunction with the business, would have every incentive to argue that her proper allocation is nothing more than the amounts actually distributed.

multi-period world in which not all after-business-income-tax income is immediately consumed, it is *necessary* for a sovereign intent on fairness to impose a double income tax regime. Specifically, the sovereign must impose a corporate, or more correctly an entity, income tax on all income generated by local business activity at the time such income is produced, and then must impose an individual income tax on all locally-consumed after-entity-income-tax income at the time such income is consumed.

I have not said anything about how a sovereign should determine the aggregate amount of tax to impose. Throughout, I have taken that amount to be given. In fact, however, a sovereign would need a way to determine this. Presumably, so long as the sovereign is benevolent, it would engage in an optimization exercise the upshot of which would be that the last dollar or yen it spends on goods and services would provide a dollar or a yen worth of aggregate benefits. Thus, for example, if the benefits it provides were capable of being targeted solely at business activity, the last dollar or yen of such benefits would facilitate the generation of an incremental dollar or yen worth of income. And if the benefits it provides were capable of being targeted solely at non-business activity, the last dollar or yen of such benefits would produce the same amount of utility as would a dollar or yen spent privately. That is, the sovereign would set marginal cost equal to marginal benefit.

In addition, in Part II, I tabled the discussion of how a sovereign should determine the fraction of the cost of the goods and services it provides that should be collected by means of an "entity" income tax, and the fraction that should be collected by means of an "individual" income tax. Perhaps the greatest problem that will be encountered in making this determination is that, as already noted, it is essentially meaningless for a sovereign to divide the goods and services it provides into those that are provided for the benefit of business activity and those that are provided for the benefit of non-business activity. Rather, most goods and services are provided for the benefit of both.

What follows from this observation is that a sovereign's breakdown of its expenditures into those that are allocable to business activity and those that are allocable to non-business activity is necessarily essentially arbitrary.[52] But it is not completely so. Thus, suppose the sovereign could imagine exactly what the world would look like with-

52 *See* HARRIS, *supra* note 32, at 479 (arguing that a country is essentially free to make this choice as it sees fit: "The only one in a position to even approximate an appropriate division of the composite income tax into source [i.e., corporate] and residence [i.e., individual] portions is the country itself.")

out any inbound investors. Clearly, in such world, there would be a diminished amount of domestic business activity. Presumably, in such world, the sovereign would provide fewer goods and services. The cost of the foregone goods and services are clearly costs that should be allocated to the business activity of the inbound investors. Thus, the relationship between these costs and the income generated by inbound investors provides a lower bound as to the rate of tax that should be imposed on such inbound investors' income, and hence on entity income in general.

Similarly, suppose the sovereign could imagine exactly what the world would look like without any outbound investors. That is, the individuals who do not invest domestically, and all of their wealth and income, simply disappear. Clearly, in such a world, there would be a diminished amount of domestic consumption. And presumably, in such world, the sovereign would provide fewer goods and services. The cost of the foregone goods and services are clearly costs that should be allocated to the non-business activity of the outbound investors. Thus, the relationship between these costs and the income generated by outbound investors provides a lower bound as to the "rate" of tax that should be imposed on such outbound investors' income, and hence on individual income in general.

My suspicion is that, after engaging in this exercise, the sovereign will still have significant flexibility as to how to divide the aggregate tax burden between entity income taxes and individual income taxes. In particular, in the case of the United States, I suspect that one plausible division of the aggregate income tax burden would be the one suggested by the current corporate income tax and the current individual income tax. For example, if foreigners did not, on average, believe that they received benefits from the U.S. government in an amount that fairly compensated them for the income taxes they pay, they would presumably invest elsewhere. Since they do not, or in any event since many of them do not, it follows that the current aggregate corporate income tax burden cannot be unreasonable. Similarly, the absence of wholesale emigration of U.S. residents to foreign lands is strong evidence that the current aggregate individual income tax burden cannot be unreasonable either.

But these observations do not mean that either the aggregate U.S. corporate income tax burden or the aggregate U.S. individual income tax burden is imposed in a reasonable way. Focusing on the corporate income tax burden first, I have already noted that a proper "corporate" income tax must burden *all* business-generated income, since all such income benefits from the package of goods and services the U.S. provides to business activity. In particular, focusing on the

purely domestic context, a proper corporate income tax must burden all businesses, not just those conducted in corporate form, for even businesses conducted as partnerships or limited liability companies benefit from the U.S. government's package of goods and services. Moreover, a proper corporate income tax must indirectly burden all participants in all businesses, not merely equity owners, since all participants at least arguably benefit from the U.S. government's package of goods and services.[53] That is, there is no reason to believe that a business that decreases its profitability (as currently defined under U.S. income tax principles) by increasing its leverage—issuing debt and retiring equity—will derive less benefit from the goods and services provided by the U.S. government after such recapitalization than it did before.

In the cross-border context, a proper corporate income tax must fully burden all business income generated by nonresidents, while a proper individual income tax must keep its fingers off such income. Thus, active business income, that is, income effectively connected with a trade or business, earned directly by nonresident individuals or earned indirectly by nonresident individuals in their capacities as equity owners in flow-through entities, must be fully burdened by the corporate income tax, but only by the corporate income tax. Under current law, such income is not burdened by the corporate income tax at all, but is fully burdened by the individual income tax.[54] Thus, the current tax regime structure incorrectly implies that the affected nonresident individuals do not benefit from the U.S. government's provision of business benefits, but do benefit from the U.S. government's provision of non-business benefits. This is exactly backwards and should be corrected.

In addition, business income earned indirectly by nonresident individuals in their capacities as equity owners in corporations should be fully burdened by the corporate income tax, but only by the corporate income tax. Under current law, such income is indeed fully burdened by the corporate income tax, but is then additionally burdened by a withholding tax.[55] Thus, the current tax regime structure incorrectly implies that the affected nonresident individuals not only fully benefit from the U.S. government's provision of business benefits, but also to

53 Even if a participant only arguably benefits, it is still necessary for the corporate income tax regime to indirectly burden her. *See* Schlunk, *supra* note 3, at 362–67.

54 I.R.C. § 871(b)(1) (2000).

55 *See id.* § 871(a)(1)(A). This withholding tax rate is generally reduced, but not eliminated, through tax treaties.

some extent benefit from the U.S. government's provision of non-business benefits.[56] This should be corrected.

Finally, business income earned indirectly by nonresident individuals in capacities other than as equity owners in businesses should be fully burdened by the corporate income tax, but only by the corporate income tax. To accomplish this, the double income tax regime must, as already mentioned, deny any deduction for payments or accruals made by a business to various stakeholders, irrespective of whether such stakeholders are residents or nonresidents. In contrast, current law generally permits payments or accruals denominated as interest, rents and royalties, and wages to be fully deducted by a business, both when made to residents and when made to nonresidents.[57] When the already taxed income is then paid to a nonresident individual, a proper double income tax regime would impose no additional tax. In contrast, under current law, interest, rents and royalties paid to nonresident individuals are all generally subject to withholding tax.[58] And wages paid to nonresident individuals are generally fully subject to the individual income tax. Thus, the current tax regime structure arguably incorrectly implies that nonresident individuals earning interest, rents and royalties, and wages do not benefit from the U.S. government's provision of business benefits, but rather to some extent benefit from the U.S. government's provision of non-business benefits.[59] This, again, is exactly backwards, and should be corrected.

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56 Alternatively, the structure might reflect the sovereign's judgment that it is more expensive to provide non-business benefits to nonresident shareholders than to resident shareholders. But I can think of no reason why that might be true.

57 The Code does, under certain limited circumstances, provide different treatment when the recipient of an interest payment is a nonresident, rather than a resident. I.R.C. § 163(j).

58 The Code nominally imposes a 30% withholding tax on all such payments. *See id.* § 871(a)(1)(A). In fairness, however, it should be noted that such tax rarely applies. *See id.* In the case of interest earned with respect to so-called portfolio debt, the withholding tax is abated. *See id.* § 871(h). In addition, the withholding tax on royalties is also generally reduced to 0% by tax treaty. *See* MODEL INCOME TAX TREATY art. 12.1 (1997).

59 Alternatively, the structure might reflect a belief that nonresidents earning interest, rents, and royalties demand and consume only business benefits, but in the amounts reflected by their withholding tax payments, rather than in the amounts that would have been determined had the corporate income tax applied. If the withholding tax rate were less than the prevailing U.S. individual income tax rate in some systematic way, it might indeed be evidence of such belief. That is, since residents also currently escape the corporate income tax on interest, rents, and royalties, it is arguable that the individual income tax they pay on such items funds both the business benefits they demand and consume to produce such income, and any non-business benefits they demand and consume. (Of course, such bifurcation would throw

Turning now to the individual income tax component of a proper double income tax regime, such component should, for the reasons explained in Part II.E, be a so-called consumption tax. Thus, amounts of after-entity-income-tax income should be subject to this tax when, and only when, they are consumed. In particular, neither the character of the income (for example, wages, interest, dividends, etc.), nor the actions of third persons with respect to the income (for example, a corporate board's decision to pay a dividend rather than to retain earnings), should affect its taxation.

In addition to adopting the timing features of a consumption tax, the ideal double income tax regime would force the amendment of another aspect of the United States' current individual income tax regime. In particular, since the individual income tax should reflect the non-business benefits provided to individuals, it would need to be fully imposed on the after-foreign-income-tax income earned (or, rather, consumed) by resident individuals. Under current law, resident individuals are generally allowed a foreign tax credit that reduces the amount of individual income tax they must pay on their foreign source income, to reflect the fact that such income has "already been taxed" by the foreign country.[60] It has, but that is largely beside the point. That is, a resident individual will benefit from the U.S. government's provision of non-business benefits in an amount determined by the amount of foreign source income she can repatriate and consume. Thus, it is inappropriate to allow her a foreign tax credit for her foreign income tax payments. Of course, it would also be inappropriate to tax her on her *gross* foreign source income, since she cannot in fact repatriate and consume amounts that have been diverted by a foreign sovereign. Thus, if for any reason her gross foreign source income is included in her individual income tax

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into grave doubt the correctness of the current income tax treatment of corporate equity.) The problem with this explanation, however, is that the withholding tax rate imposed on nonresidents is not less than the individual income tax rate in any systematic way. Rather, the withholding tax rate varies from nonresident to nonresident based on the terms of treaties or, in the absence of treaties, on the Code. This is inconsistent with the notion that the withholding tax is funding nonresidents' business benefits. Moreover, in many cases, the ultimate withholding tax rate is 0%. This, too, is inconsistent with the notion that the withholding tax is funding nonresidents' business benefits.

60 *See* I.R.C. §§ 901–908.

calculation (as it is under current law),[61] she should be entitled to a deduction for any foreign income taxes paid.[62]

Finally, to the extent that foreign source income is earned by a U.S. business, rather than by a U.S. individual, the proper double income tax regime would exclude such income from the business' taxable income for purposes of computing the business' corporate income tax. The reason, of course, is that such income will not, in general, benefit from the U.S. government's provision of business benefits, but rather only from the foreign sovereign's provision of business benefits. Thus, only as and when such foreign-source (necessarily after-foreign-tax) income makes its way (or is deemed to make its way) out of the U.S. business and into the hands of a U.S. resident individual (and is consumed by such individual) should the U.S. taxing authority take a cut: at that point the individual income tax should be levied on such income.

CONCLUSION

This Article has examined the proposition that double income taxation is "unfair" and "doesn't make any sense" and has, in general, found the proposition to be wanting. That is, although double income taxation as currently practiced in the United States is undoubtedly unfair and nonsensical, the problem lies not with the concept of double income taxation, but rather with its current implementation. In particular, so long as a sovereign provides or can be deemed to provide benefits to individuals both in their business and in their non-business capacities, as will always be the case in a world with international contacts, and as will generally be the case in a world without international contacts but with multiple tax periods, it will be fair and sensible for it to impose separate taxes that reflect the business and the non-business benefits it provides.

More is true. So long as a country has either sufficient international contacts or a multi-period time horizon, any tax regime other than a proper double income tax regime will necessarily be unfair and nonsensical! Given that the modern world is characterized both by significant and ever-increasing amounts of international contacts, and by a multi-period time horizon, it follows that every country in the world should enact a *proper* double income tax regime. In particular,

61 *Id.* § 862.

62 The Code allows such a deduction. *Id.* § 164(a)(3). In practice, however, taxpayers rarely avail themselves of this deduction due to the availability of the generally more favorable foreign tax credit mechanism.

the President, rather than dismantling the United States' very improper current double income tax regime, should devote his energies to transforming such regime into a proper double income tax regime.