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The Troubled Rule of Nondiscrimination in Taxing Foreign Direct Investment

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THE TROUBLED RULE OF NONDISCRIMINATION IN TAXING FOREIGN DIRECT INVESTMENT

ROBERT A. GREEN*

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I. INTRODUCTION

The nondiscrimination article in virtually all of the United States' bilateral income tax treaties prohibits the United States from imposing discriminatory taxes on business enterprises that are carried on, owned, or controlled by residents of the other treaty country.[1] This constraint often conflicts with Congress's desire to increase the tax revenues collected from foreign and foreign-owned firms doing business in the United States.[2] Congress has enacted numerous tax provisions in recent

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1. *See infra* notes 23–28 and accompanying text.

2. Apart from political reasons for the preference to tax foreign and foreign-owned firms rather than domestic firms, Congress recently has been motivated by Internal Revenue Service statistics indicating that U.S. subsidiaries of foreign firms, as a group, report strikingly less taxable income than comparable domestically-owned firms. *See generally Tax Underpayments by U.S. Subsidiar-*

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years that are widely thought to violate U.S. treaty nondiscrimination obligations.[3] Although Congress sometimes attempts to defend these provisions, it often concludes by stating that if courts find the provisions to be discriminatory, it intends to override the treaties,[4] in violation of international law.[5]

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ies of Foreign Companies: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 101st Cong., 2d Sess. (1990). For an analysis of these statistics, see Harry Grubert et al., *Explaining the Low Taxable Income of Foreign-Controlled Companies in the United States*, *in* STUDIES IN INTERNATIONAL TAXATION 237, 270 (Alberto Giovannini et al. eds., 1993) (concluding that these statistics provide indirect evidence that income shifting is partially responsible for the low reported taxable incomes).

3. For a discussion of these provisions, see Sanford H. Goldberg & Peter A. Glicklich, *Treaty-Based Nondiscrimination: Now You See It Now You Don't*, 1 FLA. TAX REV. 51 (1992) [hereinafter *Treaty-Based Nondiscrimination*]. Goldberg and Glicklich conclude that "[n]either the Treasury Department nor Congress seems to have a strong commitment to nondiscrimination despite the existence of a nondiscrimination provision in all modern U.S. tax treaties." *Id.* at 108; *accord* Peter A. Glicklich & Sanford H. Goldberg, *United States*, 78b CAHIERS DE DROIT FISCAL INT'L [C.D. FISC. INT'L] 715 (1993); H. David Rosenbloom, *Toward a New Tax Treaty Policy for a New Decade*, 9 AM. J. TAX POL'Y 77, 90–91 (1991); Richard L. Doernberg & Kees van Raad, *The Legality of the Earnings-Stripping Provision Under U.S. Income Tax Treaties*, 2 TAX NOTES INT'L 199, 200 (1990); Richard L. Doernberg, *Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority*, 42 TAX LAW. 173, 174 (1989).

4. *See, e.g.*, H.R. REP. NO. 247, 101st Cong., 1st Sess. 1301–02 (1989) (discussing section 6038A, which imposes additional record-keeping and information-reporting requirements on certain foreign corporations and foreign-owned U.S. corporations); *id.* at 1249 (discussing section 163(j), which denies an interest deduction to any corporation for interest payments to related, "tax-exempt" foreign corporations).

The Joint Committee on Taxation made a similar statement about congressional intent to override treaty nondiscrimination articles in connection with a controversial provision in the Foreign Income Tax Rationalization and Simplification Bill of 1992 that would have deemed certain foreign and foreign-owned corporations to have minimum taxable income. STAFF OF JOINT COMM. ON TAXATION, 102D CONG., 2D SESS., EXPLANATION OF H.R. 5270, 52 (Comm. Print 1992). In spite of the Joint Committee's attempt to defend this provision as consistent with treaty obligations, the U.S. Treasury Department concluded that the provision would constitute "blatant discrimination against our treaty partners," would override treaties, and would invite retaliation. *Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Comm. on Ways and Means on H.R. 5270*, 102d Cong., 2d Sess. 247 (1992) (statement of Fred T. Goldberg, Jr., Assistant Secretary of the Treasury for Tax Policy).

5. Under U.S. law, international treaties and statutes are of equal force. U.S. CONST. art. VI, cl. 2; I.R.C. § 7852(d)(1) (West 1993); RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 115(1)(a) cmt. a, reporter's note 1 (1986); AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, PROPOSALS ON UNITED STATES INCOME TAX TREATIES 63–72 (1992) [hereinafter ALI INCOME TAX TREATY PROJECT]. Thus, under domestic law, Congress can override a treaty provision by subsequently enacting inconsistent legislation. *Id.*; The Cherokee Tobacco, 78 U.S. 616, 621 (1871). By doing so, however, Congress breaches an obligation of the United States under international law. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 115(1)(b) cmt. b, reporter's note 2 (1986); ALI INCOME TAX TREATY PROJECT, *supra*, at 73–76.

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It is time to reconsider the role of the treaty nondiscrimination rule in the international tax system and to reassess the wisdom of such a rule.[6] Several prominent commentators have argued that the United States should restrict or even omit the nondiscrimination provision in future treaties, particularly in light of Congress's unwillingness to adhere to the nondiscrimination rule.[7] This Article disagrees with that assessment.

The Article first shows why it has proven difficult to explain the role of the nondiscrimination rule in terms of the traditional international tax policy debate. This difficulty undoubtedly has contributed to the weakened intellectual support for the nondiscrimination rule. The Article argues, however, that the traditional debate fails to reflect critical features of foreign investment that are essential to understanding the treaty nondiscrimination rule. With a different understanding of the nature of foreign direct investment, the nondiscrimination rule can be seen to promote global economic efficiency and to advance national interests as well.

Part I of the Article discusses the scope of the nondiscrimination rule. Part II discusses the uneasy fit of the nondiscrimination rule with traditional goals of international tax policy. This Part focuses primarily on the goal of tax neutrality—the principle that taxes should not interfere with market-based economic decisions. Complete tax neutrality is not possible, however, as long as nations tax income at all, much less while they employ different tax systems. Desirable forms of partial neutrality are mutually incompatible. The treaty nondiscrimination rule is largely irrelevant to the most widely advocated form of partial

6. In announcing its withdrawal of the 1981 proposed U.S. Model Income Tax Treaty on July 17, 1992, the U.S. Treasury Department specifically solicited the views of the private sector on "[i]ssues arising under nondiscrimination provisions." Treasury Dep't News Release NB-1900 (July 17, 1992), *reprinted in* [1993] 13 Stand. Fed. Tax Rep. (CCH) ¶ 46,416 (July 22, 1992)[hereinafter Treasury Dep't News Release]. *See also Treaty-Based Nondiscrimination, supra* note 3, at 59 (noting that "it is now appropriate to reconsider what function, if any, the nondiscrimination article of a U.S. income tax treaty should serve"); Rosenbloom, *supra* note 3, at 91 (arguing that it is necessary to rethink the treaty nondiscrimination rule).

7. One prominent commentator, for example, has suggested that countries that are hosts to foreign direct investment usually will want to discriminate, or at least will find that they must discriminate in order to enforce their tax laws dealing with inbound investment. Rosenbloom, *supra* note 3, at 91. Rosenbloom suggests that the treaty nondiscrimination rule should be omitted, scaled back, or made a government-to-government commitment, with no private rights, in upcoming treaties. *Id. See also Treaty-Based Nondiscrimination, supra* note 3, at 109 (suggesting that the treaty nondiscrimination rule be replaced by a "most-favored nation" rule or by a more narrowly tailored national-treatment rule).

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neutrality, known as capital export neutrality, which is said to prevail if the tax system does not distort an investor's decision regarding whether to invest at home or abroad. The treaty nondiscrimination rule is more closely related to capital import neutrality, which is said to prevail if similar investments in a given country are subject to the same effective tax rate whether they are made by domestic investors or by foreign investors. Many commentators, however, are skeptical of the value of capital import neutrality, particularly in comparison to capital export neutrality.[8] Finally, the nondiscrimination rule is difficult to defend on the basis of traditional international tax policy goals other than tax neutrality.

Part III of the Article argues that the traditional debate between capital export versus import neutrality in the taxation of foreign direct investment is becoming obsolete in an increasingly integrated world economy, in which capital markets are global and in which efficient firms, possessing unique advantages, are incorporated and headquartered in many countries. The Article argues that, in such an economy and from a global perspective, the most appropriate goal for the taxation of foreign direct investment is one that might be termed "ownership neutrality," meaning that tax rules should not interfere with market forces that result in assets being owned by the firms that can use them most productively. The treaty nondiscrimination rule promotes ownership neutrality and is therefore desirable from the standpoint of global economic efficiency.

Part IV concludes by analyzing the relevance of global economic efficiency in a world where national policymakers pursue more parochial objectives. The Article argues that nations generally can increase their national economic welfare by entering into international agreements that include globally efficient nondiscrimination rules. Nevertheless, national governments might choose to discriminate even if discrimination is not in the collective interest of the country's residents. In particular, the Article suggests several changes in circumstances that might account for Congress's reduced commitment to the nondiscrimination rule. The Article argues, however, that the rule has a beneficial restraining effect on Congress. It reduces the likelihood that Congress will enact discriminatory tax legislation, both by increasing the resultant costs and by mobilizing political support for nondiscriminatory policies.

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8. *See, e.g.,* Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 571, 582 (1990) [hereinafter Frisch, *International Tax Policy*].

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II. THE SCOPE OF THE NONDISCRIMINATION RULE

This Part of the Article briefly discusses the norms of international taxation that provide the context for the treaty nondiscrimination rule, and then discusses the nature and scope of the treaty nondiscrimination rule itself.

Countries generally assert jurisdiction to tax income on the basis of both residence and source.[9] That is, they assert jurisdiction to tax their residents on all income, regardless of its geographical source,[10] and to tax nonresidents on income derived from sources within the country.[11] Countries generally treat each corporation as a distinct taxpayer with its own residence.

The concept of "residence" is defined by each country's domestic tax laws.[12] For example, the United States treats corporations as U.S. residents for tax purposes if they are incorporated in the United States.[13] Many other countries, in contrast, use "place of effective management" as the criterion for determining the residence of a corporation.[14] Countries generally require residents to pay the regular income tax, which is computed on a "net" basis. That is, the taxpayer is taxed on the difference between gross income and allowable deductions.

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9. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 411–13 (1986) (noting wide degree of international consensus on the law of jurisdiction to tax).

10. *Id.* § 412(1)(a) (1986). In the case of the United States, see I.R.C. § 61(a) (West 1992) (defining gross income to mean all income "from whatever source derived"). This article generally uses the term "resident" to mean any person subject to tax under the residence principle.

11. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 412(1)(b), (c) (1986); *see also* ALI INCOME TAX TREATY PROJECT, *supra* note 5, at 5; ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES 36 (1991) [hereinafter OECD, TAXING PROFITS IN A GLOBAL ECONOMY]. In the case of the United States, see I.R.C. § 871 (West 1992) (tax on nonresident alien individuals), § 881 (tax on income of foreign corporations not connected with U.S. business), § 882 (tax on income of foreign corporations connected with U.S. business).

12. The United States, for example, treats alien individuals as U.S. residents for tax purposes based on such factors as their immigration status and physical presence in the country. I.R.C. § 7701(b) (West 1993). Unlike most other countries, the United States taxes its citizens on their worldwide income regardless of their place of physical presence, and thus exercises "residence"-based jurisdiction over them, although U.S. tax law does not formally define citizens as "residents." *See* I.R.C. § 7701(a)(30)(A) (West 1993).

13. *See* I.R.C. § 7701(a)(30)(C) (West 1993) (defining "United States person" to include a "domestic corporation"), § 7701(a)(4) (defining a "domestic corporation" to be a corporation "created or organized in the United States or under the law of the United States or of any State").

14. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 36 (stating that "place of effective management" is the preferred criterion for determining the residence of corporations). "The problem then becomes one of establishing where the 'effective management' is located." *Id.*

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In exercising source-based tax jurisdiction over nonresidents, host countries generally distinguish between income that is "effectively connected" with the conduct of a trade or business in the host country and income that is not so connected, such as income from passive investment activity. Host countries generally require nonresidents who engage in a business in the country to pay the regular income tax on the income attributable to the business, at least if it is carried on through a branch or other "permanent establishment" in the country.[15] In contrast, host countries generally require nonresidents who earn nonbusiness income[16] (other than capital gains) to pay a flat-rate tax on the gross amount of such income.[17] Countries enforce this "withholding

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15. The United States, for example, taxes nonresident taxpayers by statute on the income they earn from the conduct of a trade or business in the United States. *See* I.R.C. § 871(b)(1) (West 1992) (taxing nonresident alien individuals engaged in trade or business within the United States on their taxable income that is effectively connected with the conduct of a trade or business within the United States),§ 882(a)(1) (taxing foreign corporations engaged in trade or business within the United States on their taxable income that is effectively connected with the conduct of a trade or business within the United States).

Under the U.S. Model Income Tax Treaty, however, the United States taxes a foreign enterprise on business profits only if the enterprise carries on business in the United States through a permanent establishment, and then only to the extent that the business profits are attributable to that permanent establishment. U.S. MODEL INCOME TAX TREATY, art. 7(1) (U.S. Dep't of the Treasury 1981), *reprinted in* 1 Tax Treaties (CCH) ¶ 211 (1990) [hereinafter U.S. MODEL INCOME TAX TREATY]. The U.S. Model Income Tax Treaty defines "permanent establishment" to mean "a fixed place of business through which the business of an enterprise is wholly or partly carried on." *Id.* art. 5(1). The treaty provides that, subject to certain exceptions, a "permanent establishment" includes a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry, or any other place of extraction of natural resources. *Id.* art. 5(2).

16. Consider, for example, a nonresident alien investor who owns a portfolio of stocks and bonds of U.S. corporations. The United States would likely find it impracticable to require such an investor to pay the regular income tax on the resulting dividend and interest income. In particular, the United States would find it difficult to monitor the nonresident's deductions and to enforce the tax, particularly if the nonresident had few contacts with the United States and few immoveable assets in the United States. Instead, the United States would impose a flat-rate tax on the gross amounts of dividends and interest, and enforce the tax by requiring withholding at the source.

17. The Internal Revenue Code imposes withholding taxes at the rate of 30% on interest, dividends, and "other fixed or determinable annual or periodical gains, profits, and income . . . but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States." I.R.C. § 871(a)(1) (West 1992) (withholding tax on payments to nonresident alien individuals), § 881(a)(1) (withholding tax on payments to foreign corporations). Certain payments to nonresidents of portfolio interest and interest on U.S. bank deposits are exempt from withholding tax, however. I.R.C. § 871(h) (West 1992) (payments to nonresident alien individuals), § 881(c) (payments to foreign corporations). Interest does not qualify as portfolio interest if the nonresident investor has a 10% or greater equity interest in the borrower or is a controlled foreign corporation related to the borrower or if the interest is paid on a bank loan made in the ordinary course of a banking business. In addition, tax treaties often reduce the statutory

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tax" by requiring the payor of the nonbusiness income to withhold the amount of the tax from the payment.[18] This withholding tax applies not only to income from portfolio investments, such as dividends and interest paid on a portfolio of stocks and bonds, but also to dividends, interest, royalties, and similar payments that a domestic subsidiary pays to its foreign parent corporation.[19]

Thus, if a resident of one country earns business or nonbusiness income in a second country, both countries may tax the income. Generally, the residence country will relieve this double taxation,[20] either by exempting residents from taxation on some or all of their foreign-source income,[21] or by taxing residents on their worldwide income and granting them a tax credit for the income taxes they pay to foreign countries on foreign source income.[22] The former system is known as a "territorial" or "exemption" system and the latter as a "worldwide" system.

Virtually all of the United States' bilateral income tax treaties contain articles on nondiscrimination.[23] Although these articles differ

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30% tax rate. The U.S. Model Income Tax Treaty, for example, reduces the withholding tax rate on direct intercorporate dividends to 5%, and reduces the withholding tax rate on other dividends to 15%. U.S. MODEL INCOME TAX TREATY, *supra* note 15, art. 10(2). The treaty also eliminates withholding taxes on interest and royalty payments. *Id.* arts. 11(1) (interest), 12(1) (royalties).

18. I.R.C. §§ 1441–42 (West 1993).

19. The host country generally will treat the parent corporation and the subsidiary as distinct taxpayers and therefore will not attribute the subsidiary's business activities to the parent corporation. Thus, it will not treat the parent corporation as being engaged in a business in the host country, but rather will treat it as receiving investment income, which is subject to withholding taxes.

20. *See* Julie A. Roin, *The Grand Illusion: A Neutral System for the Taxation of International Transactions*, 75 VA. L. REV. 919, 923 (1989).

21. *See id.* at 924 nn.25–26.

22. *See id.* at 925–27.

23. *See Treaty-Based Nondiscrimination*, *supra* note 3, at 51 & n.1.

Customary international law imposes only very limited restrictions on tax discrimination against foreigners, such as where the tax amounts to an expropriation of property. *See* RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 712 (1986); BRIAN J. ARNOLD, TAX DISCRIMINATION AGAINST ALIENS, NON-RESIDENTS, AND FOREIGN ACTIVITIES: CANADA, AUSTRALIA, NEW ZEALAND, THE UNITED KINGDOM, AND THE UNITED STATES 24–25 (1991); KEES VAN RAAD, NONDISCRIMINATION IN INTERNATIONAL TAX LAW 25–27 (1986). A variety of international agreements and declarations impose greater restrictions. For example, in addition to income tax treaties, commercial treaties often contain articles prohibiting tax discrimination, including discriminatory income taxation. *E.g.*, Treaty of Friendship, Commerce, and Navigation, Oct. 29, 1954, U.S.-F.R.G., art. XI, 7 U.S.T. 1839; *see* ARNOLD, *supra* at 42–44, 251–52; VAN RAAD, *supra* at 213–52; Pamela B. Gann, *The US Bilateral Investment Treaty Program*, 21 STAN. J. INT'L L. 373, 426–27 (1985) (discussing the relationship between tax treaties and the tax provisions in commercial treaties). Within the European Community, the Treaty of Rome contains a number of provisions requiring nondiscriminatory treatment of foreign nationals; although these provisions do not specifically address income

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from treaty to treaty in their details, many resemble the comprehensive nondiscrimination article[24] contained in the now-withdrawn 1981 pro-

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taxation, they would appear to prohibit discriminatory income taxation of foreign and foreign-owned firms. *See, e.g.*, TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY] arts. 7 (general rule on nondiscrimination), 52 (freedom of establishment), and 67 (free movement of capital). The member states of the Organization for Economic Cooperation and Development have signed a declaration stating that each member state should afford enterprises owned or controlled by nationals of other member states treatment "no less favorable than that accorded in like situations to domestic enterprises." Declaration by the Governments of OECD Member Countries on International Investment and Multinational Enterprises ¶ II.1 (1976), *reprinted in* 1 BASIC DOCUMENTS OF INTERNATIONAL ECONOMIC LAW 563 (Stephen Zamora & Ronald A. Brand eds., 1990). *See generally* VAN RAAD, *supra*, at 27–49 (discussing legal restrictions on transnational taxation in conventional international law and supranational law).

24. Article 24 of the U.S. Model Income Tax Treaty provides in full:

> Non-discrimination
>
> 1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall apply to persons who are not residents of one or both of the Contracting States. However, for the purposes of United States tax, a United States national who is not a resident of the United States and a ______ national who is not a resident of the United States are not in the same circumstances.
>
> 2. For the purposes of this Convention, the term "nationals" means
>
> (a) in relation to ____________; and
>
> (b) in relation to the United States, United States citizens.
>
> 3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, relief, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
>
> 4. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable capital of the first-mentioned resident, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.
>
> 5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State,

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posed U.S. Model Income Tax Treaty.[25] Two other influential model income tax treaties, the OECD Model Income Tax Treaty[26] and the U.N. Model Income Tax Treaty,[27] contain similar comprehensive nondiscrimination articles. This Article will focus on a comprehensive treaty nondiscrimination article, such as the one in the 1981 U.S. Model Income Tax Treaty.

Such a comprehensive nondiscrimination article prohibits a host country from imposing discriminatory taxes on a business enterprise operating within its territory that is carried on, owned, or controlled by residents of the other treaty country.[28] The nondiscrimination article

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> shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
>
> 6. The provisions of this Article shall, notwithstanding the provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

U.S. MODEL INCOME TAX TREATY, *supra* note 15, art. 24.

25. U.S. MODEL INCOME TAX TREATY, *supra* note 15. The Treasury Department announced its withdrawal of the 1981 proposed Model Income Tax Treaty on July 17, 1992, on the ground that the treaty was out of date. Treasury Dep't News Release, *supra* note 6, at ¶ 46,416. Until its withdrawal, however, U.S. negotiators used the U.S. Model Income Tax Treaty as the starting point in their income tax treaty negotiations with developed countries. *Id.* Thus, the nondiscrimination article in the U.S. Model Income Tax Treaty is representative of the nondiscrimination articles in many actual U.S. income tax treaties. In addition, it is representative of the comprehensive nondiscrimination provisions found in other model income tax treaties. *See* ALI INCOME TAX TREATY PROJECT, *supra* note 5, at 254.

26. OECD MODEL TAX CONVENTION ON INCOME AND ON CAPITAL, art. 24, *reprinted in* 1 Tax Treaties (CCH) ¶ 201 (1992). Australia, Canada, and New Zealand have expressed reservations to the nondiscrimination article in the OECD Model Income Tax Treaty. OECD COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND CAPITAL, COMMENT 64 ON ARTICLE 24 CONCERNING NON-DISCRIMINATION (1994) (reservations of Australia, Canada, and New Zealand).

Australia agreed only with great reluctance to include a watered-down nondiscrimination article in its treaty with the United States. *See* Robert M. Gordon, *Australia*, 78b C.D. FISC. INT'L 273, 273 (1993); *Treaty-Based Nondiscrimination*, *supra* note 3, at 55–57; Richard J. Vann, *International Implications of Imputation*, 2 AUSTL. TAX F. 451, 468 (1985).

Canada also has insisted on limiting the scope of the nondiscrimination articles in its tax treaties. *See Treaty-Based Nondiscrimination*, *supra* note 3, at 58; ARNOLD, *supra* note 23, at 157.

27. UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, art. 24 (1980), *reprinted in* 1 Tax Treaties (CCH) ¶ 206 (1990).

28. Because each of the treaty countries will have its own domestic rules for determining tax "residence," and these rules will not necessarily be consistent, tax treaties generally provide their own definitions of "residence." *See* U.S. MODEL INCOME TAX TREATY, *supra* note 15, art. 4.

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does not, however, prohibit the host country from imposing discriminatory taxes on the nonresident investors in such an enterprise.[29]

To be more specific, suppose that the two treaty countries are Home and Foreign. Then if a foreign[30] firm has a branch or other permanent establishment in Home, the treaty nondiscrimination rule prohibits Home from taxing the foreign firm on the income attributable to the permanent establishment less favorably than it would tax a domestic firm carrying on the same activities.[31] Similarly, if a foreign resident wholly or partly owns or controls a domestic firm, the treaty nondiscrimination rule prohibits Home from taxing the domestic firm less favorably than it would tax a similar domestic firm that was owned and controlled by domestic residents.[32] In particular, if a foreign corporation has a domestic subsidiary, Home may not tax the subsidiary less favorably than it would tax a similar domestically owned corporation.

The treaty nondiscrimination rule does not, however, prevent Home from taxing nonresident investors who receive dividends, interest, royalties, or similar payments from an enterprise carried on in Home less favorably than it would tax resident investors receiving similar payments.[33] Indeed, as discussed earlier, host countries generally do tax nonresident investors differently from resident investors.[34] The nonresident investor will be subject to gross-basis withholding taxes, while the resident investor will be subject to a net-basis tax. The nondiscrimination rule, being inapplicable, requires neither that the nonresident be

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29. *See generally* VAN RAAD, *supra* note 23, at 225–52.

30. In the context of discussions of the hypothetical treaty countries Home and Foreign, this Article will use the lower-case adjective "domestic" to refer to a resident of Home and the lower-case adjective "foreign" to refer to a resident of Foreign.

31. U.S. MODEL INCOME TAX TREATY, *supra* note 15, art. 24(3).

32. *Id.* art. 24(5). A separate clause of this nondiscrimination article prohibits Home from placing greater limitations on a domestic firm's ability to deduct interest, royalties, and similar payments when they are made to a foreign resident than when they are made to a domestic resident. *Id.* art 24(4). These two clauses overlap. Clause (4), however, applies even when the foreign residents have no ownership or control of the domestic firm.

33. Article 24(1) of the U.S. Model Income Tax Treaty prohibits tax discrimination based on nationality. *Id.* art. 24(1). This clause does not, however, prohibit discrimination based on residence. A nonresident foreign national and a resident domestic national are not considered to be similarly situated for purposes of the nationality clause. Thus, a nonresident investor cannot invoke the nationality clause to argue that he or she should be taxed the same as a resident investor.

Moreover, the withholding taxes that host countries impose on payments to nonresident investors are the subject of other articles of the treaty. Thus, even if the nondiscrimination article were otherwise applicable to these taxes, the general nondiscrimination rule should probably not be interpreted to override the articles dealing specifically with withholding taxes. *See* ALI INCOME TAX TREATY PROJECT, *supra* note 5, at 257, 263.

34. *See supra* notes 15–19 and accompanying text.

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taxed on a net basis nor that the gross-basis withholding taxes be comparable to the net-basis tax.[35]

The nondiscrimination rule raises difficult questions of interpretation. When is the taxation of the domestic branch or subsidiary of a foreign firm "less favorably levied"[36] or "other or more burdensome"[37] than the taxation of wholly domestic firms? Do these phrases permit any differences at all in taxation and, if so, when? Also, when should two taxpayers be considered to be "in the same circumstances,"[38] or "carrying on the same activities,"[39] or "similar"?[40] Commentators generally agree that these phrases should be interpreted flexibly to require only reasonably comparable treatment of foreign and domestic taxpayers, given the totality of the circumstances.[41]

III. THE UNEASY FIT OF THE NONDISCRIMINATION RULE WITH TRADITIONAL GOALS OF INTERNATIONAL TAX POLICY

Prescriptive analyses of international taxation generally focus on the goal of global economic efficiency.[42] Other commonly identified goals include intercountry equity in the division of the global tax base, taxpayer equity,[43] simplicity, and administrative feasibility.[44] Realistically, however, national policymakers are likely to pursue more parochial objectives than those listed above—a factor that this Article will consider in Part V.

35. *See* ALI INCOME TAX TREATY PROJECT, *supra* note 5, at 260–65.

36. U.S. MODEL INCOME TAX TREATY, *supra* note 15, art. 24(3).

37. *Id.* art. 24(5). The nationality clause uses the same language. *Id.* art. 24(1).

38. *Id.* art. 24(1).

39. *Id.* art. 24(3).

40. *Id.* art. 24(5).

41. *See* ALI INCOME TAX TREATY PROJECT, *supra* note 5, at 255–56. For example, nonresident taxpayers might have a limited connection to the host country and have few, if any, assets located there. Information located abroad is not readily accessible to the host country's tax agency. It is generally agreed that these factors justify differences in enforcement and collection mechanisms without introducing prohibited discrimination. *Id.*

42. *See* Alberto Giovannini et al., *Introduction*, *in* STUDIES IN INTERNATIONAL TAXATION 3 (Alberto Giovannini et al. eds., 1993) (noting that most economic research on international taxation has focused on efficiency rather than on equity and simplicity).

43. Since this Article focuses on the international taxation of investment income, considerations of taxpayer equity are relatively unimportant. *See* Daniel J. Frisch, *Comment*, *in* TAXATION IN THE GLOBAL ECONOMY 46, 49 (Assaf Razin & Joel Slemrod eds., 1990) (arguing that it makes very little sense to consider equity in analyzing international tax rules, because the relative position of individual investors, in equilibrium, will not be affected by "inequitable" taxation of corporations or other investment opportunities) [hereinafter Frisch, *Comment*].

44. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 21, 35.

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If markets are perfectly competitive, global economic efficiency is achieved by tax rules that do not distort the decisions that investors would have made in the absence of taxation. In other words, tax neutrality should be the ideal. Tax neutrality requires a zero rate of income taxation, however, since any non-zero level of income taxation distorts decisions regarding labor, saving, and investment, even in an economy that is closed to international transactions.[45] In an open economy, additional distortions are inevitably created because income tax systems differ from country to country. Investors base their decisions on the after-tax returns that they can earn from various alternative investments. Because of differences among national tax systems, these after-tax returns depend not only on the corresponding before-tax returns, but also on the location of the investment, the residence of the investor, and the residence of corporate intermediaries used in making the investment.

Thus, complete international tax neutrality is not feasible. Consequently, analyses of international taxation traditionally have focused on two competing forms of partial neutrality, "capital export neutrality" and "capital import neutrality."[46] The following sections show that the treaty nondiscrimination rule is at best indirectly related to the goal of capital export neutrality. Although it is directly related to the goal of capital import neutrality, most analysts have concluded that capital export neutrality is the more valuable of these two mutually exclusive policies. The traditional analysis of global economic efficiency therefore provides at most a weak justification of the treaty nondiscrimination rule.

A. *Capital Export Neutrality*

It is difficult to justify the treaty nondiscrimination rule on the ground that it promotes capital export neutrality. First, the treaty rule is the wrong rule for this purpose. As will be discussed below, capital export

45. *See* DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 174–207 (1986).

46. The distinction between these two forms of partial neutrality is generally attributed to Richard Musgrave. *See* Richard A. Musgrave, *Criteria for Foreign Tax Credit*, *in* TAX INSTITUTE, TAXATION AND OPERATIONS ABROAD 83, 84–86 (1960). For more recent discussions, see U.S. DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 75 (1992) [hereinafter TREASURY INTEGRATION REPORT]; Frisch, *International Tax Policy*, *supra* note 8, at 583–84. A third framework for the taxation of international income—worldwide taxation with a deduction for foreign taxes (known as "national neutrality")—will not be considered here. *See* Frisch, *Comment*, *supra* note 43, at 49 (noting that national neutrality is rarely suggested as a serious alternative today).

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neutrality requires a rule of "locational" nondiscrimination rather than the treaty rule of "ownership" nondiscrimination. Second, the international tax system is a second-best world from the standpoint of capital export neutrality, so that even an appropriate ("locational") nondiscrimination rule would not necessarily move the overall system closer to capital export neutrality.

To explain capital export neutrality, it is useful to outline the simple model of international investment that, implicitly or explicitly, underlies much of the traditional analysis of international taxation.[47] Suppose there are two countries, Home and Foreign.[48] There are also two factors of production, capital and labor, which are homogeneous and in fixed supply in each country. There is no trade in commodities between the two countries. Labor is immobile and, initially, so is capital. Thus, residents of Home invest their capital in Home, and residents of Foreign invest their capital in Foreign. Suppose that, initially, Home has a higher ratio of capital to labor and a lower rate of return to capital (reflecting a lower marginal productivity of capital) than Foreign. Now suppose that barriers to the international flow of capital are removed. Residents of Home will start moving their capital from Home to Foreign, where it initially earns a higher rate of return. As a result of this movement of capital, the ratio of capital to labor will decrease in Home and increase in Foreign. As a result, the marginal productivity of capital invested in Home will increase and the marginal productivity of capital invested in Foreign will decrease. If all markets are competitive, the rate of return to capital invested in Home will increase and the rate of return to capital invested in Foreign will decrease. This process will continue until the rates of return to capital in the two countries are equalized.

The above model does not take income taxes into account. The idea of capital export neutrality is that the international tax system should not distort the efficient flow of capital from initially low-return countries to initially high-return countries;[49] that is, the international tax system should not distort investors' decisions about where to invest their

47. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 270–71; RICHARD E. CAVES, MULTINATIONAL ENTERPRISES AND ECONOMIC ANALYSIS 132 (1982).

48. Home might be thought of as the United States during much of the post-World War II period. The example of Home and Foreign set forth above is analyzed in greater detail in Richard Caves' book. *See* CAVES, *supra* note 47, at 132–36.

49. The flow is efficient in the sense that capital moves to the locations where it can be employed most productively. However, not all groups within each country will be made better off by this movement of capital. Owners of capital residing in Home and labor residing in Foreign will be better off, because these groups will earn a higher return on their investments and a higher wage

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capital. The international tax system will achieve capital export neutrality if investors face the same effective tax rate[50] on income from investments at home as on income from similar investments abroad. Given such a system, and assuming that capital is internationally mobile, capital will flow from country to country until the *before*-tax rate of return on the marginal investment in each country is equalized. Under these circumstances, there is no way to increase global income by reallocating capital from one country to another.

There are several ways in which countries could, in theory, agree on an international tax system that achieves capital export neutrality.[51] One, which obviously is not currently feasible, would be to agree on complete harmonization of all national tax systems. A second way would be to permit only residence-based tax jurisdiction. Capital export neutrality would then prevail if residence countries taxed their residents on their worldwide income without deferral[52] and did not discriminate between income from investments at home and income from investments abroad. Investors would then face the same effective tax rate—determined solely by their residence country's tax system—on income from similar investments, regardless of whether the investments were located at home or abroad.

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rate, respectively. Labor residing in Home and owners of capital residing in Foreign, however, will be worse off.

50. An effective tax rate takes into account not only the statutory rate of tax but also other aspects of the tax system that determine the amount of tax paid. This amount is then expressed as a percent of the before-tax return on the investment.

51. As will be discussed in Part IV(A), the following analysis assumes that investors, whether individuals or firms, have fixed endowments of capital to invest.

52. If a corporation has a foreign subsidiary, the residence country of the parent corporation generally will not tax the earnings of the subsidiary until they are repatriated to the parent corporation as a dividend or other payment. This is because the subsidiary is regarded as a nonresident, so that residence-based jurisdiction is lacking, and because the subsidiary's earnings are regarded as foreign source income, so that source-based jurisdiction is lacking. This phenomenon is known as "deferral."

The deferral phenomenon is not absolute. Since 1962, the United States has repealed deferral for some types of income earned by foreign subsidiaries, especially income that is passive (such as interest, dividends, and royalties) or particularly mobile. Revenue Act of 1962, Pub. L. No. 87–834, §§ 951–64, 76 Stat. 960, 1006–27 (enacting subpart F of the Internal Revenue Code). The Internal Revenue Code now contains several overlapping sets of provisions that eliminate deferral on all or a portion of a foreign subsidiary's income if the subsidiary earns passive or mobile income or holds assets that produce such income. I.R.C. §§ 951–64 (West 1992) (subpart F rules), §§ 531–37 (accumulated earnings tax), §§ 541–47 (personal holding company rules), §§ 551–58 (foreign personal holding company rules), §§ 1246–47 (foreign investment company rules), 1291–1297 (passive foreign investment company rules). Many other countries now have similar anti-deferral regimes. *See* Roin, *supra* note 20, at 966 n.172.

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This approach is not consistent with existing norms of international taxation, however, which call for source jurisdiction as well as residence jurisdiction.[53] Given the existence of source-based taxation and divergent national tax systems, capital export neutrality requires a system under which residence countries neutralize the distortionary effects of differing host-country tax systems. This will occur if the residence country taxes its residents on their worldwide income without deferral, grants its residents an unlimited, refundable foreign tax credit for income taxes paid to host countries, and does not discriminate between income from investments at home and income from investments abroad. Such a system essentially reverses the host country's tax and substitutes the residence country's tax. Thus, once again, the residence country's investors will face the same effective tax rate—determined solely by the residence country's tax system—on income from similar investments, regardless of whether the investments are located at home or abroad.

1. Locational Nondiscrimination and Ownership Nondiscrimination

The treaty nondiscrimination rule appears, at least at first glance, to be irrelevant if one's goal is to achieve capital export neutrality. Capital export neutrality requires "locational" nondiscrimination: the residence country must not discriminate between income from investments at home and income from investments abroad. The treaty nondiscrimination rule, however, does not prohibit countries from taxing investments located at home more favorably than investments located abroad.[54] Indeed, countries often offer investment incentives, such as accelerated depreciation or investment tax credits, that apply only to investments located at home.[55] A nondiscrimination rule that required countries to

53. In addition, an international tax system based exclusively on residence jurisdiction would create enforcement problems, since countries generally find it difficult to enforce taxes on income earned abroad. If investors are better able to evade residence-country taxes on foreign-source income than on domestic-source income, then an exclusively residence-based system will not achieve capital export neutrality, but rather will promote investment abroad.

54. *See* ALI INCOME TAX TREATY PROJECT, *supra* note 5, at 253–54.

55. *See* ALI INCOME TAX TREATY PROJECT, *supra* note 5, at 253; OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 177–78 (noting that the usual practice of residence countries is to make tax incentives applicable only to domestic investments); ARNOLD, *supra* note 23, at 127–29 (discussing Canadian tax incentives limited to domestic activities or investments). For examples of U.S. tax incentives that are limited to domestic activities or investments, see I.R.C. § 28(d)(3) (West 1992) (credit for expenses incurred in clinical testing for rare diseases), § 29(d)(1) (credit for alternative energy production), § 41(d)(4)(F) (credit for scientific research), § 42 (credit for low-income housing), § 168(g)(1)(A) (accelerated depreciation).

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extend such tax expenditure programs to investments located abroad would represent a radical change from the existing system.[56]

Rather, the treaty nondiscrimination rule prohibits what might be called "ownership" discrimination: host countries may not impose discriminatory taxes on business enterprises operating within their territories that are carried on, owned, or controlled by residents of the other treaty country. This rule seems to have no relevance to capital export neutrality. If the international tax system otherwise achieves capital export neutrality—meaning that the residence country provides an unlimited foreign tax credit—then the host country's taxation of foreign and foreign-owned firms, whether discriminatory or not, is neutralized by the residence country's tax system, and thus has no effect on economic efficiency. On the other hand, if the international tax system does not otherwise achieve capital export neutrality, ownership discrimination by the host country actually can move the system closer to capital export neutrality. A simple example would be where Home is a high-tax country with an exemption system and Foreign is a low-tax country. In that case, Home's firms will have a tax incentive to invest in Foreign, violating capital export neutrality. If Foreign raises its rate of taxation of Home's firms to the rate of taxation prevailing in Home, without changing its rate of taxation of its own firms, Foreign will violate the treaty nondiscrimination rule. This discrimination will remove the tax incentive for Home's firms to invest in Foreign, however, and thus will promote capital export neutrality.

Some commentators nevertheless have argued that the treaty nondiscrimination rule does play a role in securing capital export neutrality.[57] This role depends on strategic considerations. As noted earlier, capital export neutrality requires the residence country to maintain an unlimited foreign tax credit system. Given such a system in the residence country, the host country has an incentive to impose confiscatory taxes on local investments owned by residents of the residence country, since those taxes effectively will be passed on to the residence country's treasury, and thus will not deter inward foreign direct investment. It is unlikely, however, that residence countries would tolerate such a drain on their treasuries. In response, residence countries would likely repeal or restrict their foreign tax credit systems. Thus, the system of capital

56. *See* ALI INCOME TAX TREATY PROJECT, *supra* note 5, at 253.

57. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 178; RICHARD A. MUSGRAVE, FISCAL SYSTEMS 252 (1969) [hereinafter MUSGRAVE, FISCAL SYSTEMS]; Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 TAX L. REV. 565, 575 (1992).

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export neutrality would break down. Under this analysis, one can view the host country's agreement to a nondiscrimination rule as being a quid pro quo for the residence country's agreement to maintain an adequate foreign tax credit system.

Although this view of the nondiscrimination rule probably captures an element of the tax treaty dynamic, it is not wholly satisfactory. Most industrialized countries are both residence countries and host countries.[58] Countries that endorse the nondiscrimination rule are likely to view it as a constraint to which they are willing to commit themselves as a host country, because they have a strong interest as a residence country in having the other treaty country make a reciprocal commitment not to discriminate. In other words, the nondiscrimination rule probably results largely from reciprocal bargaining, rather than as one country's quid pro quo for the other country's foreign tax credit system. Moreover, many countries employ exemption systems rather than worldwide systems of taxation with foreign tax credit mechanisms. It is not clear how these countries are able to induce their treaty partners to agree to nondiscrimination articles, if the quid pro quo for such articles is the maintenance of a foreign tax credit system. In any case, if the purpose of the nondiscrimination rule is to advance capital export neutrality, then it is puzzling that the rule does not also impose a requirement of locational nondiscrimination.

2. Second-Best Problems

The previous section argued that a rule of locational nondiscrimination would be appropriate to achieve capital export neutrality. This conclusion assumes, however, that the international tax system also implements all of the other features necessary to achieve capital export neutrality. The existing international tax system, in contrast, departs substantially and unsystematically from capital export neutrality, quite apart from any instances of locational discrimination. Given this second-best regime, a nondiscrimination rule that would be appropriate in an ideal international tax system will not necessarily move the existing system closer to capital export neutrality. The following discussion will,

58. A fundamental weakness of the model of international investment discussed at the beginning of this part of the Article is that it fails adequately to account for the amount of cross-hauling of international investment that occurs. Rather, the model predicts that the flow of international investment will be entirely from initially low-rate-of-return residence countries to initially high-rate-of-return host countries. A limited amount of cross-hauling might be explainable, however, in terms of the desire of host-county residents to diversify their investments or to evade host-country taxes.

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as an example, analyze this issue from the perspective of the U.S. tax system.

From the point of view of achieving capital export neutrality, one significant defect of the current international tax system is the phenomenon of deferral: the United States generally defers taxation of the income earned by foreign subsidiaries of domestic corporations until the income is repatriated.[59] As a result, a U.S. multinational has a tax incentive to invest through a foreign subsidiary in a low-tax foreign country rather than to invest at home. Until the subsidiary's earnings are repatriated to the parent corporation, they will only be subject to the low foreign taxes. Although the United States will tax the earnings when eventually repatriated, the present value of global taxes can be lowered significantly through the deferral.

A second feature of the international tax system that undermines capital export neutrality is the existence of limitations on foreign tax credits. Countries that employ the foreign tax credit system generally limit the credit.[60] The United States, for example, limits the credit to the amount of the taxpayer's before-credit U.S. tax liability that is attributable to foreign-source income.[61] As a result, a U.S. multinational in some cases has a tax incentive to invest at home rather than in a foreign country with a higher tax rate than the United States, since the high foreign taxes paid in the latter case will not be fully creditable against U.S. taxes.[62]

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59. *See supra* note 52 and accompanying text.

60. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 38.

61. I.R.C. § 904(a) (West 1992). More precisely, the limitation is equal to the taxpayer's before-credit U.S. income tax liability on worldwide taxable income multiplied by the ratio of the taxpayer's foreign-source taxable income to the taxpayer's worldwide taxable income. Foreign-source taxable income consists of foreign source gross income less expenses allocated and apportioned to foreign source gross income. *See* I.R.C. §§ 861–65 (West 1992).

The foreign tax credit limitation is calculated and applied separately with respect to several categories or "baskets" of foreign source taxable income. I.R.C. § 904(d) (West 1992). The system is designed to prevent foreign taxes paid on a category of highly taxed income (such as active business income) from being "cross-credited" against the residual U.S. tax otherwise due on a category of lightly taxed income (such as passive investment income). *See* STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 861–62 (Comm. Print 1987). A taxpayer may carry excess foreign tax credits back two years and forward five years to offset U.S. tax liability for those years, but only to the extent that there is "excess limitation" available; that is, only to the extent that foreign taxes on foreign income in those years are less than the U.S. tax. I.R.C. § 904(c) (West 1992).

Additional limitations apply to taxpayers subject to the alternative minimum tax.

62. For example, suppose the U.S. tax rate is 35% and the foreign tax rate is 40%. If a U.S. firm earns $100 from a U.S. investment, it will pay $35 in U.S. tax and $0 in foreign tax, for a global tax

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This disincentive to invest abroad is exacerbated by the existence of host-country withholding taxes on dividends. Suppose, for example, that the United States and Foreign both impose a corporate income tax at an effective rate of 35 percent and also impose a withholding tax on intercompany dividends at a rate of five percent. Also suppose that a U.S. firm without excess foreign tax credit limitation[63] makes an equity investment in a subsidiary in Foreign. Assuming that the subsidiary currently repatriates all of its profits, the effective tax rate (corporate plus withholding tax) on the equity investment in Foreign will be 38.25 percent.[64] Thus, the U.S. firm has a tax incentive to invest at home (at an effective tax rate of 35 percent) rather than abroad (at an effective tax rate of 38.25 percent), even though the corporate income tax rates in the two countries are equal

In contrast, the foreign tax credit limitation, in other circumstances, creates the opposite incentive: it inclines a U.S. multinational to invest abroad rather than at home. The United States currently computes the foreign tax credit limitation on a worldwide basis rather than on a per country basis.[65] As a result, a U.S. firm in an excess credit position[66] will

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burden of $35. If the firm earns $100 from a foreign investment (made through a foreign branch), it will pay $40 in foreign tax. It will have a before-credit U.S. tax liability of $35, all of which is attributable to foreign source income. Thus, its U.S. foreign tax credit limitation will be $35. After taking the foreign tax credit, the firm will have a U.S. tax liability of zero. Thus, the firm's global tax burden will be $40. After taxes, therefore, the U.S. investment is preferable to the foreign investment.

This analysis, as well as the statement in the text above, assumes that the U.S. firm does not have excess foreign tax credit limitation from other foreign investments in low-tax countries. *See infra* note 63.

63. A U.S. firm is said to have excess foreign tax credit limitation if its foreign tax credit limitation is greater than the total amount of foreign income taxes that it pays (e.g., because it invests only in low-tax foreign countries). In that case, if it earns additional foreign source income, any foreign taxes it pays on that income will be fully creditable against U.S. taxes, no matter how high the foreign tax rate, until the foreign tax credit limitation becomes binding.

64. If the Foreign subsidiary earns $100 in profits, the subsidiary will owe $35 in corporate income taxes to Foreign. If the subsidiary then repatriates the remaining $65 by paying a dividend to the U.S. parent corporation, the parent corporation will owe $3.25 in withholding tax to Foreign. The U.S. will not impose any residual taxation on the U.S. parent corporation, because of the direct and indirect foreign tax credits (ignoring the alternative minimum tax for simplicity). Thus, the $100 of profits in Foreign will be subject to an effective tax rate of 38.25%.

65. *See supra* note 61 and accompanying text. Under a per country method, the taxpayer calculates the foreign tax credit limitation separately for each country in which it earns income. The foreign income taken into account in each calculation is the foreign income derived from the foreign country for which the limitation is being determined. Thus, a per country limitation prevents the use of taxes imposed by one country to reduce U.S. tax on income arising elsewhere.

66. A U.S. firm is said to be in an excess credit position if the foreign income taxes that it pays exceeds its foreign tax credit limitation (e.g., because it invests only in high-tax foreign countries).

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have a tax incentive to make additional investments in a low-tax foreign country rather than at home. The income earned in the low-tax country will increase the firm's foreign tax credit limitation by more than the amount of the foreign taxes paid on that income, enabling the firm to use some of its excess credits. As a result, the income earned in the low-tax country effectively will be subject only to the low foreign taxes.[67]

In addition to these features, many countries (not including the United States) have integrated their corporate and individual tax systems in ways that create locational biases.[68] For example, many residence countries provide shareholder-level tax relief for domestic corporate income taxes but not for foreign corporate income taxes.[69] Such a system relieves double taxation of corporate income in the case of

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A firm may carry excess foreign tax credits back two years and forward five years to offset U.S. tax liability for those years, but only to the extent that there is "excess limitation" available; that is, to the extent that foreign taxes on foreign income in those years are less than the U.S. tax. I.R.C. § 904(c) (West 1992). However, if a firm is chronically in an excess credit position, it will not be able to use its excess credits. Moreover, credits carried forward lose their value, since there is no interest adjustment.

67. For example, suppose the U.S. tax rate is 35%, the tax rate in foreign country High is 40%, and the tax rate in foreign country Low is 30%. Suppose that a U.S. firm has an investment in High (made through a branch) that earns $100 before taxes. It will owe $40 in foreign taxes on this income.

If the U.S. firm earns an additional $100 from a U.S. investment, it will be liable (before credits) for $70 in U.S. tax (on $200 of worldwide income), and will be entitled to a U.S. foreign tax credit of $35 (because of the limitation). As a result, it will owe $35 in U.S. tax. Its global tax burden will therefore be $75.

If the U.S. firm earns an additional $100 from an investment in Low (made through a branch), it will owe $30 in foreign taxes on this income. It will again be liable (before credits) for $70 in U.S. tax. Now, however, it will be entitled to a U.S. foreign tax credit of $70. As a result, it will owe U.S. tax of zero. Its global tax burden will therefore be $70. After taxes, therefore, the investment in Low is preferable to the investment in the United States.

68. Under a classical corporate income tax system, such as that in the United States, corporate earnings are taxed at the corporate level when earned and again at the individual level when the corporation distributes the after-tax earnings as dividends. The corporation is not allowed a deduction for the dividends paid, and the individual shareholders are not allowed a credit for the corporate taxes paid on the underlying earnings. In an integrated income tax system, the corporate and individual income tax systems are coordinated so that corporate income is taxed only once. For a brief description of the integration systems in Australia, Canada, France, Germany, New Zealand, and the United Kingdom, see TREASURY INTEGRATION REPORT, *supra* note 46, at 159–84.

69. This is the usual practice in OECD countries. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 39. A recent Treasury Department report on integration also proposes that shareholder-level relief not be provided by statute with respect to foreign corporate income taxes. TREASURY INTEGRATION REPORT, *supra* note 46, at 16. This practice does not violate the treaty nondiscrimination rule or any other treaty constraints. *See id.* at 78.

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domestic investments, but not in the case of foreign investments, thus creating a tax incentive to invest at home rather than abroad.

The features described above create unsystematic distortions. In some circumstances, they favor investments at home; in others, they favor investments abroad. Therefore, if a residence country were to adopt additional tax provisions that discriminated against investments abroad, in violation of a locational nondiscrimination rule, these provisions would detract from capital export neutrality in some circumstances but would enhance capital export neutrality in others. Similarly, as discussed earlier, ownership discrimination by a low-tax host country in violation of the existing treaty nondiscrimination rule can move the overall tax system toward greater capital export neutrality in some circumstances.[70]

This second-best problem is further complicated by the existence of non-tax governmental distortions to the location of capital. Transnational differences in the level of public safety and public services, the legal protection of property, the stability of money, and so forth can affect the location of capital at least as much as differences in taxation.[71] To take a simple example, if a high-tax country also provides a high level of governmental services of value to businesses, then the high taxes should not necessarily be regarded as distorting the location of capital.[72]

The best solution theoretically would be to preserve an appropriate nondiscrimination rule while directly eliminating the other biases in the international tax system. This would not be feasible, however, in part because of revenue-raising and enforcement considerations. For example, if a residence country adopted an unlimited foreign tax credit system, as required for capital export neutrality, it would potentially lose tax revenues attributable to domestic-source income.[73] It is highly unlikely that any residence country would be willing to accept such a loss of tax revenue.[74] For another example, if the phenomenon of deferral were eliminated, the losses incurred by foreign subsidiaries would be available to offset domestic income. This would create severe compli-

70. *See supra* text at 127–129.

71. *See* KLAUS VOGEL, TAXATION OF CROSS-BORDER INCOME, HARMONIZATION, AND TAX NEUTRALITY UNDER EUROPEAN COMMUNITY LAW: AN INSTITUTIONAL APPROACH 25–30 (1994).

72. In general, however, there is no definite relationship between the amount of corporate income taxes that a corporation pays and the value or cost of the governmental services that the corporation receives. *See* RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 373–74 (5th ed. 1989); Charles E. McLure, Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm,* 45 NAT'L TAX J. 145, 149 (1992).

73. *See supra* note 61 and accompanying text.

74. *See* Roin, *supra* note 20, at 928–30.

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ance problems, since a residence country would find it difficult to monitor the losses of foreign subsidiaries.

B. *Capital Import Neutrality*

It is easier to rationalize the treaty nondiscrimination rule in terms of capital import neutrality, the other form of partial neutrality that is sometimes advanced as the proper goal of the international tax system. The problem with this rationalization is that capital import neutrality and capital export neutrality are mutually exclusive in the absence of international tax harmonization, and public finance experts have generally treated capital export neutrality as the preferred goal.[75]

The traditional global-efficiency argument for capital import neutrality can be explained by reference to the simple model of international investment discussed earlier.[76] That discussion showed that when capital export neutrality prevails and capital is mobile, the marginal investment in every country will earn the same *before*-tax rate of return, resulting in an efficient international allocation of world capital. Owners of capital who are residents of different countries, however, will obtain different *after*-tax rates of return on the marginal investments, depending on the tax systems in their respective residence countries. In the earlier discussion, these differences in after-tax rates of return did not create distortions because the model assumed that the amount of capital owned by residents of each country was fixed. The differences in after-tax rates of return do become distortional, however, if we relax that assumption and suppose that residents of each country can add to their capital by saving. An efficient international allocation of world saving requires that residents of each country face the same after-tax rate of return on their capital, so that the market trade-off between present consumption and future consumption is the same for every saver.

Capital import neutrality is said to prevail if domestic and foreign suppliers of capital to any national market face the same effective tax

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75. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 180 (most public finance experts tend to emphasize capital export neutrality over capital import neutrality); Frisch, *International Tax Policy*, *supra* note 8, at 582 (capital export neutrality is widely considered to be a more important objective than the competing objective of capital import neutrality). *Cf.* TREASURY INTEGRATION REPORT, *supra* note 46, at 75 (noting that economic analyses generally offer no strong endorsement of one form of capital neutrality over the other, but also noting that many economists and policymakers presume that capital export neutrality offers better guidance for international tax policy than capital import neutrality).

76. *See supra* note 47 and accompanying text.

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rate on similar investments in that market.[77] Under such a system, if capital is homogeneous and mobile, it will flow among countries until the *after*-tax rate of return to capital is equal, regardless of the country in which the supplier of capital resides (and regardless of the country in which the capital is located), thereby producing an efficient international allocation of world saving.[78] In the absence of international tax harmonization, capital import neutrality requires that residence countries exempt their residents from taxation on the income from their investments abroad, and that host countries tax the income from investments in the country equally, regardless of whether the investments are owned by domestic or foreign residents. Thus, the treaty nondiscrimination rule is consistent with capital import neutrality.[79]

The problem with this justification of the treaty nondiscrimination rule is that most analysts believe that saving decisions are relatively insensitive to the after-tax rate of return to saving, so that departures from capital import neutrality do not cause large distortions compared to the distortions caused by departures from capital export neutrality.[80] Therefore, they believe that capital import neutrality is a less worthy goal than capital export neutrality.[81]

An alternative argument for capital import neutrality appeals to the notion of competitiveness. Proponents of capital import neutrality in the United States, for example, have argued that capital import neutrality is necessary if U.S. firms are to be competitive when their foreign subsidiaries in low-tax host countries compete with foreign firms in those countries.[82] They argue that the United States should exempt

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77. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 39; COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION 17 (1992) [hereinafter RUDING COMMITTEE REPORT].

78. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 39–40 & n.26; Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q.J. ECON. 793, 796 (1980). In addition, capital import neutrality can increase the level of saving by reducing the tax burden on saving. This will enhance global economic efficiency if saving is inefficiently low. *See* TREASURY INTEGRATION REPORT, *supra* note 46, at 75.

79. *Cf.* ALVIN C. WARREN, AMERICAN LAW INSTITUTE, INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES: REPORTER'S STUDY OF CORPORATE TAX INTEGRATION 172 (1993) (noting that the treaty nondiscrimination rule helps to implement a policy of capital import neutrality) [hereinafter ALI CORPORATE TAX INTEGRATION STUDY].

80. *See* TREASURY INTEGRATION REPORT, *supra* note 45, at 75; OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 40.

81. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 40.

82. *See Hearing on H.R. 10650, 87th Cong., The Revenue Act of 1962, Public Law 87–834, Before the House Comm. on Ways & Means,* 90th Cong., 1st Sess. 464–65 (1967) (testimony of business representatives that complete elimination of deferral would place U.S. corporations operating in

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foreign-source business income from U.S. taxation, or at least should maintain the principle of deferral, so that U.S. firms operating abroad do not face a higher global tax burden than their foreign competitors. This argument has never succeeded with Congress, in part because of revenue considerations. As traditionally formulated, it does not address the treaty nondiscrimination rule, and its proponents seek to promote national interests rather than to increase global efficiency.

C. *Other Traditional Goals*

Although the primary focus of this Article is the role of the treaty nondiscrimination rule in promoting tax neutrality and therefore in promoting global economic efficiency, the nondiscrimination rule also plays a role in determining how global tax revenues are divided between the host country and the residence country. Suppose, for example, that the residence country maintains a foreign tax credit system that is sufficiently generous to enable residence-country firms to credit all income taxes paid to the host country. Under those circumstances, host-country taxation of direct investment from the residence country involves a pure shift of tax revenues from the residence country's treasury to the host country's treasury. It has no effect on investment decisions, because the residence country's firms will have no reason to alter their behavior in response to changes in the host country's taxation of them.

To further illustrate how the nondiscrimination rule might affect tax revenue division but not investment efficiency, suppose that residence-country firms are able to earn a higher after-tax rate of return on business investment in the host country than is necessary to compensate the suppliers of capital and other factors of production used in the business project. The host country could then tax the surplus, or economic profits,[83] without causing the firms to reduce their investment. This taxation would shift profits from the foreign firms (and perhaps ultimately from the residence country's treasury) to the host country's treasury, but would not affect investment decisions. In the general case, however, the treaty nondiscrimination rule affects both investment decisions and the division of tax revenues.

Another way to analyze the treaty nondiscrimination rule is to ask

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low-tax countries at a tax disadvantage relative to local corporations and corporations from countries that permitted exemption or deferral of income earned by foreign subsidiaries).

83. This is a hypothetical example, since actual corporate income taxes do not tax only economic profits.

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whether it produces an equitable division of the global tax base. This goal might be referred to as "intercountry equity." The treaty nondiscrimination rule dictates that a host country's share of tax revenues from foreign direct investment be determined by the manner in which the host country chooses to tax its own residents.

It is not clear, however, why this division of tax revenues should be considered more equitable than other possible options.[84] One possibility would be the principle of reciprocity, under which the level of host-country tax on foreign direct investment would be determined not by comparison with the level of host-country tax on host-country firms investing in the host country, but rather by comparison with the level of residence-country tax that host-country firms would bear if they invested in the residence country.[85] Tax treaties use the principle of reciprocity to constrain host-country withholding-tax rates by requiring both treaty partners to lower withholding-tax rates to the same level.[86] It seems anomalous that one principle of equity (nondiscrimination) applies to corporate income taxes, while a different principle (reciprocity) applies to withholding taxes,, considering that it is the aggregate level of the two taxes that determines the ultimate division of tax revenues between the two countries.[87]

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84. *See* Peggy B. Musgrave, *The OECD Model Tax Treaty: Problems and Prospects*, 10 COLUM. J. WORLD BUS. 29, 36 (1975) (arguing that the nondiscrimination rule is not a compelling one on inter-country equity grounds, because the tax rates chosen for internal domestic reasons are not necessarily appropriate for determining a country's share of the tax revenues from foreign investment) [hereinafter Musgrave, *The OECD Model Tax Treaty*]; *see also* MUSGRAVE, FISCAL SYSTEMS, *supra* note 57, at 248 (arguing that the nondiscrimination rule results in a reasonable division of tax revenues between the host country and the residence country, but that alternative rules might be reasonable as well). Notwithstanding this criticism, it is possible that the nondiscrimination rule serves as a natural "focal point" for agreement on the proper division of the global tax base. *Cf.* THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 67–74 (1980) (discussing the role of "focal points" in determining the outcome of bargaining).

85. *See* Hugh J. Ault, *Corporate Integration and Tax Treaties: Where Do We Go from Here?*, 4 TAX NOTES INT'L 545, 547 (1992) [hereinafter Ault, *Corporate Integration and Tax Treaties*]; Musgrave, *The OECD Model Tax Treaty*, *supra* note 84, at 36.

86. *See, e.g.*, U.S. MODEL INCOME TAX TREATY, *supra* note 15, art. 10(2) (withholding taxes on dividends).

87. The Treasury Department's recent report on corporate tax integration suggests that the treaty nondiscrimination rule can be explained as protecting the parties' bargain concerning withholding-tax rates. This report notes that treaties directly limit withholding-tax rates but generally do not directly limit host-country corporate income tax rates. Host countries therefore could alter the bargain, without increasing withholding-tax rates, by increasing the level of corporate income taxation of foreign and foreign-owned firms. The treaty nondiscrimination rule indirectly prevents this by requiring that changes in corporate income taxation burden wholly

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IV. RETHINKING THE NONDISCRIMINATION RULE AS PROMOTING THE GOAL OF OWNERSHIP NEUTRALITY

None of the traditional tax policy goals discussed in Part III provides a satisfactory justification of the treaty nondiscrimination rule. This part of the Article argues that the rule can only be adequately understood in light of a re-examination of the underlying model of foreign investment. This re-examination indicates that the case for capital export neutrality as the primary goal for the taxation of foreign direct investment is weaker than traditionally thought. It also demonstrates the importance of "ownership neutrality" for global economic efficiency. Ownership neutrality prevails if the international tax system is neutral with respect to the identity of the firm that owns and controls capital in a given country. The treaty nondiscrimination rule advances the goal of ownership neutrality.

A. *A Reappraisal of Capital Export Neutrality as the Desired Goal for the International Taxation of Foreign Direct Investment*

The traditional debate between capital export versus capital import neutrality is based on a model of foreign investment that is no longer adequate. That model does not reflect the current realities that there are efficient firms incorporated and headquartered in many countries, and that international capital flows can take place at least as efficiently through foreign portfolio investment as through foreign direct investment.[88] Foreign direct investment refers to the ownership of domestic assets by foreign residents for the purpose of controlling the use of those assets.[89] Most foreign direct investment is carried on by multinational corporations,[90] which make the direct investment through a branch or controlled[91] subsidiary in the host country. Foreign portfolio investment

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domestic firms to the same extent as foreign and foreign-owned firms. TREASURY INTEGRATION REPORT, *supra* note 46, at 77 n.12.

88. *See* Frisch, *International Tax Policy*, *supra* note 8, at 587; GARY C. HUFBAUER & JOANNA M. VAN ROOIJ, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 60 (1992).

89. *See* EDWARD M. GRAHAM & PAUL R. KRUGMAN, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES 7 (2d ed. 1991).

90. *See id.*; *see also* TREASURY INTEGRATION REPORT, *supra* note 46, at 77.

91. The definition of "control" involves arbitrary line drawing. The U.S. Department of Commerce defines a foreign investment in a U.S. firm as direct when a single investor has acquired a stake of 10 percent or more in the U.S. firm. *See* GRAHAM & KRUGMAN, *supra* note 89, at 7–9.

This is also the ownership threshold for a U.S. corporate shareholder of a foreign firm to be eligible for the "indirect" foreign tax credit. I.R.C. § 902 (West 1992). Under the indirect foreign tax credit, corporate taxpayers that receive dividends from at least 10%-owned foreign subsidiaries

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refers to the establishment of a noncontrolling claim on domestic assets by foreign residents for the purpose of realizing some return.[92] Such investment occurs, for example, if foreign residents purchase stock or bonds of domestic firms without acquiring control.[93]

In the model of foreign investment discussed earlier,[94] firms were regarded as holding fixed amounts of capital which they could directly invest either at home or abroad. If the residence country's corporate income tax system achieved capital export neutrality, resident firms would invest their capital where it earned the highest before-tax rate of return and, therefore, produced the greatest social value. The existence of efficient foreign firms and world capital markets, however, means that owners of capital can engage in foreign investment not only by investing in domestic firms that engage in foreign direct investment, but also by making portfolio investments in foreign firms. Thus, domestic and foreign firms must compete for capital on world capital markets. To obtain financing, firms must find business projects that yield an expected (risk-adjusted) rate of return, after corporate income taxes, at least as great as the return that portfolio investors can obtain from their best alternative investment. This means that a residence country's corporate income tax system affects not only the incentives its firms have to invest their capital at home versus abroad, but also the ability of its firms to attract capital in the first place. If a high-tax country adopts a corporate income tax system that achieves capital export neutrality, its firms will not have a tax incentive to make direct investments in low-tax countries. However, its firms generally will have a higher cost of

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may claim a foreign tax credit for a ratable portion of the foreign income taxes that the subsidiary paid on the income out of which the dividends are paid. In determining its U.S. taxable income, the corporate taxpayer must gross up the dividend by the amount of the indirect credits claimed. For example, suppose that a foreign subsidiary of a U.S. corporation earns $100 abroad, pays $40 in foreign corporate income taxes, and distributes $30 (half of its after-tax earnings) to the U.S. corporation as a dividend. Suppose further that, out of this $30, the foreign subsidiary withholds $1.50 of withholding taxes. The U.S. corporation will report $50 of foreign-source taxable income (the $30 dividend grossed up by the $20 of indirect credits claimed), will claim a direct foreign tax credit for the $1.50 of withholding taxes, and will claim an indirect foreign tax credit for $20 of the foreign corporate income taxes that the subsidiary paid. The amount of the allowable foreign tax credit for the year will be subject to the U.S. corporation's foreign tax credit limitation.

92. *See* GRAHAM & KRUGMAN, *supra* note 89, at 8.

93. Residence countries with exemption systems often limit the exemption to income from foreign direct investment. Residence countries with worldwide tax systems, such as the United States, generally allow foreign tax credits for foreign corporate income taxes only in the case of foreign direct investment.

94. *See supra* note 47 and accompanying text.

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capital[95] for making investments in low-tax countries than foreign firms that are not subject to high corporate income taxes on the income they earn from investments in low-tax countries. These foreign firms might be residents of low-tax countries, or they might be residents of high-tax countries that employ exemption systems of international taxation. Because of their lower cost of capital for investments in low-tax countries, these foreign firms will tend to undertake such investments even when they yield a lower expected rate of return, before corporate income taxes, than investments in other countries. Thus, some firms will still tend to inefficiently allocate capital to low-tax countries. These will be firms from low-tax or exemption countries[96] rather than firms from high-tax residence countries whose corporate income tax systems achieve capital export neutrality, and they will be able to raise the capital on world portfolio markets.

The key point is that multinational firms—that is, firms that produce in more than one country—are no longer essential for the international movement of capital, and no single residence country can ensure the efficient allocation of world capital through the design of its system for taxing multinational firms. This is a relatively recent development. Throughout much of the post-World War II period, many governments imposed legal barriers to the international movement of portfolio capital.[97] Today, however, governments have eliminated most of these barriers.[98] In the absence of these legal barriers, one would expect organized portfolio capital markets, which specialize in the transfer of capital, to be a more efficient means of transferring capital than multinational firms, which specialize in the production of goods and

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95. The term "cost of capital" here refers to the rate of return that a firm must earn, before corporate income taxes, in order to provide potential investors with a given rate of return after corporate income taxes. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 88. The cost of capital for a specific investment project depends on how the project is financed (e.g., by using debt, equity, or retained earnings) and on various features of the income tax system. *See id.* at 89–95.

96. In theory, a low-tax residence country could have a tax system that achieves capital export neutrality, but to do so it would have to grant its firms refundable foreign tax credits when they invest in high-tax countries. In practice, countries are not willing to do this. A country that maintains an exemption system cannot have a tax system that achieves capital export neutrality, because exemption systems are incompatible with capital export neutrality.

97. During this period, governments restricted foreign exchange transactions primarily to those required to finance trade or direct investment. In the 1960's, most governments began gradually liberalizing the regulation of private capital flows. Today, governments of most industrialized countries allow full convertibility for all transactions in foreign exchange. *See* BARRY P. BOSWORTH, SAVING AND INVESTMENT IN A GLOBAL ECONOMY 35 (1993).

98. *See id.*

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services. Now that multinational firms are no longer essential to the international movement of capital, capital export neutrality is no longer as compelling a goal for the taxation of foreign direct investment.

B. *The Transactional Model of Foreign Direct Investment and the Goal of Ownership Neutrality*

This leads to the question of what role multinational firms currently play in the world economy and, more basically, why they exist at all. Under the model of foreign investment discussed earlier,[99] multinational firms served as the vehicles by which capital owned by residents of low-return countries became invested in high-return countries. If this movement of capital can take place at least as efficiently through portfolio investment, however, then there must be some other reason why multinational firms come into being.

The transactional or "industrial organization" theory of foreign direct investment provides the most satisfactory answer to this question.[100] This theory begins by noting that local firms have natural advantages in their home market over foreign firms, which must operate across national and cultural boundaries, generally with inferior knowledge of local languages, business practices, consumer preferences, and government regulations. Thus, if foreign firms engage in direct investment in a host country, it must be because they possess firm-specific advantages, or "ownership" advantages, such as patents, distinct products, or unique know-how, that enable them to overcome the natural advantages of local firms.[101] However, this observation does not fully explain the existence of multinational firms. It is also necessary to explore why the foreign firm chooses to exploit its ownership advantage by engaging in direct investment in the host country, thus becoming a multinational firm, rather than by producing domestically and exporting the manufactured goods, or by selling or licensing its ownership advantage to local firms.

The first alternative—producing domestically and exporting—would be unattractive if locational considerations made it less costly or risky for the firm to produce in the country where it sells.[102] For example,

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99. *See supra* note 47 and accompanying text.

100. For a very brief discussion of this theory, see PAUL R. KRUGMAN & MAURICE OBSTFELD, INTERNATIONAL ECONOMICS: THEORY AND POLICY 159–61 (3d ed. 1994). For a more extensive discussion, see CAVES, *supra* note 47, at 1–30.

101. *See* CAVES, *supra* note 47, at 3–4.

102. *See* KRUGMAN & OBSTFELD, *supra* note 100, at 160.

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high transportation costs, or low wage rates in the market country, or trade barriers imposed by the market country, might make it less costly to produce the product in the market country than to export. The firm also might find it easier to adjust the product to accommodate local tastes if production occurs locally. In addition, the firm might be able to minimize the risk of exchange rate fluctuations if it produces locally and thus incurs production costs as well as obtains revenues in the local currency.

The second alternative—selling or licensing the ownership advantage to local firms—would be unattractive if there were some advantage to internalizing international transactions within a single firm rather than conducting transactions at arm's length in external markets. This advantage might arise from the difficulties of selling or licensing intangibles such as managerial or technical knowledge or reputation to unrelated parties.[103] In the case of a vertically integrated firm, the advantage might arise from the difficulties of negotiating and monitoring arm's length contracts for the sale of unique intermediate goods.[104]

In summary, the transactional model of foreign direct investment shows that capital in a given location might be less productive if owned and controlled by a local firm than if owned and controlled by a foreign firm that possesses a unique ownership advantage that cannot be exploited efficiently through arm's length market transactions. The international tax system would then enhance global economic welfare if it did not distort ownership of capital by the firm that could obtain the highest before-tax return from employing it. This suggests that, in designing an international tax system for taxing business enterprises, the primary goal should be ownership neutrality rather than capital export neutrality.

The case for ownership neutrality almost certainly becomes stronger still if one takes into account economies of scope and scale, and spillover benefits. Foreign direct investment often occurs in markets where there are economies of scope and scale. Under these circumstances, even if neither domestic nor foreign firms have ownership advantages over one another, it might be beneficial to have large firms that serve both markets and compete with one another.[105] To a significant extent, the benefits of large size and international competition could be achieved

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103. *See id.* at 160; CAVES, *supra* note 47, at 5–7.

104. *See id.* at 160–61; CAVES, *supra* note 47, at 16–18.

105. *See* Frisch, *International Tax Policy*, *supra* note 8, at 589.

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through free international trade,[106] without necessarily providing ownership neutrality for direct investment. The transactional model of foreign direct investment shows, however, that because of market failures, international trade is not always an adequate substitute for international direct investment.

In addition, foreign direct investment produces both spillover costs and spillover benefits. Spillover benefits might include the introduction of new technology or management methods, which local firms can copy, and the training of workers, some of whom will likely change jobs and transfer their skills to local firms.[107] On the other hand, spillover costs might result if domestic owners operate businesses in the foreign host country in ways that are systematically different from the way that local owners would have operated those businesses.[108] Spillover costs also might include "noneconomic" costs, such as threats to the host country's sovereignty,[109] cultural values,[110] or national security.[111] It is impossible to quantify these costs and benefits, but it is plausible to suppose that, at least in many cases, the benefits will outweigh the costs.

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106. *Cf.* KRUGMAN & OBSTFELD, *supra* note 100, at 161–62 (noting that much of what multinationals do could be done without multinationals, through ordinary international trade).

107. *See generally* GRAHAM & KRUGMAN, *supra* note 89, at 58–59.

108. For an assessment of this possibility in the case of foreign direct investment in the United States, see *id.* at 59–66.

109. Foreign owners of foreign-based firms are likely to try to influence the domestic political process to adopt policies that benefit them. These policies will tend to redistribute income from domestic residents to foreign residents. Although domestic owners of domestic firms also will try to influence the political process, the policies they seek will tend only to redistribute income among domestic residents. Thus, foreign influence on the political process might be a greater threat to national welfare than influence by domestic special-interest groups. For an assessment of this argument as it applies to the United States, see *id.* at 85. For popular accounts of the influence of foreign firms on the U.S. political process, see generally PAT CHOATE, AGENTS OF INFLUENCE: HOW JAPAN'S LOBBYISTS IN THE UNITED STATES MANIPULATE AMERICA'S POLITICAL AND ECONOMIC SYSTEM (1990); MARTIN TOLCHIN & SUSAN TOLCHIN, BUYING INTO AMERICA: HOW FOREIGN MONEY IS CHANGING THE FACE OF OUR NATION (1988); Stephen Engelberg & Martin Tolchin, *Foreigners Find New Ally in U.S. Industry*, N.Y. TIMES, Nov. 2, 1993, at A1, B8.

110. For a discussion of discriminatory tax rules in Canada apparently aimed at promoting Canadian culture, see ARNOLD, *supra* note 23, at 118–20.

111. *See generally* GRAHAM & KRUGMAN, *supra* note 89, at 95–118. As an example of the congressional response to this concern, section 721 of the Omnibus Trade and Competitiveness Act of 1988 gives the President limited power to block mergers, acquisitions, or takeovers of U.S. persons by foreign interests when such actions are deemed a threat to national security. For a discussion of this provision, see Vito Tanzi & Isaias Coelho, *Barriers to Foreign Investment in the U.S. and Other Nations*, 516 ANNALS AM. ACAD. POL. & SOC. SCI. 154, 154, 161–62 (1991).

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If so, this provides another reason to believe that the principle of ownership neutrality will promote global economic welfare.

C. *Second-Best Problems in Advancing Ownership Neutrality*

Ownership neutrality requires that direct investment in a host country be subject to the same effective rate of tax regardless of the identity of the firm that undertakes the investment. The treaty nondiscrimination rule is an appropriate component of a tax system that achieves this goal, since it prohibits a host country from imposing discriminatory taxes on business enterprises that are carried on, owned, or controlled by residents of another treaty country. Again, however, in analyzing the actual international tax system, it is necessary to take possible second-best problems into account. Earlier, we saw that even though an appropriate nondiscrimination rule was necessary to achieve capital export neutrality, the introduction of such a nondiscrimination rule into a system that contained other distortions would not necessarily move that system closer to capital export neutrality. This section of the Article will consider whether the same type of second-best problem arises with ownership neutrality as the goal.

Ownership neutrality requires both the residence country and the host country to adopt appropriate corporate income tax systems. The residence country must exempt its resident firms from taxation on the income attributable to their business operations abroad. In particular, if a firm operates a foreign business through a foreign subsidiary, the residence country must exempt the resident firm from taxation on dividends paid by the subsidiary. If the firm operates a foreign business through a foreign branch, the residence country must exempt the firm from taxation on the income attributable to the branch. The income attributable to the foreign business will then be taxed exclusively by the host country.

The host country, in turn, must not discriminate against foreign or foreign-owned business enterprises operating within its territory. If a nonresident firm engages in business in the host country through a subsidiary, the host country must not tax the subsidiary less favorably than it would tax a similar domestically owned firm. The host country also must not impose withholding taxes when the subsidiary pays dividends, interest, royalties, or similar payments to the parent corporation. If a nonresident firm engages in business in the host country through a branch, the host country must not tax the nonresident firm on the income of the branch less favorably than it would tax a domestic firm carrying on the same business. The host country also must not impose

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additional taxes on income attributable to the branch, such as branch profits taxes,[112] branch-level interest taxes,[113] or second-level withholding taxes on dividends paid by the nonresident firm out of the income of the branch.[114]

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112. Under U.S. law, a foreign corporation engaged in business in the United States is subject both to the regular corporate income tax on income that is effectively connected with the U.S. business, I.R.C. § 882(a), and to a "branch profits tax" equal to 30% of the foreign corporation's "dividend equivalent amount." I.R.C. § 884(a). The dividend equivalent amount is the foreign corporation's earnings and profits attributable to income that is effectively connected with the U.S. business, reduced by the increase in its "U.S. net equity" for the year. I.R.C. § 884(b). U.S. net equity is essentially the corporation's net investment in the assets used in the U.S. business. I.R.C. § 884(c). The 30% rate is often reduced by treaty. I.R.C. § 884(e)(2)(A). This branch profits tax is designed to make the U.S. tax treatment of foreign corporations doing business through a U.S. branch similar to the U.S. tax treatment of foreign corporations doing business through a U.S. subsidiary. *See* STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 1036–37 (Comm. Print 1987).

The branch profits tax conflicts with those treaty nondiscrimination articles that prohibit the United States from taxing a foreign (treaty country) corporation with a U.S. permanent establishment less favorably than it would tax a U.S. corporation carrying on the same activities. If the branch profits tax were imposed on the foreign corporation, that corporation would be subject both to the regular corporate tax and to the branch profits tax, while a U.S. corporation carrying on the same activities would be subject only to the regular corporate tax. To mitigate this conflict, the statute provides that the branch profits tax is not to be imposed when doing so would conflict with an income tax treaty, provided that the foreign corporation is a "qualified resident" of the other treaty country, as defined by the statute. I.R.C. §§ 884(e)(1), (4).

113. Under U.S. law, interest "paid by" the U.S. branch of a foreign corporation is treated as if it were paid by a domestic corporation. I.R.C. § 884(f)(1)(A). That is, it is treated as U.S. source interest income, I.R.C. § 861(a)(1), and is subject to U.S. withholding tax of 30% when received by a foreign person, unless the tax is reduced or eliminated by a specific Code or treaty provision. I.R.C. §§ 871(a), 881(a). The question of when interest should be considered to be "paid by" a branch is left to regulations. *See* Treas. Reg. § 1.884–4(b) (1993). In addition, to the extent that regulations allocate to the U.S. branch an interest deduction in excess of the interest treated as "paid by" it, the excess is treated as if it were interest paid on a notional loan to a U.S. subsidiary from its foreign corporate parent. I.R.C. § 884(f)(1)(B). Therefore, this excess is also subject to the 30% withholding tax, absent a specific Code exemption or treaty reduction.

The statute provides rules for coordinating the branch-level interest tax with income tax treaties. I.R.C. § 884(f)(3). These rules are similar to those applicable to the branch profits tax. *See supra* note 112.

114. Under U.S. law, dividends received from a foreign corporation are treated as U.S. source income if 25% or more of the foreign corporation's gross income, for the preceding three years, was effectively connected with a U.S. trade or business (e.g., a business conducted through a U.S. branch). I.R.C. § 861(a)(2)(B). The amount of the U.S. source income depends on the ratio of the effectively connected income to the total amount of income in the three-year testing period. *Id.* As U.S. source income, the dividend is subject to U.S. withholding tax, I.R.C. §§ 871(a), 881(a), which the foreign distributing corporation is required to withhold from the distribution. I.R.C. § 1442. This "second-level" withholding tax on dividends is designed to operate like the dividend withholding tax that would have applied if the foreign corporation had conducted its U.S. business through a

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The existing international tax system does not satisfy these criteria,[115] and thus would not achieve ownership neutrality even if all host countries were to adhere to the treaty nondiscrimination rule. First, many residence countries employ worldwide tax systems rather than exemption systems. Second, the treaty nondiscrimination rule does not prohibit all host-country practices that have a discriminatory effect on foreign direct investment. Third, it is difficult to determine how much of a multinational firm's income is attributable to any one branch or subsidiary when the multinational firm's international business operations are highly integrated.

Many residence countries, including the United States, maintain worldwide tax systems.[116] When residence countries tax domestic firms on their income from foreign business operations, firms from different residence countries will be subject to different effective tax rates on investment in a given host country, even if the host country itself does not discriminate in taxing those firms. Thus, it is impossible to achieve complete ownership neutrality. This result is strikingly illustrated by the argument that the Tax Reform Act of 1986 made ownership of U.S. business assets less attractive for domestic firms, but more attractive for foreign firms from countries with worldwide tax systems.[117] The Tax Reform Act of 1986 raised effective corporate income tax rates. In the long run, this should reduce capital intensity and therefore raise the before-tax rates of return on U.S. investment. For U.S. firms, the resulting after-tax returns will still be less than or equal to the corresponding returns prior to the tax change. In contrast, for foreign firms that can credit U.S. taxes against their residence-country tax liability, the resulting after-tax returns will be higher than the corresponding

separately incorporated U.S. subsidiary that repatriated its earnings by paying dividends to the foreign parent corporation.

The second-level withholding tax is difficult to administer, because it requires calculation of the corporation's worldwide income and imposes a withholding liability on foreign corporations making distributions to foreign shareholders. *See* GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 112, at 1036. In 1986, Congress enacted the "branch profits tax," which replaces the second-level withholding tax in all situations except those in which a treaty prohibits the application of the branch profits tax but permits the second-level withholding tax. I.R.C. § 884 (e)(3); *see supra* note 112.

115. In addition to the tax-related distortions to ownership neutrality discussed below, the international investment regime contains non-tax rules that distort the ownership of capital. For a description of the restrictions that various countries impose on foreign direct investment, see Tanzi & Coelho, *supra* note 111; ARNOLD, *supra* note 23, at 108–111, 174, 199–200, 223–24, 249.

116. *See supra* text accompanying notes 20–22.

117. *See* MYRON S. SCHOLES & MARK A. WOLFSON, TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 268 (1992).

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returns prior to the tax change. Thus, these foreign firms will find ownership of U.S. assets more valuable and domestic firms will find it less valuable than before the passage of the Act.

Given that worldwide tax systems are distortionary from the perspective of ownership neutrality, the first-best solution would be for countries with worldwide systems to switch to exemption systems.[118] However, this solution is not practicable. There are many reasons why residence countries maintain worldwide systems, including the desire for the additional tax revenues, the equitable view that two domestic taxpayers with equal worldwide incomes should pay the same amount of global taxes, and the view that such systems advance capital export neutrality. Particularly in light of the tax revenue considerations, it is not realistic to suppose that these countries would switch to exemption systems in order to advance the goal of ownership neutrality. Indeed, it is likely that these countries already have resisted domestic political pressure to switch to exemption systems, since worldwide tax systems generally place domestic firms at a disadvantage when they engage in foreign business operations, relative to foreign firms.[119] The best that can be hoped for is that tax rates in different countries will tend to converge, reducing the distortionary effects of worldwide tax systems.[120]

Given that some residence countries maintain worldwide corporate income tax systems, which are incompatible with ownership neutrality, the next question is whether the treaty nondiscrimination rule will necessarily move the overall system closer to ownership neutrality. There are two reasons to think that it will. First, in practice, worldwide tax systems often function very much like exemption systems. Because

118. This would be the best solution from the point of view of achieving ownership neutrality. The elimination of worldwide tax systems might have other adverse consequences, however. In particular, it might make it more difficult for all countries to maintain non-zero levels of capital income taxation in the face of international capital mobility. *See* Roger H. Gordon, *Can Capital Income Taxes Survive in Open Economies?*, 47 J. FIN. 1159, 1159 (1992) (arguing that the United States' dominance as a capital exporting country during much of the post-World War II period and its maintenance of a worldwide system of income taxation might have contributed to the survival of a non-zero equilibrium level of capital income taxes during this period, in spite of the openness of national economies).

119. An exception can occur if the residence country calculates the foreign tax credit limitation on a worldwide basis rather than on a per-country basis. *See supra* notes 61 & 65. For example, if a U.S. firm with existing investments in low-tax foreign countries makes an additional investment in a high-tax foreign country, the income from that latter investment effectively might be subject only to the lower U.S. taxes, because all of the taxes paid to the high-tax country might be eligible for the U.S. foreign tax credit.

120. *See* Frisch, *International Tax Policy*, *supra* note 8, at 590.

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of the phenomenon of deferral[121] and the effects of limitations on foreign tax credits,[122] the income earned by foreign subsidiaries and branches of firms that are residents of countries with worldwide tax systems is, in many cases, effectively taxed only by the host country. Second, to the extent that such income is effectively taxed by the residence country as well as by the host country, the additional taxation puts residence-country firms at a disadvantage relative to host-country firms when they engage in business operations in the host country.[123] Host-country discrimination against such residence-country firms would generally add to the distortionary effects of the worldwide systems. Therefore, host-country adherence to the treaty nondiscrimination rule would tend to move the overall system in the direction of greater ownership neutrality.

The second reason that the current international tax system does not achieve ownership neutrality is that the treaty nondiscrimination rule does not prohibit host countries from engaging in all practices that have a discriminatory effect on foreign direct investment. Although the rule prohibits host countries from discriminating against business enterprises that are carried on, owned, or controlled by foreign residents, it does not prohibit host countries from discriminating against the nonresident owners themselves. In particular, the rule does not prohibit host countries from imposing withholding taxes on dividends, interest, royalties, and similar payments that domestic subsidiaries pay to foreign parent corporations.[124] When these withholding taxes are taken into account, a host country that applies its corporate income tax in a nondiscriminatory manner to domestic subsidiaries of foreign corporations will end up discriminating against those foreign firms.[125] The treaty nondiscrimination rule also does not prohibit host countries from imposing second-level withholding taxes on dividends paid by foreign corporations with domestic branches.[126] When these withholding taxes

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121. *See supra* note 52 and accompanying text.

122. *See supra* notes 60–61 and accompanying text.

123. *See supra* note 119.

124. *See supra* note 33 and accompanying text.

125. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 37; Peter R. Merrill et al., *Tax Treaties in a Global Economy: The Case for Zero Withholding on Direct Dividends*, 5 TAX NOTES INT'L 1387, 1389 (1992). The European Community Council of Ministers adopted the "Parent—Subsidiary Directive," which requires elimination of withholding taxes on nonportfolio dividends between member countries generally effective January 1, 1992. Council Directive 90/435, 1990 O.J. (L 225) 6.

126. *See supra* note 114. The comprehensive treaty nondiscrimination rule considered in this Article does, however, prohibit host countries from imposing branch profits taxes, in addition to the

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are taken into account, a host country that applies its corporate income tax in a nondiscriminatory manner to foreign corporations with domestic branches will end up discriminating against those foreign corporations.

In addition, many countries have integrated their corporate and individual income tax systems,[127] and countries generally do not extend the benefits of integration to foreign shareholders.[128] Suppose, for example, that a host country has adopted an integrated tax system using the imputation method. Under this method, a shareholder who receives a dividend from a corporation must "gross up" the dividend by the amount of corporate income tax attributable to the earnings out of which the dividend is paid, include the grossed-up dividend in income, and claim an "imputation credit" for the attributed corporate income tax. If a corporation distributes its after-tax earnings currently, this system has the effect of eliminating the corporate income tax and taxing the shareholders as if they had directly earned the before-tax earnings out of which the dividends are paid. If a country applies this method to domestic shareholders but does not extend it to foreign shareholders, it will mitigate the effect of the corporate tax for domestically owned corporations but not for foreign-owned corporations. This puts foreign-owned corporations at a disadvantage relative to domestically owned corporations. Such integration methods do not violate the treaty nondiscrimination rule, however, because the discrimination formally applies to the nonresident shareholders rather than to the business enterprise.[129]

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regular corporate income tax, on the domestic branches of foreign firms. The U.S. branch profits tax overrides the treaty nondiscrimination rule when applied to a foreign firm that is a "resident" of a treaty partner, as defined in the treaty, but is not a "qualified resident" of the treaty partner, as defined by statute. *See supra* note 112.

127. *See supra* note 68.

128. *See* TREASURY INTEGRATION REPORT, *supra* note 46, at 79 & n.20; OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 37, 39; Ault, *Corporate Integration and Tax Treaties*, *supra* note 84, at 545. Historically, the United States has protested the failure of other countries to extend the benefits of their integration systems to U.S. shareholders. *See* TREASURY INTEGRATION REPORT, *supra* note 46, at 79 n.22; Ault, *Corporate Integration and Tax Treaties*, *supra* note 85, at 545–46; Hugh J. Ault, *International Issues in Corporate Tax Integration*, 10 LAW & POL'Y INT'L BUS. 461, 486 n.96 (1978). The recent Treasury integration report, however, recommends that the United States also not extend integration benefits by statute to foreign shareholders. TREASURY INTEGRATION REPORT, *supra* note 46, at 16.

129. It does not violate the nationality clause to tax nonresident shareholders less favorably than resident shareholders, because the discrimination is based on residence rather than on nationality, even if the nonresident shareholders are foreign nationals and the resident shareholders are domestic nationals. *See supra* note 33. One could argue that the shareholder credit system is

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The best solution would be to eliminate these distortionary practices directly, perhaps by extending the nondiscrimination rule to prohibit them. Again, this solution would not be practicable. Eliminating withholding taxes would alter the division of the global tax base between residence and host countries in a way that would favor those that are primarily residence countries. Some countries perceive themselves as being primarily host countries, with relatively minor residence-country interests.[130] It is unlikely that these countries would agree to an extension of the treaty nondiscrimination rule without receiving some compensating treaty concessions. Thus, complicated negotiations probably would be required to deal with this issue. Similarly, extensions of the benefits of integration systems to foreign shareholders potentially would upset the balance of interests currently reflected in tax treaties, again requiring negotiations to resolve the conflicts.[131] Moreover, because the integration methods adopted by different countries differ widely, a simple reciprocal extension of integration benefits to foreign shareholders would be perceived as inequitable.

Given the existence of discriminatory withholding taxes and integration systems, the next question is whether the treaty nondiscrimination rule necessarily moves the overall international tax system in the direction of greater ownership neutrality. As in the case of worldwide tax systems, these features put residence-country firms at a disadvantage relative to host-country firms when the former engage in business operations in the host country. Thus, the treaty nondiscrimination rule tends to counteract the distortionary effect of these features. Consequently, it tends to advance the goal of ownership neutrality.

The third reason that the current international tax system does not achieve ownership neutrality is that it is difficult to allocate the income from international business operations among the source countries in any principled manner.[132] This problem is particularly acute in the case of permanent establishments.[133] The allocation of income to a permanent establishment is based on the legal fiction that the permanent

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economically equivalent to a lower tax on corporate earnings, and therefore violates the ownership clause. Since the credit is formally given to the shareholders, however, this argument has not prevailed. For a discussion of the application of the treaty nondiscrimination rule to integrated tax systems, see TREASURY INTEGRATION REPORT, *supra* note 46, at 79 & n.22; Goldberg & Glicklich, *supra* note 3, at 100.

130. *See* Roin, *supra* note 20, at 961.

131. *See* TREASURY INTEGRATION REPORT, *supra* note 46, at 80; *see generally* Ault, *Corporate Integration and Tax Treaties*, *supra* note 85.

132. *See* OECD, TAXING PROFITS IN A GLOBAL ECONOMY, *supra* note 11, at 36.

133. *See* OECD COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND

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establishment is an independent enterprise that deals at arm's length with the "general" enterprise of which it is a part. In reality, however, the operations of a permanent establishment are likely to be highly integrated with the operations of the rest of the general enterprise. The same difficulty arises in allocating income between a parent corporation and foreign subsidiary when there are intercompany transactions, particularly if these transactions involve unique intangible property or intermediate goods that are not traded in any arm's length transactions.

This problem is not usually thought of in terms of the treaty nondiscrimination rule, since most treaties contain provisions specifically dealing with income allocation.[134] Nevertheless, even if a country nominally taxes the income of business enterprises operating within its territory identically regardless of the residence of the owners, it will discriminate against foreign multinational enterprises if it over-allocates income to their local operations. Moreover, a country could target specific firms and industries for discriminatory treatment through selective enforcement of its income allocation rules. On the other hand, a country that under-allocated income to the local operations of foreign multinationals, perhaps because of difficulties in enforcing its income allocation rules against those multinationals, would end up favoring foreign and foreign-owned firms over domestic firms. To some extent, Congress's reduced commitment to the nondiscrimination rule appears to be due to its view that such a bias in favor of foreign and foreign-owned firms does exist,[135] and that some discrimination is permissible in order to offset it.[136]

It is extraordinarily difficult to eliminate these distortions, since the arm's-length standard cannot be unambiguously applied to transactions that never occur at arm's length. Unlike the distortions discussed earlier, these distortions do not necessarily place foreign firms at a disadvantage relative to host-country firms when the former engage in business operations in the host country. Therefore, there is no assurance that host-country adherence to the nondiscrimination rule will always

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CAPITAL, COMMENTARY ON ARTICLE 24 CONCERNING NON-DISCRIMINATION ¶ 23 (1994); VAN RAAD, *supra* note 23, at 145.

134. *See, e.g.*, U.S. MODEL INCOME TAX TREATY, *supra* note 15, arts. 7(2) ("arm's length" standard for permanent establishments), 9(1) ("arm's length" standard for associated enterprises).

135. *See supra* note 2.

136. For example, the recent congressional proposal to impose a minimum tax on certain foreign and foreign-owned corporations that do not enter into advance pricing agreements with the Service was widely criticized as violating the nondiscrimination rule. Foreign Income Tax Rationalization and Simplification Act of 1992, H.R. 5270, 102d Cong., 2d Sess. § 304 (1992); *see supra* note 4.

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move the overall international tax system closer to ownership neutrality. In practice, however, a host country that would violate the treaty nondiscrimination rule would also be likely to use its income allocation rules in a way that discriminates against foreign and foreign-owned business enterprises. Thus, the treaty nondiscrimination rule probably tends to reduce overall discrimination against such enterprises, rather than to prevent discrimination that would offset distortions caused by income allocation practices.

V. THE NONDISCRIMINATION RULE IN CONFLICT WITH NATIONAL TAX POLICY MAKING

This Article has argued that the treaty nondiscrimination rule increases global economic efficiency by promoting ownership neutrality. Does this mean that national policymakers should or will support the nondiscrimination rule more vigorously?

An initial response to this question might be that such support is uncertain, because national policymakers are likely to pursue national interests, which are not necessarily congruent with global interests. This response, however, overlooks the possibility of bargaining. Each country ought to be able to increase its national economic welfare by agreeing to international rules that increase global efficiency, as long as there is some mechanism by which the winners can compensate the possible losers. This conclusion follows because the gains to the countries that benefit from a globally efficient rule must exceed the losses to any countries that are harmed; otherwise, the rule would not be efficient. Winners might be able to compensate losers through other concessions in the tax treaty containing the nondiscrimination article, or by linking the tax treaty with other promises or agreements.

Notwithstanding this analysis, there are reasons why national governments might fail to reach efficient agreements, or why they might later breach such agreements if they are made initially. Focusing on the treaty nondiscrimination rule, one reason for Congress's breaches of this rule might be that changing circumstances, or changing assessments of ongoing circumstances, have caused Congress to conclude that the country's tax treaty bargains no longer further the national interest. A second reason might be that public choice problems cause members of Congress to act in ways that do not increase national economic welfare.[137] Part V.A will examine these possibilities. Part V.B will then

137. This Part of the Article discusses situations in which a government might want to engage in actions that would clearly violate the treaty nondiscrimination rule. Of course, as noted earlier,

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argue that the treaty nondiscrimination rule has a beneficial restraining effect on Congress.

A. *Reasons for Tax Discrimination*

Consider the case of a country without a treaty or other legal constraints on its international tax system. One would not necessarily expect the government of that country to refrain from tax discrimination merely because doing so would increase global efficiency. Instead, it is likely that the country's politicians will make a more parochial calculation of the benefits and costs of discrimination.

Suppose, as an initial assumption, that those politicians seek to maximize national economic welfare. Leaving aside the possibility of intercountry bargains with side payments, it is possible that discriminatory taxation of foreign firms can advance this goal. The extent to which this is so depends largely on how responsive foreign firms and foreign governments are to the host country's tax system.

If foreign firms do not change their investment decisions in response to changes in the host country's tax system, then increased host-country taxation of foreign firms will merely transfer income from those firms (or from the residence country's treasury) to the host country's treasury. For example, if the residence country maintains a generous foreign tax credit system, increased host-country taxation of foreign firms will transfer income from the residence country's treasury to the host country's treasury. Under these circumstances, the host country should impose confiscatory taxes on foreign firms or, more realistically, should impose the highest taxes that the residence country is willing to credit. At the other extreme, if foreign direct investment is perfectly elastic with respect to the return on that investment after host-country taxes, then any increase in the host-country's effective rate of taxing foreign firms will cause a reduction in foreign direct investment until the before-tax return on the remaining investment is sufficiently high to compensate for the higher tax. In that case, the burden of the host-country tax will not be borne by the foreign firms, but by consumers or owners of immobile factors of production in the host country, such as labor and land owners. It would be less distortionary for the host country to tax those persons directly. Thus, the optimal rate of taxation of

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treaty nondiscrimination articles contain ambiguous phrases and should be interpreted flexibly. *See supra* notes 35–40 and accompanying text. Not all differential treatment of foreign firms will violate the nondiscrimination rule. Moreover, a government sometimes might choose to take actions whose consistency with the nondiscrimination rule is debatable, when the government has concluded that those actions would not violate the rule.

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foreign firms depends on the responsiveness of those firms to taxation, and might be either higher or lower than the rate of taxation chosen for domestic firms.[138]

Foreign governments also might respond to changes in the host country's tax system. In particular, if the host country discriminates against foreign firms, a residence country might retaliate by imposing taxes that discriminate against those of the host country.[139] The efficacy of such retaliation will depend on the level of foreign direct investment from the host country to the residence country, and on how responsive the host country's firms are to increased taxation by the residence country.

These observations shed some light on the widely held perception of the decline in recent years in the U.S. government's commitment to the nondiscrimination rule. Until the late 1970's, the United States was overwhelmingly a residence country. The amount of inward foreign direct investment was not significant compared to the amount of outward foreign direct investment. Thus, the United States had virtually nothing to lose and everything to gain from reciprocal nondiscrimination commitments. Since then, however, there have been several surges of foreign direct investment into the United States, particularly from 1978 to 1981 and from 1986 to 1990.[140] As a result, the United States now has a much greater incentive than previously to use taxation to shift income from foreign firms (or foreign treasuries) to the U.S. treasury. There is more money to be shifted, and the more even balance between inward and outward foreign direct investment makes it more likely that the United States will come out ahead even if foreign governments retaliate.[141]

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138. Unlike the taxation of foreign firms, the taxation of domestic firms does not increase national income. It merely shifts control of that income from the private sector to the public sector, with some "deadweight loss."

139. U.S. law explicitly provides for retaliatory tax discrimination. *See* I.R.C. § 891 (authorizing the President to double the taxes imposed on citizens or corporations of a foreign country if that country discriminates against U.S. citizens or corporations); *see also* I.R.C. § 896(b) (providing for adjustment of taxes on nationals, residents, or corporations of a foreign country that discriminates against U.S. citizens or corporations, following presidential proclamation).

140. For a brief discussion of the rise in foreign direct investment in the United States, examining several alternative measures of foreign direct investment, see GRAHAM & KRUGMAN, *supra* note 89, at 11–23. *See also* KRUGMAN & OBSTFELD, *supra* note 100, at 163–64 (focusing on balance of payments as a fraction of national income).

141. The United States is still predominantly a residence country for foreign direct investment, however. At the end of 1990, private U.S. investors owned direct investments abroad with a market value of $714 billion, while private foreign investors owned $530 billion in direct investment in the United States. U.S. investors received a total of $54.4 billion of income from their direct

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Moreover, because of changes in the tax laws, the United States now has less reason to be concerned about foreign discrimination against U.S. firms. As long as the United States maintained a generous foreign tax credit system, foreign countries that were hosts to direct investment from the United States had a strong incentive to impose high taxes against U.S. firms.[142] However, several changes in U.S. and foreign tax laws in the 1980's reduced this incentive. First, Congress lowered corporate income tax rates to a level below that of many foreign countries.[143] Second, Congress restricted the foreign tax credit mechanism.[144] In particular, Congress increased the extent to which firms must characterize their income as domestic source rather than foreign source,[145] which has the effect of reducing firms' foreign tax credit limitations.[146] In addition, Congress required firms to compute and apply the foreign tax credit limitation separately for an increased number of categories, or "baskets," of income.[147] The result of these changes in rates and foreign tax credit calculations is that many U.S. multinationals are now in an excess credit position.[148] Therefore, if foreign countries increase their effective rate of taxation of U.S. multinationals, it is likely that the additional taxes will be borne by the multinationals rather than shifted to the U.S. treasury. These changes significantly reduce the incentive that foreign countries have to impose such tax increases. As a result, the United States has less need to insist upon the nondiscrimination rule in order to protect its treasury from discriminatory foreign taxation.

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investments abroad in 1990, while foreign investors received $1.8 billion from their direct investments in the United States in 1990. TREASURY INTEGRATION REPORT, *supra* note 46, at 73.

142. *See* Robin Boadway, *Corporate Tax Harmonisation: Lessons from Canada*, *in* BEYOND 1992: A EUROPEAN TAX SYSTEM 52, 54 (Malcolm Gammie & Bill Robinson eds., 1989) (noting that as long as the United States allows a foreign tax credit on corporate taxes paid by subsidiaries abroad, "Canada would be foolish not to tax these firms on an origin basis and up to the limit of the allowable credit").

143. *See* TREASURY INTEGRATION REPORT, *supra* note 46, at 78 (noting that tax rates in many foreign jurisdictions are higher than current U.S. tax rates); Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, *in* TAXATION IN THE GLOBAL ECONOMY 11, 16 (Assaf Razin & Joel Slemrod eds., 1990).

144. *See, e.g.*, Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 1211 (source of gross income from sales of personal property), 1215 (allocation and apportionment of interest expense), 100 Stat. 2085, 2533-36, 2544-49.

145. *Id.*

146. *See supra* note 61.

147. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1201, 100 Stat. 2085, 2520-28 (separate foreign tax credit limitation baskets). For a discussion of the concept of foreign tax credit "baskets," see *supra* note 61.

148. *See supra* note 66; Ault & Bradford, *supra* note 143, at 16.

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The above discussion indicates that politicians who seek to maximize national economic welfare might find tax discrimination attractive, at least if they are unable reach agreements with other countries under which the global efficiency gains from nondiscrimination can be shared. The political attractiveness of tax discrimination might be much greater than this analysis suggests, however, if public choice problems cause politicians to adopt goals that diverge from maximization of national economic welfare.

First, the attractiveness of tax discrimination will increase as a government increasingly discounts future income and costs. The responses of foreign governments and foreign firms to discriminatory taxation are likely to take place over a substantial period of time. It is unlikely that foreign governments will retaliate against discriminatory taxation without extensive deliberations and attempts to resolve the situation through diplomacy. Moreover, foreign firms generally cannot respond immediately to tax changes. Existing investment projects are often immobile for the duration of their useful life, and new investment projects generally require substantial advance planning. Thus, the initial effect of discriminatory taxation will almost certainly be to increase tax revenues, at little cost to domestic firms or to global economic efficiency from retaliation or reduced foreign direct investment, respectively. Over time, however, as foreign governments retaliate and foreign firms reduce their investment in the host country, the host country will incur costs. Even though the discrimination might be detrimental to the national welfare in the long run, a government might find discrimination an attractive strategy if it discounts future costs at a sufficiently high rate.

In the case of the United States, it is possible that members of Congress discount future costs at a higher rate now than formerly, because of increased difficulties in meeting current revenue targets. Until approximately the 1980's, Congress could raise additional tax revenue without explicitly raising taxes by relying on rapid economic growth and "bracket creep" in the individual income tax.[149] Beginning in the 1980's, however, these two sources of easy additional revenue dried up; economic growth slowed down; and Congress eliminated bracket creep through the indexing of tax brackets and other monetary figures in the Internal Revenue Code.[150] Furthermore, the enormous

149. *See* Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25, 34–37 (1989); C. Eugene Steuerle, *Effects of the Budget Process on Tax Legislation*, 10 AM. J. TAX POL'Y 141, 142–43 (1992).

150. *See* McLure, *supra* note 149, at 34–37; Steuerle, *supra* note 149, at 143–45.

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federal budget deficits of the 1980's now make it difficult to finance additional spending programs by incurring even greater budget deficits. The Gramm-Rudman-Hollings Act, for example, required Congress to reduce deficits each year.[151] The difficulties of meeting current revenue targets tend to make members of Congress extremely concerned with the short-term revenue effects of tax policies, to the neglect of long-term effects.[152] As a corollary, these difficulties tend to make members of Congress more receptive to enacting discriminatory tax provisions.

Moreover, because of tight budget constraints, increased benefits for one group must be matched by either decreased benefits or increased costs to another group.[153] The political cost of having identifiable losers gives politicians a strong incentive to find ways to finance government spending that hide the true costs to voters. Imposing discriminatory taxes on foreign firms can accomplish this objective.[154] In general, the benefits from discriminatory taxation of foreign firms are much more visible than the costs. The higher tax revenues from the foreign direct investment that remains in the country are easily measured. Although these tax revenues come at the expense of the foreign firms (or at the expense of foreign treasuries), this cost to foreign interests does not enter into the assumed domestic political calculus, because the affected foreign interests do not vote.[155] The costs of tax discrimination include the foregone tax revenues from foreign firms that curtail or terminate their domestic operations, and the foregone efficiency gains and spill-over benefits from those operations. Foreign retaliation, if it occurs, will impose costs on domestic firms with foreign operations. These costs tend to be invisible and impossible to quantify. Politicians therefore might have an incentive to impose discriminatory taxes on foreign direct investment, not because such taxes maximize national income, but because they enable the politicians to claim that they are financing government spending by taxing foreigners at a low cost to domestic residents.

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151. Balanced Budget and Emergency Deficit Control Act of 1985, Pub. L. No. 99–177, 99 Stat. 1037 (1985).

152. McLure, *supra* note 149, at 40.

153. *See* Steuerle, *supra* note 149, at 154 (noting that the elimination of traditional sources of funds for expenditure programs makes it harder to enact legislation in which the losers remain unidentified).

154. For a discussion of this point in the context of discriminatory state taxation in the United States, see Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895, 956 (1992).

155. This analysis is not necessarily consistent with an interest-group approach, however. As noted below, foreign interests can act as a powerful interest group. *See infra* note 161.

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One alternative to the assumption that politicians seek to maximize national income is that they seek to redistribute national income to interest groups. The effects of inward foreign direct investment on the distribution of income in the host country are complicated and imperfectly understood.[156] In the simple model of foreign investment described in Part III.A, inward foreign investment benefits domestic labor and hurts domestic owners of capital.[157] This model becomes much more complicated, however, if some of the assumptions are relaxed. For example, if there is trade in commodities between Home and Foreign, the movement of capital from Home to Foreign generally will affect this trade. This in turn will have further effects on the distribution of income in Foreign (and in Home).[158] Similarly, if the rates of saving in Home and Foreign depend on the rates of return on saving, the movement of capital from Home to Foreign will affect the level of saving in the two countries, which also will affect the distribution of income in the two countries.[159]

In addition, the host country government is likely to react to inward foreign direct investment in ways that have further repercussions for the distribution of income. Suppose, for example, that there were a surge of inward foreign direct investment into the United States, and that the foreign production increased total U.S. production (perhaps by substituting for imports) rather than merely substituting for production by U.S. firms. The initial result might be a decrease in total U.S. unemployment. If the Federal Reserve responded by tightening monetary policy to control inflation, the job gains from the foreign direct investment would be offset by job losses elsewhere as the economy slowed. Thus, the foreign direct investment would increase employment in the industries and regions of the country where that investment occurred, and decrease employment in other industries and regions of the country.[160]

The purpose of this discussion is not to reach definitive conclusions about the effect of foreign direct investment on the distribution of income, but simply to note that such investment is likely to have complex effects on the distribution of income between capital and labor, and among different industries and regions of the country. As a result,

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156. *See* CAVES, *supra* note 47, at 137 (noting that the issue of the long-run distributional consequences of foreign investment is unsettled); Edward M. Graham, *Government Policies Towards Inward Foreign Direct Investment: Effects on Producers and Consumers, in* MULTINATIONAL ENTERPRISES IN THE WORLD ECONOMY 176, 192–93 (Peter J. Buckley & Mark Casson eds., 1992).

157. *See supra* note 49.

158. *See generally* CAVES, *supra* note 47, at 132–47.

159. *See id.*

160. *See* GRAHAM & KRUGMAN, *supra* note 89, at 61–62.

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groups in the host country that oppose these effects will want to restrict the flow of foreign direct investment, and might seek to influence politicians to impose discriminatory taxes as a means of achieving that objective.

On the other hand, groups in the host country that benefit from the effects of foreign direct investment will tend to oppose tax discrimination. However, collective action problems might prevent them from combatting it effectively.[161] In particular, the injury might be spread over a large number of people, none of whom individually would have enough at stake to justify taking political action. In addition, the injury in many cases would be too indirect to stimulate a response. For example, consumers might be injured because tax discrimination deters foreign firms from entering domestic markets and thus reduces the competitiveness of those markets. The resulting injury to consumers from higher prices and reduced quality and variety would likely be small, and its connection to restricted foreign direct investment would be difficult to understand. Similarly, domestic firms with foreign branches or subsidiaries might be injured if enough instances of tax discrimination occurred to trigger foreign retaliation, but no isolated instance of tax discrimination would be likely to pose a significant threat.[162]

In the case of the United States, one can speculate that national interests that believe that they would lose from discriminatory taxation—particularly organized labor[163]—have been declining in political power

161. *Cf.* Shaviro, *supra* note 154, at 931 (discussing an analogous situation in state taxation in the United States).

162. One counterweight to these public-choice problems is that foreign firms themselves can act as an interest group that opposes tax discrimination. *Cf.* Shaviro, *supra* note 154, at 931 (discussing an analogous situation in state taxation in the United States). Like any other interest group, they can use their money to buy influence. For a list of amounts of money spent by foreign interests from 30 countries on U.S. lobbyists in 1992, see Stephen Engelberg & Martin Tolchin, *Foreigners Find New Ally in U.S. Industry*, N.Y. TIMES, Nov. 2, 1993, at A1, B8. Japanese interests lead the list, having spent over $60 million on U.S. lobbyists in 1992. *Id.* In addition to the possibility that these lobbying efforts directly influence policymakers, the expenditures might have indirect payoffs as well. For example, if the highly paid lawyers and lobbyists later become senior government officials, their experiences in their previous roles might make them more sympathetic to the foreign interests. In addition, current government officials might ponder the effects of their actions in office on their future prospects of employment as lobbyists representing foreign interests. *Id.* Foreign firms also can try to enlist U.S. interest groups with common interests to lobby on their behalf. *See id.*

163. *See* Tanzi & Coelho, *supra* note 111, at 154, 159 (noting that while organized labor tends to welcome foreign direct investment, which it sees as increasing job opportunities, some segments of the entrepreneurial sector worry about the effect of foreign investment on the prices of capital goods and about the added competition).

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relative to interests that believe that they would gain, such as firms in industries subject to foreign competition.[164] This theory serves as further explanation for the reduction in the United States' commitment to the nondiscrimination rule.

B. *The Restraining Role of the Nondiscrimination Rule*

The above discussion indicates that national governments sometimes might choose to engage in tax discrimination, even though it would be detrimental to both global economic welfare and national economic welfare. A government would be particularly likely to choose to engage in tax discrimination if it believed that other governments' tax policies were fixed.[165] However, if the government is able to coordinate its tax strategy with the strategies of other countries by entering into reciprocal nondiscrimination agreements (which might also involve other concessions), it would be much more likely to refrain from tax discrimination. In part, this is because the first government would secure the benefits from the other governments' reciprocal commitments not to discriminate, producing greater national gains than would result from unilateral nondiscrimination. In addition, the very act of framing the issue of tax nondiscrimination as one of reciprocal agreement on general policy can help overcome some of the public choice problems described above.

By framing the issue as one of reciprocal agreement on general policy, domestic interests that would gain from nondiscriminatory tax regimes in foreign countries become political counterweights to domestic interests that would gain from discriminatory tax regimes in the home country.[166] The former interest groups would be relatively unlikely to mount organized opposition to specific instances of tax discrimination by the home country, because the linkage between home-country discrimi-

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164. For a discussion of union decline in the United States generally, see Katherine Van Wezel Stone, *The Legacy of Industrial Pluralism: The Tension Between Individual Employment Rights and the New Deal Collective Bargaining System*, 59 U. CHI. L. REV. 575, 578–84 (1992). For a discussion of the limited political power of organized labor, see Katherine Van Wezel Stone, *Policing Employment Contracts Within the Nexus-of-Contracts Firm*, 43 U. TORONTO L.J. 353, 377 (1993) (discussing the inability of organized labor to obtain congressional enactment of labor law reforms).

165. If each government believes that the other government's tax policies are fixed, the situation could be a classic "prisoner's dilemma." That is, each country might rationally conclude that its optimal strategy is to discriminate, regardless of what the other country does. Yet both countries might be better off if neither discriminates.

166. This is analogous to the argument that international trade agreements mobilize political support for free trade. *See* KRUGMAN & OBSTFELD, *supra* note 100, at 239–40; JADGISH BHAGWATI, THE WORLD TRADING SYSTEM AT RISK 50–51 (1991).

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nation and foreign discrimination would be uncertain and the amount at stake might be relatively small. Furthermore, by framing the issue as one of reciprocal agreement, it becomes difficult for the latter interest groups to defend their position on grounds of fairness. Finally, when the issue is framed in terms of general policy rather than in terms of specific discriminatory tax proposals, attention is more likely to be drawn away from narrow revenue consequences and toward the broader implications of foreign direct investment for domestic welfare. The likelihood of fiscal illusion is thus reduced.

When two countries enter into a reciprocal nondiscrimination agreement, it is possible that one of them will subsequently want to depart from the agreement because of changing circumstances or changing assessments of continuing circumstances. The point of the agreement, however, is to prevent such defections; it is in interest of each country, ex ante, to have the agreement binding in the future.[167] The obvious difficulty is that there is no international authority that can enforce the treaty. To a significant extent, however, such a treaty is likely to be self-enforcing. First, just as reciprocity of agreement makes national commitment to a policy of tax nondiscrimination more politically attractive, it makes breaches of that commitment more politically costly. Second, incorporation of the reciprocal agreement in a treaty imposes automatic, additional costs on countries that discriminate. It accomplishes this in two ways: By increasing the reputational cost of tax discrimination and by increasing the likelihood that other governments will retaliate against instances of tax discrimination. A country has a strong interest in maintaining a reputation of adherence to its treaty commitments. If a country agrees to a treaty nondiscrimination rule and then discriminates, it will damage this reputation, and impair its ability to negotiate treaties in the future. This action also will tend to erode global respect for international agreements, to the likely future detri-

167. Because reciprocal nondiscrimination is globally efficient, a breach of reciprocal nondiscrimination will cost the victim more than it benefits the perpetrator. Thus, even if each country is equally likely to want to discriminate in the future, each country might be better off ex ante if there is a mutual commitment not to do so. Moreover, it is plausible that each government will believe that it is less likely to want to discriminate in the future than the other government or a successor government in the other country. A government might not consider it a cost that a binding commitment constrains its own successors. Indeed, a government might consider this a benefit, because it means that a policy that it favors will be perpetuated, and also that a potential rival cannot easily obtain votes by promising to reverse course and start discriminating. On the other hand, a government will consider it very much a benefit that a binding commitment constrains the other government's successors. Indeed, each government is likely to be particularly concerned about policy reversals when the other government changes hands.

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ment of the breaching country. In addition, the other treaty partner has an interest in maintaining its reputation for enforcing its treaties by retaliating against treaty violations, because such a reputation will tend to deter other countries from committing violations.[168]

This analysis indicates that, under a broad view of the national interest, adherence to treaty nondiscrimination rules is likely to be beneficial when those rules conflict with the desires of national policymakers to adopt discriminatory tax measures. The political desire to engage in tax discrimination might reflect excessive discounting of future costs, attempts to achieve fiscal illusion, or attempts to benefit narrow interest groups. The nondiscrimination rule beneficially restrains policymakers from adopting such measures. On the other hand, it is conceivable that, because of changed circumstances, some discriminatory tax measures would be in the national interest if it were not for the existence of treaty nondiscrimination rules. Even in these cases, however, adherence to the nondiscrimination rules is desirable in order to preserve the country's ability to enter into future self-enforcing international agreements that are beneficial *ex ante*, including future tax treaties with nondiscrimination articles.

VI. CONCLUSION

The treaty nondiscrimination rule is difficult to justify in terms of traditional international tax policy goals. The goal of capital export neutrality requires a rule that prohibits discrimination based on the location of investment, but the treaty nondiscrimination rule does not prohibit such discrimination. Instead, it prohibits discrimination based on the ownership of investment, which is not directly relevant to the goal of capital export neutrality. In any event, the international tax system departs in unsystematic ways from capital export neutrality, and given this second-best regime, even an appropriate nondiscrimination rule will not necessarily move the system closer to that ideal.

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168. There is a problem with both of these mechanisms, however. The problem arises because the treaty nondiscrimination rule must be interpreted flexibly and is therefore ambiguous. *See supra* note 41 and accompanying text. A country that contemplates engaging in tax discrimination might believe that it can justify the discrimination, thus avoiding the reputational cost. The treaty partner might be reluctant to retaliate because of concern that the international community will agree with the other country's justification. Under these circumstances, if the treaty partner retaliated, it would not gain a desirable reputation for enforcing its treaties, but rather an undesirable reputation for breaching its treaties. These problems indicate that it would be desirable to create an international mechanism for promulgating authoritative interpretations of the treaty nondiscrimination article in specific cases, even if those interpretations are not enforceable.

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On the other hand, the treaty nondiscrimination rule does promote capital import neutrality. The traditional arguments in favor of this goal, however, have not been persuasive. Capital import neutrality promotes the efficient international allocation of world saving, but many analysts do not believe that this is a particularly important goal. Some U.S. proponents of capital import neutrality have argued that this form of neutrality is necessary if U.S. firms are to be competitive abroad. The focus of this argument, however, is on the U.S. taxation of U.S. multinationals, not on host-country taxation of foreign multinationals—the subject of the nondiscrimination rule. Moreover, this argument is generally framed in terms of advancing national, rather than global, interests.

This Article argues that these difficulties in justifying the treaty nondiscrimination rule do not reflect inadequacies in the rule itself, but rather result from inadequacies in the model of foreign investment that underlies the traditional international tax policy debate. A more satisfactory model would primarily attribute foreign direct investment to firms' inability to exploit their firm-specific advantages efficiently on an international basis through market transactions. Instead, they must extend control over business operations abroad, which requires foreign direct investment. This view indicates that the productivity of assets in a host country can depend on which firm owns those assets, with the result that a host-country rule of ownership neutrality will promote global economic efficiency. The existence of imperfectly competitive markets almost certainly increases the desirability of ownership neutrality as a goal. The treaty nondiscrimination rule advances the goal of ownership neutrality.

Nevertheless, the international tax system also contains features that detract from the goal of ownership neutrality. The Article argues, however, that it generally would not be desirable to extend the treaty nondiscrimination rule to prohibit these features. Although some of these features could usefully be limited through international agreements, case-by-case negotiation rather than blanket prohibition would be necessary because of difficulties in agreeing on an appropriate intercountry division of tax revenues and because of problems of coordinating different national tax systems.

Finally, the Article examines the practical relevance of the conclusion that the nondiscrimination rule promotes global economic efficiency, given the reality that national governments will likely pursue other goals. The Article argues that countries generally can increase their national economic welfare by entering into tax treaties that include globally efficient nondiscrimination rules. Nevertheless, there are circum-

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stances under which a government would find it in its interest to engage in tax discrimination, even though discrimination is globally inefficient, and even though it might not be in the collective interest of the country's residents. In particular, the Article suggests changes in the circumstances facing Congress that might account for Congress's diminished commitment to the nondiscrimination rule. The Article argues, however, that the nondiscrimination rule does restrain Congress from pursuing discriminatory policies, both by imposing additional national costs on decisions to discriminate and by helping to overcome public choice problems that tend to lead to the adoption of discriminatory policies. In conclusion, the nondiscrimination rule increases global economic welfare and also promotes domestic policies that tend to increase national economic welfare.

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