SOME PERSPECTIVES FROM THE UNITED STATES ON THE WORLDWIDE TAXATION VS. TERRITORIAL TAXATION DEBATE[*]

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I INTRODUCTION

Worldwide taxation and territorial taxation are the major alternatives by which a country (the "residence country") can levy on its residents' foreign income ("foreign-source income").[1] In a true worldwide system, a residence country imposes its regular income tax on its residents' entire foreign-source income at the time the income is earned.[2] Of course, that same income is also taxed by the foreign country where it originated (the "source country").[3] To relieve the resulting double burden, the residence country credits the source country tax against the residence country tax (the "foreign tax credit").[4] But if credits were allowed for foreign taxes in excess of the residence country tax on foreign-source income, the excess foreign taxes would effectively reduce the residence country tax on residence country domestic income. This would go beyond what is required to eliminate double taxation and would

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[1] See Charles H. Gustafson, Robert J. Peroni and Richard Crawford Pugh, *Taxation of International Transactions* (3d ed, 2006) 19-21. See *also*, Brian J. Arnold and Michael J. McIntrye, *International Tax Primer* (2d ed, 2002) 15, 30-47.

[2] See United States Treasury Department, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (2007) 55 <http://www.ustreas.gov/press/releases/reports/hp749_approachesstudy.pdf> (hereinafter U.S. Treas. Dep't, *Approaches)*; J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, 'Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income' (2001) 5 *Florida Tax Review* 299, 339-340 <http://ssrn.com/abstract=1022099> (hereinafter Fleming, Peroni and Shay, Fairness*)*.

[3] See Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation* (2d ed, 2004) 345; Stephen E. Shay, J. Clifton Fleming, Jr., and Robert J. Peroni, 'The David R. Tillinghast Lecture: "What's Source Got to Do with It?" Source Rules and U.S. International Taxation' (2002) 56 *Tax Law Review* 81, 83-106.

[4] See Gustafson, Peroni and Pugh, above n 1, 19-20.

effectively subsidize the activity that produced the foreign-source income.[5] To prevent the domestic tax base from being eroded by credits for source country taxes in excess of the residence country tax and to confine the foreign tax credit to the alleviation of international double taxation, the residence country usually limits its foreign tax credit to the amount of residence country tax on foreign-source income.[6] If, however, the source country is a low-tax jurisdiction in comparison to the residence country, a worldwide system allows the residence country to collect a "residual tax" equal to the amount by which the residence country tax exceeds the source country tax.[7]

By contrast, under a pure territorial or exemption system, the residence country imposes no tax on its residents' foreign-source business income. This is usually accomplished by allowing corporate residents an exemption for both foreign branch income and for dividends received from foreign corporations in which a corporate resident owns a substantial stock interest (often referred to as non-portfolio dividends).[8] Thus, in a conventional territorial system, foreign-source business income bears only the source country tax.

In the real world, no country operates either a pure worldwide system or a pure exemption system. For example, worldwide countries generally permit residence tax on the foreign-source active business income of foreign corporations controlled by residents to be deferred until the income is repatriated.[9] When the deferral period is lengthy, the effect is to substantially reduce the present value of the residence country tax, thereby narrowing the difference between a worldwide system and an exemption system.[10] Likewise, exemption countries typically depart from a "pure" exemption

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[5] This would also shift the economic consequences of the high tax rate from the high tax source country to the residence country. See generally, Organization for Economic Cooperation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis* (2007) 18, 99 (hereinafter OECD, *Tax Effects*)("[F]oreign tax credit limitations are in order to avoid pure transfers of revenue."); Harry Grubert and John Mutti, 'Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?', (1995) 2 *International Tax and Public Finance* 439, 441 (hereinafter Grubert and Mutti, Taxing Multinationals) ("Even a government with a cosmopolitan perspective cannot be indifferent to the … incentives provided to other governments to divert revenue to their own coffers."); Harry Grubert and Rosanne Altshuler, *Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income* (2006) 8 Rutgers University <http://econweb.rutgers.edu/altshule/research/200626.pdf> at 25 October 2008 (hereinafter Grubert and Altshuler, *Corporate Taxes*) ("[The justification for the credit limitation has to do with the behavior of governments and not the behavior…of taxpayers.").

[6] See Staff of Joint Committee on Taxation, *Economic Efficiency and Structural Analyses of Alternative U.S. Tax Policies for Foreign Direct Investment*, JCX-55-08 (2008) 6 <http://www.house.gov/jct/x-55-08.pdf> (hereinafter Joint Comm., *Alternative U.S. Tax Policies*); Gustafson, Peroni and Pugh, above n 1, 20, 277; Ault and Arnold, above n 3, 362.

[7] See Gustafson, Peroni and Pugh, above n 1, 20, 280.

[8] See Ault and Arnold, above n 3, 372-73.

[9] See Staff of Joint Committee on Taxation, *Present Law and Background Related to Selected Business Tax Issues,* JCX-41-06 (2006) 55 <http://www.house.gov/jct/x-41-06.pdf> (hereinafter Joint Comm., *Business Tax Background*); Ault and Arnold, above n 3, 377. This feature of worldwide systems is sometimes referred to as the deferral privilege or the deferral principle.

[10] See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 16 n. 41; J. Clifton Fleming, Jr. and Robert J. Peroni, 'Reinvigorating Tax Expenditure Analysis and Its International Dimension' (2008) 27 *Virginia Tax Review* 437, 529-30, 547-50 <http://ssrn.com/abstract=1119326> (hereinafter Fleming and Peroni, Tax Expenditure Analysis); Staff of Joint Committee on Taxation, *The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses*, JCX-22-06 (2006) 32-46 <http://www.house.gov/jct/x-22-06.pdf> (hereinafter Joint Comm., *Competitiveness Background);* Staff of Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures*, JCS-02-05 (2005) 189

model by imposing worldwide taxation on all foreign-source income of non-corporate residents and on foreign-source passive income of corporate residents (except for non-portfolio dividends), thus bringing real-world exemption systems closer to "non-pure" worldwide systems.[11] Accordingly, when commentators label countries as worldwide or exemption (territorial) countries, it should be understood that the commentators are referring to the predominant characteristics of those countries' respective international tax systems and are not suggesting that those countries have adopted the pure or ideal form of the system attributed to them. Indeed it is more accurate to characterize a worldwide system with deferral as a "hybrid worldwide" system and to describe exemption (territorial) systems that require worldwide treatment for certain kinds of income and taxpayers as "hybrid exemption" systems.[12]

In recent years, there has been a movement towards hybrid exemption systems.[13] Indeed, they are now employed by more than half of the OECD member countries[14] and the OECD recently recommended that the United Kingdom adopt such a system.[15]

The United States approach to taxing foreign-source income is a hybrid worldwide system in form. However, because of deferral of U.S. tax on foreign-source active business income, liberal cross crediting opportunities and other defects, the U.S. system can actually produce a better-than-exemption result in the form of a negative rate of U.S. tax on foreign-source income.[16] Moreover, the current U.S. system involves more complexity than the typical hybrid exemption system without achieving a dramatically greater revenue yield.[17]

<http://www.house.gov/jct/s-2-05.pdf> (hereinafter Joint Comm., *Options*); Harry Grubert and T. Scott Newlon, 'The International Implications of Consumption Tax Proposals' (1995) 48 *National Tax Journal* 619, 626 .

[11] See Joint Comm., *Options,* above n 10, 187; Ault and Arnold, above n 3, 357-60; Commission of the European Communities, *Dividend Taxation of Individuals in the Internal Market*, COM (2003) 810 final (2003) 19 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2003:0810:FIN:EN:PDF>; Grubert and Newlon, above n 10, 623. See also T. Timothy Tuerff, Daniel Shaviro, Douglas A. Shackelford, Timothy M. McDonald and Michael Mundaca, 'Session 4: Alternatives for Taxation of Foreign Source Income', (June 2008) 86 *Taxes* 71, 76 (suggesting that if an income tax regime applies progressive rates to individuals, the tax base for individuals subject to the regime should be their worldwide incomes).

[12] See Joint Comm., *Options,* above n 10, 186-87; Ault and Arnold, above n 3, 358-60.

[13] See U.S. Treas. Dep't, *Approaches,* above n 2, 54, 57.

[14] See OECD, *Tax Effects*, above n 5, 19, 104-05; U.S. Treas. Dep't, *Approaches,* above n 2, 57.

[15] See Charles Gnaedinger, 'OECD Recommends Corporate Tax Changes for U.K.', (2007) 48 *Tax Notes International* 151. With respect to earlier discussions regarding a U.K. territorial system, See Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 46-48.

[16] See J. Clifton Fleming, Jr., Robert J. Peroni and Stephen E. Shay, 'Better Than Exemption' (forthcoming) (hereinafter cited as Fleming, Peroni and Shay, Better); U.S. Treas. Dep't, *Approaches,* above n 2, 57; Joint Comm., *Options,* above n 10, 188-89. When excess foreign tax credits on high-taxed foreign-source income are cross-credited against U.S. residual tax on low-taxed foreign-source income, the U.S. tax saving is effectively a negative U.S. tax on the high-taxed foreign-source income. Likewise, if expenses that have an economic nexus with high-taxed foreign income are deducted against U.S. domestic income, the U.S. tax saving is effectively a negative U.S. tax on the high-taxed foreign source income. Because of its defects, the U.S. international income tax system can be roughly described as more generous than a territorial system with respect to the foreign-source business income of U.S. resident corporations and as a worldwide system with respect to all other foreign-source income received by U.S. residents.

[17] See U.S. Treas. Dep't, *Approaches,* above n 2, 57 ("U.S. tax on all corporate foreign income was about $18.4 billion in 2004").

These shortcomings of the U.S. system plus the movement of other developed countries towards hybrid exemption systems has led to serious suggestions that the United States should adopt a hybrid exemption system.[18] Most observers agree that the present U.S. hybrid worldwide system is, indeed, unacceptable and requires major reform.[19] Beyond that point of agreement a pair, however, of debates has emerged. Although these two debates are distinguishable and have quite different answers, there is an erroneous tendency to believe that the solution to the first also dictates the outcome of the second. We strongly disagree.

The first of these debates focuses on the question of whether a well-designed hybrid exemption system is superior to the present U.S. hybrid worldwide system. As explained below, we believe that a well-designed hybrid exemption system is preferable to the defective regime presently employed by the United States. This is a spurious and distracting discussion, however, because there is no need for the U.S. system to be so poorly designed. Therefore, it is inappropriate to use the highly compromised U.S. approach as the point of comparison in the argument over whether the United States should adopt a theoretically correct exemption regime.[20]

The second debate is the appropriate controversy. It centers on whether a well-designed hybrid exemption system is superior to a well-designed worldwide system that would differ importantly from the seriously flawed hybrid regime currently being operated by the United States. We conclude that a properly constructed worldwide system is preferable to a well-designed exemption regime.

II A SPURIOUS DEBATE: TERRITORIALITY V. PRESENT U.S. SYSTEM

A correctly framed territorial (exemption) system would exempt only foreign-source income, would ensure that foreign expenses and losses are not deductible against domestic income and would tax foreign-source interest, royalties and service

[18] The U.S. Treasury Department has recently described the virtues of a territorial system in terms that amount to a recommendation for replacing the current U.S. regime with a territorial system. See U.S. Treas. Dep't, *Approaches,* above n 2, 54-63; For details of the major U.S. exemption system proposals, see Joint Comm., *Options,* above n 10 186-97; President's Advisory Panel on Federal Tax Reform, *Simple, Fair, & Pro-Growth: Proposals to Fix America's Tax System* (2005) 132-35 (hereinafter Advisory Panel, *Proposals*). For critiques of these proposals, See J. Clifton Fleming Jr. and Robert J. Peroni, 'Exploring the Contours of a Proposed U.S. Exemption (Territorial) Tax System' (2005) 109 *Tax Notes* 1557 <http://ssrn.com/abstract=870539> (hereinafter Fleming and Peroni, *Exploring*); Paul R. McDaniel, 'Territorial vs. Worldwide International Tax Systems: Which Is Better for the U.S.?' (2007) 8 *Florida Tax Review* 283; Peter Merrill, Oren Penn, Hans-Martin Eckstein, David Grosman, and Martijn van Kessel, 'Restructuring Foreign-Source-Income Taxation: U.S. Territorial Tax Proposals and the International Experience' (2006) 111 *Tax Notes* 799*;* James R. Repetti, 'Will U.S. Investments Go Abroad in a Territorial Tax: A Critique of the President's Advisory Panel on Tax Reform' (2007) 8 *Florida Tax Review* 303.

[19] See 'Report of the Task Force on International Tax Reform, ABA Tax Sec.' (2006) 59 *Tax Lawyer* 649, 717-18 (hereinafter Tax Sec. Report); Joint Comm., *Options,* above n 10, 188-89; George K. Yin, 'Reforming the Taxation of Foreign Direct Investment by U.S. Taxpayers' (2008) 118 *Tax Notes* 173 (hereinafter Yin, Reforming).

[20] If the current U.S. worldwide system could not be made substantially more consistent with a well-designed worldwide system than it presently is, then it would make sense to compare the flawed U.S. System with an ideal territorial system. This is not the case, however. With respect to feasible steps for bringing the U.S. system in line with a well-designed worldwide system, See Robert J. Peroni, J. Clifton Fleming, Jr. and Stephen E. Shay, 'Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income' (1999) 52 *Southern Methodist University Law Review* 455 <http://ssrn.com/abstract=1096262> (hereinafter, Peroni, Fleming and Shay, Getting Serious); Robert J. Peroni, J. Clifton Fleming, Jr. and Stephen E. Shay, 'Reform and Simplification of the Foreign Tax Credit Rules' (2003) 101 *Tax Notes* 103 (hereinafter Peroni, Fleming and Shay, Reform).

fees paid by foreign subsidiaries and branches.[21] Thus, structurally sound territorial systems require properly designed source rules, expense allocation rules and robust transfer pricing rules. Moreover, because a principal purpose for adopting a territorial system instead of a worldwide system is to make companies resident in the adopting country competitive with companies resident in exemption system countries,[22] a well-designed exemption system would be no more generous than the systems of other countries. Consequently, it would follow the pattern established in other exemption system countries of preserving worldwide taxation with respect to all foreign-source income of non-corporate residents and foreign-source passive income of corporate residents.[23] This would require foreign tax credit rules for income and taxpayers that are excluded from exemption treatment and rules to distinguish included and excluded income and taxpayers. As a result, well-designed territorial systems are not simple.[24] They are, however, modestly simpler than worldwide systems including the present U.S. international income tax regime. Moreover, because of (1) defective cost allocation rules,[25] (2) aggressive transfer pricing,[26] (3) the deferral privilege,[27] (4) a two-basket foreign tax credit limitation that facilitates extensive cross-crediting[28] and

[21] Royalties and service fees are typically treated by foreign countries as deductible expenses that bear no foreign tax. See U.S. Treas. Dep't, *Approaches,* above n 2, 58, 62; Joint Comm., *Options,* above n 10, 189-95. Because the purpose of an exemption system is to alleviate double taxation, there is no reason to grant exemption to items that bear no foreign tax and it is no surprise that exemption treatment systems typically tax royalties and service fees. In addition, royalties are often a return on research and development costs incurred in the residence country and, to that extent, they are not properly classified as foreign-source income. See generally, Grubert and Mutti, Taxing Multinationals, above n 5, 450-51. See also, Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 38 (discussing a "subject to foreign tax" requirement).

[22] See eg, Grubert and Mutti, Taxing Multinationals, above n 5, 441.

[23] See Joint Comm., *Options,* above n 10, 189; Ault and Arnold, above n 3, 372-75.

[24] See Fleming and Peroni, Exploring, above n 18, 1560-68.

[25] See generally, Harry Grubert, 'Enacting Dividend Exemption and Tax Revenue', (2001) 54 *National Tax Journal* 811.

[26] See OECD, *Tax Effects*, above n 5, 112 ("Business claims that income that has been irregularly shifted offshore can be taxed by properly applying transfer pricing rules and principles… [This] argument assumes that tax authorities will be able in each instance to ensure that prices applied in related-party transactions result in offshore profits that are not in excess of amounts that would arise from transactions between unrelated parties operating at arm's length. For many transactions, in particular those that involve intangibles, the task is very difficult and may be impossible to ensure in many cases, even assuming available resources to audit all related-party transactions."); Lee A. Sheppard, 'Treasury Officials Discuss Reform, Contract Manufacturing' (2008) 118 *Tax Notes* 1083, 1084 ("Transfer pricing is dead …. Despite everyone's efforts, we're not collecting tax." Quoting Edward D. Kleinbard, Chief of Staff of the Joint Committee on Taxation of the U.S. Congress); Martin A. Sullivan, 'Democratic Senators Eye Offshore Profits' (2006) 110 *Tax Notes* 590, 591 ("Methods consistent with the arm's-length method (as interpreted by the private-sector consultants) yield an enormous range of defensible results. Because there is a wide range of possible outcomes, the victories in transfer pricing battles go to the party with the most economic and legal firepower. That's almost always the corporation, not the IRS."); Tax Sec. Report, above n 19, 703 ("Even with small price adjustments, the aggregate amount of income that may be shifted within the range allowable under the regulations (and the amount of tax saved) can be material."). See also, J. Clifton Fleming Jr., Robert J. Peroni and Stephen E. Shay, 'An Alternative View of Deferral: Considering a Proposal to Curtail, Not Expand, Deferral' (2000) 20 *Tax Notes International* 547 (hereinafter Fleming, Peroni, and Shay, Deferral); Martin A. Sullivan, 'U.S. Multinationals Shifting Profits Out of the United States' (2008) 118 *Tax Notes* 1078 (hereinafter Sullivan, Shifting,); Martin A Sullivan, 'The IRS Multibillion-Dollar Subsidy for Ireland', (2005) 108 *Tax Notes* 287.

[27] See Peroni, Fleming and Shay, Getting Serious, above n 20, 458-470.

[28] See Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 8; Gustafson, Peroni and Pugh, above n 1, 602-03; J. Clifton Fleming, Jr. and Robert J. Peroni, 'Eviscerating the Foreign Tax Credit

(5) the deductibility of overall foreign losses against domestic income,[29] the current U.S. international taxation system can be more generous than a well-designed exemption system.[30] Indeed, the U.S. regime can be manipulated to produce a negative U.S. tax on foreign-source income.[31] For these reasons, if the question is whether the current U.S. international income tax system should be replaced with a well-designed territorial approach, we believe the answer is that replacement should occur.

This is, however, the correct answer to the wrong question. Because present defects can be cured,[32] the appropriate inquiry is how well does a *well-designed* worldwide system measure up against a well-designed exemption regime.[33] We address that debate in part III.

III THE APPROPRIATE DEBATE: TERRITORIALITY V. A WELL-DESIGNED WORLDWIDE SYSTEM

A *Describing a Properly Designed Worldwide System*

A properly designed worldwide system would tax foreign-source income as it is earned (i.e. there would be no deferral) so that (1) the distortive bias in favor of locating business activity in low-tax foreign jurisdictions would be eliminated,[34] (2) the repatriation tax barrier would be removed[35] and (3) the incentive to engage in aggressive transfer pricing with respect to outbound activity would be substantially reduced.[36] Such a system would also have a foreign tax credit limitation that curtailed cross-crediting,[37] expense allocation rules that prevented foreign losses and expenses from being deducted against domestic-source income[38] and source rules that

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Limitations and Cutting the Repatriation Tax – What's ETI Repeal Got to Do with It?' (2004) 104 *Tax Notes* 1393, 1394, 1403-05 (hereinafter Fleming and Peroni, Eviscerating).

[29] See Gustafston, Peroni and Pugh, above n 1, 615-17.

[30] See Joint Comm., *Options,* above n 10, 188-89; Lawrence Lokken, 'Does the U.S. Tax System Disadvantage U.S. Multinationals in the World Marketplace?' (Summer 2004) 4 *Journal of the Taxation of Global Transactions* 43.

[31] See Fleming, Peroni and Shay, Better, above n 16; Lawrence Lokken, 'Territorial Taxation: Why Some U.S. Multinationals May Be Less Than Enthusiastic About the Idea (and Some Ideas They Really Dislike)' (2006) 59 *Southern Methodist University Law Review* 751, 759-70 (hereinafter Lokken, Territorial Taxation). This state of affairs has led to the argument that because the current U.S. system can yield better-than-exemption results, the United States should abandon the pretense of worldwide taxation and adopt an explicit territorial system with respect to foreign-source income. See Robert Goulder, 'If in Doubt, Blame Check the Box' (2008) 119 *Tax Notes* 1061, 1063. As explained at below n 46, we disagree.

[32] See authorities cited in below n 46.

[33] See Lokken, Territorial Taxation, above n 31, 771. See also, Randall Jackson, 'Support for Territorial Tax Regime Growing, Panelists Say' (2008) 118 *Tax Notes* 899 ("[A]cademics have come to view a middle position between the two poles of worldwide and territorial-based taxation as weaker than a position at one of the two poles.") For an example of an appropriate framing of the inquiry, although it differs somewhat from the structure used in the this article, see Joint Comm. *Alternative U.S. Tax Policies,* above n 6.

[34] See Gustafson, Peroni and Pugh, above n 1, 17-20, 277-78; Grubert and Newlon, above n 10, 624-25.

[35] See Fleming and Peroni, Eviscerating, above n 28, 1413-14.

[36] See Grubert and Altshuler, *Corporate Taxes,* above n 5, 14; Peroni, Fleming and Shay, Getting Serious, above n 20, 512, 514.

[37] See Peroni, Fleming and Shay, Reform, above n 20, 110; Fleming and Peroni, Eviscerating, above n 28, 1394, 1403-05; authorities cited in above n 5, above n; see also Grubert and Newlon, above n 10, 626.

[38] See Gustafson, Peroni and Pugh, above n 1, 118; Arnold and McIntyre, above n 1, 48-50.

prevented domestic-source income from being misclassified as foreign-source income.[39] The present U.S. worldwide system is deficient on all these points. Specifically, it permits deferral of tax on foreign-source income until repatriation,[40] subject to only feeble limitations.[41] Moreover, it has a two-basket foreign tax credit limitation (a passive income basket with look through rules and an active income basket) that allows substantial cross-crediting.[42] It also permits certain foreign expenses and losses to be deducted against domestic-source income.[43] Finally, it employs rules for sourcing income that misclassify certain U.S.-source income as foreign-source income.[44]

As noted above, a worldwide system burdened with these deficiencies receives a failing grade when compared with a well-designed exemption or territorial system.[45] But a worldwide system need not be so imperfect. Proper design is feasible[46] and if a worldwide system is structurally sound, then we believe it is superior to an exemption system.

B *Economic Doctrines*

Among economists, the worldwide taxation vs. territorial taxation debate has been principally a dispute regarding the strengths and weaknesses of three economic doctrines: capital export neutrality, which is associated with worldwide taxation, and capital import neutrality and capital ownership neutrality, both of which are linked to territorial taxation.[47] In this article, we do not delve into the controversy regarding the comparative merits of these three economic theories because the debate is

[39] See Peroni, Fleming and Shay, Reform, above n 20, 132.
[40] See Peroni, Fleming and Shay, Getting Serious, above n 20, 459-60. See also, Grubert and Newlon, above n 10, 626 ("One feature pushing the U.S. system…[in the direction of exemptions or territorial taxation] is deferral, which can substantially reduce the present value of U.S. tax on the income of foreign subsidiaries of U.S. companies").
[41] See Peroni, Fleming and Shay, Getting Serious, above n 20, 460-64.
[42] See Tax Sec. Report, above n 19, 694. Until 2007, the United States attempted to curtail cross-crediting by assigning foreign-source income to eight separate baskets for foreign tax credit purposes. See Gustafson, Peroni & Pugh, above n 1, 602-14. Nevertheless, extensive cross-crediting occurred because most income involved in foreign tax credit computations fell into a single basket, the so-called general limitation basket. For example, in 2004, 73.4% of the foreign-source income involved in U.S. foreign tax credit computations was general limitation basket income. See Scott Luttrell, 'Corporate Foreign Tax Credit, 2004' (2008) 28 *SOI Bulletin* No. 1 at 111 <http://www.irs.gov/pub/irs-soi/04cofortxcr.pdf>. The two-basket system that applies after 2006 allows even more extensive cross-crediting.
[43] See Fleming, Peroni and Shay, Better, above n 16.
[44] See Peroni, Fleming and Shay, Reform, above n 20, 132; Grubert and Mutti, Taxing Multinationals, above n 5, 450-51.
[45] See text, accompanying above n 25-31.
[46] See Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 50-63; Tax Sec. Report, above n 19, 731-35; Peroni, Fleming and Shay, Reform, above n 20; Peroni, Fleming and Shay, Getting Serious, above n 20, 507-23.
[47] See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 12-13; OECD, *Tax Effects,* above n 5, 96-101; Joint Comm., *Competitiveness Background,* above n 10, 3, 5; Joint Comm., *Business Tax Background,* above n 9, 55-56; Grubert and Altshuler, *Corporate Taxes,* above n 5, 3; Arnold and McIntyre, above n 1, 5-6; United States Treasury Department, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* (2000) 26-42 <http://www.treas.gov/offices/tax-policy/library/subpartf.pdf> (hereinafter U.S. Treas. Dep't, *Deferral*); Michael J. Graetz, 'The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies' (2001) 54 *Tax Law Review* 261, 270-71 (hereinafter Graetz, Outdated Concepts).

unresolved[48] and all three doctrines have deficiencies that make them inadequate as organizing principles for an international income tax regime.[49] Instead we focus on distortions and inequities that policy makers should seek to avoid, or at least minimize when constructing an international income tax system, regardless of the theoretical strengths and weaknesses of capital export neutrality, capital import neutrality and capital ownership neutrality.[50]

C *Inefficient Distortions*

In choosing between worldwide and territorial taxation, policy makers should be aware that both regimes have the capacity to create important and inefficient behavioral distortions. As explained below, however, we believe that these distortions are significantly less problematic under the worldwide approach than under territorial taxation and that a properly designed worldwide system should be preferred on that ground alone.[51]

1 *Tax Haven Finance Subsidiary*

For an example of the distortiveness inherent in territorial systems, assume that Parentco is a resident of an exemption system country, that Parentco has a wholly owned Country A active-business subsidiary that pays a 40 percent Country A tax on its profits (calculated with a deduction for interest payments) and that tax haven Country B, which has a 10 percent corporate income tax and no withholding taxes, is available to facilitate tax planning. In a no-tax world, Parentco would simply cause the Country A subsidiary to periodically remit its profits as dividend distributions. Given the preceding facts, however, Parentco will have a strong incentive to undercapitalize the Country A subsidiary and to organize and capitalize a Country B finance subsidiary that will make interest-bearing loans to the Country A subsidiary. The Country B subsidiary will then periodically transfer its interest receipts to Parentco as exempt dividends. Under this arrangement, all income of the Country A subsidiary that is paid as interest to the Country B subsidiary will move from the 40 percent Country A tax to the 10 percent Country B tax. This saving of 30 percentage points will be a powerful inducement for Parentco to incur the costs of establishing and operating the Country B subsidiary even if doing so would be senseless in a no-tax world.[52] This distortion, which benefits only the professionals engaged in document creation and follow-up legal compliance with respect to tax haven finance subsidiaries, could be reduced if Parentco's residence country adopted a controlled

[48] See Fleming, Peroni and Shay, Fairness, above n 2, 308 n. 14.

[49] See United States Treasury Department, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper* (2007) 48-49 <http://www.treas.gov/press/releases/reports/07230%20r.pdf> (hereinafter U.S. Treas. Dep't, *Background Paper*); Grubert and Altshuler, *Corporate Taxes*, above n 5, 3, 16-18; Graetz, Outdated Concepts, above n 47, 276-99. In our judgment, however, the doctrine of capital export neutrality comes closest to being the correct organizing principle and serves as a useful guide, notwithstanding its deficiencies.

[50] See Grubert and Altshuler, *Corporate Taxes*, above n 5, 18 ("[W]hat reform within an income tax can hope to accomplish is to eliminate unnecessary waste and the possibility of extremely high or low tax burdens that are not justified under any standard. Then we can at least be sure that we are moving toward the optimum without overshooting it and running the risk of making things worse.").

[51] See Grubert and Altshuler, *Corporate Taxes*, above n 5, 4.

[52] See generally, ibid 28; OECD, *Tax Effects,* above n 5, 101, 113.

foreign corporation regime that caused Parentco to pay a current tax on the interest received by the Country B subsidiary from the Country A subsidiary. However, given that this measure would not completely eliminate the distortive incentive[53] and that Parentco's home country policy makers were willing to let Parentco directly receive the Country A subsidiary's profits without paying home country tax, the home country might not choose to impose a tax on Country A profits routed through the Country B subsidiary.[54] If that were the case, the distortive force of the home country exemption system would remain fully in place. And if Parentco's home country did adopt a measure that imposed tax on dividends received from the Country B finance subsidiary, this would add a layer of complexity to the home country exemption system.

By contrast, these issues are substantially less important in a well-designed worldwide system in which the income of the low-taxed subsidiary bears a residual tax equal to the excess of the parent corporation's home country tax over the tax in the low-tax country.[55] Thus, transforming income of a high-taxed subsidiary into interest receipts of a low-taxed subsidiary accomplishes nothing except to the extent that the levy in the high tax country exceeds the tax rate in the parent corporation's home country[56] or except where the parent corporation has sufficient credits from other high-taxed income to eliminate the residual tax on the dividends received from the low-taxed subsidiary.[57] In the latter case, an effective barrier to cross crediting, such as a per-country foreign tax credit limitation, would protect the residual tax.[58] On balance, therefore, a worldwide system is somewhat less distortive than a territorial system with respect to the tax haven finance subsidiary strategy described above.

2 *Aggressive Transfer Pricing*

A second potential distortion that must be considered when choosing between worldwide and territorial taxation is income shifting through aggressive transfer pricing. To be specific, a territorial system inherently encourages a parent company to undercharge for goods, services and loan funds supplied to low-taxed foreign subsidiaries and to overpay such subsidiaries for the use of intangibles that were transferred to, or developed by the subsidiary.[59] These tactics shift income from the parent corporation to the foreign subsidiary, thereby causing the income to morph from domestic income taxable at the parent's marginal rate into foreign-source income that bears only the low foreign tax imposed by the subsidiary's residence country. This erodes the tax base of the parent corporation's residence country and causes parent-subsidiary transactions to be structured in ways that would not occur in the absence of tax considerations.

[53] On the facts of the example, this measure would result in reducing the tax burden on the shifted income from 40% to 30% (10% Country B tax plus 20% home country residual tax). Thus, the finance subsidiary strategy would continue to produce a tax saving.
[54] See Ault and Arnold, above n 3, 372-73.
[55] See Grubert and Altshuler, *Corporate Taxes,* above n 5, 28.
[56] See Grubert and Altshuler, *Corporate Taxes,* above n 5, 34-35. In the example in the text, if Parentco's residence country operated a well-designed worldwide system, imposed a 30% tax on corporate profits and limited its foreign tax credit to the 30% domestic tax, the Country A subsidiary's income would bear a full 40% Country A tax but the tax burden would fall to 30% with respect to income paid as deductible interest to the Country B subsidiary.
[57] See ibid 35.
[58] See Peroni, Fleming and Shay, Reform, above n 20, 121-23.
[59] See Yin, Reforming, above n 19, 175; Grubert and Altshuler, *Corporate Taxes,* above n 5, 24, 33.

This distortion can be combated only if the parent corporation's residence country is willing to adopt rigorous transfer pricing rules and then fund an effective administration of those rules.[60] These steps, however, will inevitably produce a significant level of conflict between taxpayers and the revenue service. By contrast, the current home country residual tax imposed on the income of foreign subsidiaries under a properly designed worldwide system eliminates the advantage of using aggressive transfer pricing to shift income to low-tax foreign subsidiaries except where the parent corporation has excess foreign tax credits that can be used to absorb the home country residual tax on the shifted income.[61] However, this is a less significant income shifting problem than exists under a territorial regime and it can be combated with a per-country foreign tax credit limitation[62] or a rigorous basket approach that separates high- and low-taxed income for foreign tax credit purposes.[63] At the end of the day, the potential for distortion on this margin seems substantially smaller under a well-designed worldwide system than under a territorial system.

3 *Transforming Interest and Royalties Into Exempt Dividends*

A closely-related form of distortion arises from the fact that royalty payments and interest payments from a foreign subsidiary to its parent are taxable income for the parent under an archetypical territorial system whereas dividend distributions from the subsidiary to the parent are exempt income under such a system.[64] This creates an incentive for parent corporations to minimize taxable interest and royalty income by undercharging foreign subsidiaries for loans and the use of intangibles and then to recapture the undercharges through exempt dividends from the subsidiaries.[65] Combating this tactic requires rigorous transfer pricing rules and vigilant enforcement that leads to complexity and controversy. By contrast, under a well-designed worldwide system, dividends from a subsidiary are also exempt income[66] but a parent corporation is taxed on its foreign subsidiary's net income as it accrues so that the dividend exemption does not avoid tax in the parent's home country.[67] Thus, interest and royalty undercharges to the subsidiary by the parent merely give the subsidiary a larger net income on which the parent pays a larger current tax. This means that there is no tax advantage under a well-designed worldwide system from converting royalty and interest payments into exempt dividends and this distortive incentive, which is an inherent feature of a territorial system, is absent from a worldwide system. Thus, a well-designed worldwide system is less distortive along this margin than an exemption system.

[60] See OECD, *Tax Effects,* above n 5, 112.
[61] See Grubert and Altshuler, *Corporate Taxes,* above n 5, 14, 24, 34-35.
[62] See Peroni, Fleming and Shay, Reform, above n 20, 121-23.
[63] See ibid 118-19.
[64] See Joint Comm., *Options* above n 10, 187; Ault and Arnold, above n 3, 357-60.
[65] See Grubert and Altshuler, *Corporate Taxes,* above n 5, 33.
[66] See Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 50-54.
[67] See ibid 50-54.

4 *Location Distortion*

(a) Pretax vs. Post Tax Returns

Although the preceding distortions are important to the choice between a well-designed worldwide system and an exemption or territorial system, we believe that the principal efficiency reason for preferring the worldwide approach is that exemption systems distort business location decisions. To be specific, taxpayers operating under exemption systems are encouraged to invest capital in low-tax foreign countries instead of in their residence country or in high-tax foreign countries, even if the pretax return from the low-tax country investment is inferior to the pretax return from an investment in the residence country or in a high-tax foreign country.[68] Consider the following example:

> *Example 1.* U.S. Multinational Inc. (USM) is a U.S. domestic corporation with skilled management and valuable intangibles that can be applied abroad. It pays U.S. tax on its U.S.-source income at a rate of 35 percent but assuming that the United States has adopted an exemption system, there is no U.S. tax on USM's foreign-source income. The assets of a business that earns only foreign-source income are for sale in Country X, a wonderful tax haven that has no tax on corporate profits and no withholding tax regime. A business is also for sale in the United States. USM can earn a 20 percent before-tax return on capital invested in the U.S. business and a 15 percent before-tax return if it invests capital in the Country X business.

Given those facts, USM would prefer the Country X investment to the U.S. investment even though the latter is economically superior to the Country X investment. That is because USM's 20 percent before-tax return from investing in the U.S. business would be reduced to 13 percent by the 35 percent U.S. tax on domestic-source income,[69] while the U.S. exemption system for foreign-source income would provide USM a 15 percent return on its investment in the Country X business. Thus, the exemption system would cause USM to forgo the economically superior purchase of the U.S. business in favor of the economically inferior acquisition of the Country X

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[68] See Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 26; Robert J. Peroni, 'Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules' (1997) 51 *University of Miami Law Review* 975, 983 (hereinafter Peroni, Back to the Future); Robert J. Peroni, 'Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle With Subpart F?' (2001) 79 Texas Law Review 1609 (hereinafter Peroni, End It); See also Jane G. Gravelle, 'Foreign Tax Provisions of the American Jobs Act of 1996' (1996) 13 *Tax Notes International* 763. But see Terrence R. Chorvat, 'Ending the Taxation of Foreign Business Income' (2000) 42 *Arizona Law Review* 835, 841-845.

The magnitude of this distortion is quite significant. See Harry Grubert and John Mutti, 'Do Taxes Influence Where U.S. Corporations Invest?' (2000) 53 *National Tax Journal* 825 (hereinafter Grubert and Mutti, Where U.S. Corporations Invest) (suggesting that almost one out of every five dollars invested abroad by U.S. corporations is drawn to its investment location because of low host country taxes); Donald J. Rousslang, 'Deferral and Optimal Taxation of International Investment Income' (2000) 53 *National Tax Journal* 589, 596; Sullivan, Shifting, above n 26; Martin A. Sullivan, 'U.S. Citizens Hide Hundreds of Billions in Cayman Accounts' (2004) 103 *Tax Notes* 956, 957 ("[F]rom 1993 through 2001, assets of non-financial subsidiaries of U.S. corporations grew from $9 Billion to $142 Billion.").

[69] 0.20 x (1-0.35)=0.13.

business, an undesirable policy result.[70] By contrast, a U.S. worldwide system without deferral would impose a 35 percent tax on both the U.S. and Country X returns with the result that the 15 percent before-tax Country X return would be reduced to 9.75 percent and USM would choose the economically superior U.S. investment.[71]

(b) The Competitiveness Argument

Those who believe in hybrid exemption systems (i.e., that a zero rate of domestic tax on foreign-source active business income is the right result) rely principally on a competitiveness argument that can be stated as follows: local businesses in a low-tax foreign country pay only the low local income tax on their in-country profits. The same is true of foreign corporations operating in the low-tax country but resident in a country that exempts foreign-source income from residence country tax. Without exemption, companies resident in a worldwide country (residence country companies) would be unduly disadvantaged when competing in low-tax foreign countries because in addition to the low foreign tax, they would pay a current home country residual tax on their foreign profits while their local and exemption country competitors would pay only the low foreign tax. Therefore, so the argument goes, residence countries should exempt the foreign-source active business income of their resident companies.[72]

This argument is not a request for the residence country to give double taxation relief that would otherwise be unavailable in a worldwide system. The necessary relief is provided in a worldwide system by means of the foreign tax credit. Instead,

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[70] See Grubert and Mutti, Taxing Multinationals, above n 5, 443 ("[T]here is no a priori reason to increase the competitiveness of [foreign] affiliates at the expense of domestic production."); Grubert and Newlon, above n 10, 624-25. In the U.S. context, both the Advisory Panel's and the Joint Committee Staff's recent exemption proposals attempt to minimize the significance of this point by invoking economic studies concluding that adoption of a U.S. exemption system would not cause a material movement of business from the United States to low-tax foreign countries. See Advisory Panel, *Proposals,* above n 18, 135; Joint Comm., *Options,* above n 10, 196. But those studies compare results under an exemption system with results under the current U.S. international tax system that can be even more distortive than a properly designed exemption system. Thus, those studies do not undermine the conclusion that when compared with a well-designed worldwide system, an exemption system significantly distorts the business location decision.

[71] See generally, Grubert and Newlon, above n 10, 624-25.

[72] See generally, OECD, *Tax Effects*, above n 5, 108-111; Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 29; Joint Comm., *Competitiveness Background,* above n 10, 56, 59; National Foreign Trade Council, *International Tax Policy for the 21st Century* (2001) vol 1, 12 (hereinafter NFTC, *International Tax Policy*); Grubert and Mutti, Taxing Multinationals, above n 5, 441; James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income* (2007) 32-33, <http://taxprof.typepad.com/taxprof_blog/files/hines_reconsidering_nov_07.pdf> at 25 October, 2008 (hereinafter Hines, *Reconsidering*); U.S. Treas. Dep't, *Approaches,* above n 2, 46; Peter Mullins, 'Moving to Territoriality? Implications for the U.S. and the Rest of the World' (2006) 43 *Tax Notes International* 839, 844 (hereinafter Mullins, Moving to Territoriality). As explained at below n 255, VAT rebates on exports from countries that employ the VAT create the appearance of an export subsidy even though economists generally characterize this appearance as false. Nevertheless, because the U.S. does not employ a VAT, this appearance has created political momentum for a series of U.S. export subsidy regimes structured as income tax provisions that were said to be necessary for making U.S. exporters competitive with exporters resident in VAT countries. Each of these U.S. regimes has been held non-compliant with either GATT law or WTO law. Regarding this interesting episode in U.S. tax history, see Paul R. McDaniel, 'The David R. Tillinhast Lecture: Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions,' (2004) 57 *Tax Law Review* 275; Paul R. McDaniel, 'Trade and Taxation' (2001) 26 *Brooklyn Journal of International Law* 1627, 1627-33.

the competitiveness argument is a request for tax system assistance that is not available to earners of income sourced in the residence country. This appeal for preferential treatment of foreign-source income should be closely scrutinized. In our judgment, such scrutiny reveals that, in the U.S. context at least, there is no persuasive case for relieving foreign-source active business income from residence country income tax.

To be specific, the argument by U.S. proponents of exemption proposals that adoption of an exemption system is necessary for U.S. multinationals to compete in the global marketplace is unsupported by empirical evidence that a competitiveness problem exists and that the proposed exemption system would solve the problem. Claims by exemption advocates that a competitiveness problem exists are rendered questionable at best by the extensive overseas success of many U.S. businesses.[73] Where is the proof (as contrasted with anecdotes and special pleading) of a systemic competitiveness problem[74] that is substantially caused by the U.S. international

[73] For a sample of sources regarding the successes of U.S. multinational corporations in foreign markets, see Matt Andrejczak and Donna Kardos, 'Heinz Earnings Rise by 7.2%, Helped by Higher Prices', *The Wall Street Journal* (New York City) May 30, 2008, B4; William M. Bulkeley, 'High-Margin Services Lift IBM', *The Wall Street Journal* (New York City) Oct. 17, 2008, B2; Russell Gold, 'Exxon to Boost Spending, Broaden Exploration', *The Wall Street Journal* (New York City) March 6, 2008, B1; Christopher Hinton, 'Monsanto Net Nearly Triples', *The Wall Street Journal* (New York City), Jan. 4, 2008, C14; Kathryn Kranhold, 'GE's Strength Abroad Helps It Weather Weakness in U.S.', *The Wall Street Journal* (New York City) Jan. 19-20, A3; Tom Lauricella, 'Economic Split Seen in Corporate Earnings', *The Wall Street Journal* (New York City) April 18, 2008, A1 (In the recession of 2008, U.S. businesses continue to perform well in foreign markets); Betsy McKay, 'Pepsi to Boost China Outlay by $1 Billion,' *The Wall Street Journal* (New York City) Nov. 4, 2008, B3; Betsy McKay, 'Coke Net Rises 19%, Aided by Weak Dollar', *The Wall Street Journal* (New York City) April 17, 2008, B3; Betsy McKay & Anjali Cordeiro, 'Coke Overcomes Weak U.S. Results', *The Wall Street Journal* (New York City), Oct. 16, 2008, B3; Shira Ovide, 'P&G Profit Rises 33%; Costs Hit Outlook', *The Wall Street Journal* (New York City) Aug. 6, 2008, B3.

[74] See U.S. Treas. Dep't., *Deferral*, above n 47 56, ("[T]he United States, as a general matter, is agreed upon by almost any measure to be one of the most competitive countries in the world."), 57; Martin A. Sullivan, 'Tax Incentives and Economists', (2006) 111 *Tax Notes* 20, 23-25; Timothy Aeppel, 'Overseas Profits Help U.S. Firms Through Tumult', *The Wall Street Journal* (New York City) Aug. 9, 2007, 1 (U.S. companies continue to experience growth in foreign-source profits); 'U.S. Again Holds No. 1 Rank in Competitiveness Survey', *The Wall Street Journal* (New York City) Oct. 9, 2008 A8 (2008 World Economic Forum Report ranks U.S. economy as most competitive in the world); Marc Champion, 'U.S. Ranked Most Competitive; Oil-Rich Nations Show Promise', *The Wall Street Journal* (New York City) Nov. 1, 2007, A4 (2007 World Economic Forum report characterized the U.S. economy as the most competitive in the world); World Economic Forum, *The Global Competitiveness Report 2005-2006, Executive Summary* (2006) 3 World Economic Forum http://www.weforum.org/pdf/Gcr/GCR_05_06_Executive_Summary.pdf at 25 October 2008 (finding that the United States had the world's second most competitive economy in 2005 because of "continuing technological supremacy, and a pipeline of innovation second to none in the world"). See also Mitchell A. Kane, 'Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks', (2006) 20 *Virginia Tax Review* 53, 64-65; Richard C. Pugh, 'The Deferral Principle and U.S. Investment in Developing Countries', in Robert Hellawell (ed) *United States Taxation and Developing Countries* (1980) 267, 280 (stating that "one faces a relative scarcity of detailed empirical analysis" in assessing the claims of advocates and opponents of deferral). But compare Joint Comm., *Options*, above n 10, 189 (opining that the current U.S. international tax system "arguably" impairs the competitiveness of U.S. multinationals "in some cases"); U.S. Treas. Dep't, *Background Paper*, above n 49, 43 ("[T]he United States likely experiences some reduction of both foreign direct investment and its corporate tax base due to its above-average CIT [corporate income tax] rate."). For a skeptical economic efficiency critique of the competitiveness arguments for the deferral subsidy, see Jane G. Gravelle, 'Foreign Tax Provisions of American Jobs Act of 1996' (1996) 72 *Tax Notes* 1165, 1168.

income tax regime[75] instead of by labor cost differentials, product quality differences, regulatory differences and other non-tax factors? Stated differently, if there are specific industries that face an international competitiveness problem, why is taxation the cause and how would adoption of an exemption proposal solve the problem? Answers to these questions have not been forthcoming.[76]

Of course, an exemption advocate might shift ground by conceding that U.S. businesses are competing effectively abroad but then argue that this success is due to the generous tax assistance provided by the current U.S. regime,[77] that withdrawal of this aid would cause U.S. businesses to founder in foreign markets and that copious tax assistance should be continued but streamlined by substituting an exemption system for the more complex U.S. system of deferral, cross-crediting and other problematic features noted above. This argument, however, fails for the same reason as the basic competitiveness argument. Just as there is a paucity of evidence to support the allegation that U.S. businesses are at a competitive disadvantage because of the current U.S. international tax system, there is also an absence of evidence that their competitive success is due to the tax benefits provided by that system.[78]

(c) Targeting

Not only is the need for competitive assistance highly doubtful in the U.S. context, but an exemption system would be a poor device for delivering the assistance. For example, under a territorial regime, exemption is fully available without regard to whether the beneficiary has little competition in the foreign country (for example, a pharmaceutical company selling one-of-a-kind patent-protected drugs[79]) or faces fierce competition. In addition, exemption is fully available without regard to whether the exemption beneficiary's principal competitor in a particular foreign country is a resident of the beneficiary's country or is a foreign person. The struggle in foreign markets between U.S. software manufacturers and U.S. soft drink producers are examples of this case.[80] As these points illustrate, exemption systems are poorly targeted ways to enhance competitiveness vis-à-vis significant foreign competitors.

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[75]See Mullins, Moving to Territoriality, above n 72, 844 ("[T]here is little evidence to assess the impact of U.S. taxes on the competitiveness of multinational corporations in foreign markets, and especially the extent to which competitiveness is affected by the use of the worldwide system").

[76] See Grubert and Mutti, Taxing Multinationals, above n 5, 446 ("The implication is that cutting tax on foreign income would not be a very effective way of encouraging U.S. R&D because it has little impact on foreign sales."); Grubert and Mutti, Taxing Multinationals at 453 ("Reducing U.S. taxes on foreign income does not seem to be any more effective in strengthening U.S. companies' worldwide competitiveness than reducing taxes on domestic corporate income.").

[77] See text accompanying above n 40-44.

[78] See U.S. Treas. Dep't, *Deferral* above n 47, 57 ("[T]he available data simply do not provide a reliable basis for evaluating whether…[the current U.S. international tax regime] has affected multinational competitiveness to any significant extent.").

[79] Another example is those markets where a United States multinational has established an overwhelming competitive position. See, eg, Nikhil Deogun, 'Australia Blocks Coke's Bid to Purchase Brands of Cadbury Schweppes There', *The Wall Street Journal* (New York City) Apr. 9, 1999, A3; Brandon Mitchener and Betsy McKay, 'EU Raids Coca-Cola's Offices in Four Countries', *The Wall Street Journal* (New York City) July 22, 1999, A4.

[80] See, eg, Don Clark and John R. Wilke, 'FTC Begins Formal Inquiry into Intel's Chip Pricing', *The Wall Street Journal* (New York City) June 7-8, 2008, A.3. A prominent example is the battle between Coca-Cola and Pepsi for dominance in some foreign markets. See, eg, Betsy McKay, 'PepsiCo CEO Adapts to Tough Climate', *The Wall Street Journal* (New York City) Sept. 11, 2008, B1; Betsy McKay, Sky Canaves and Geoffrey A. Fowler, 'Coke Deal Juices Its China Business', *The Wall Street*

Moreover, exemption of foreign-source income from a residence country's tax base erodes that base and contributes to the need for higher tax rates than would otherwise be the case. Those higher tax rates bring about distortions in economic behavior. Stated differently, given budgetary constraints, proposals to exempt foreign-source income from a residence country's tax base work at cross-purposes with proposals to reduce the distortionary effects of its tax system generally.[81]

Finally, even if we were to stipulate that the United States faces a systemic international competitiveness problem, it is doubtful that providing tax assistance to U.S. multinational corporations ranks very high among the potential remedies. For example, strengthening public education in the United States holds greater promise for effective results.[82]

(d) Recapitulation

To summarize, it is quite clear that a territorial system distorts the business location decision and in the worst case scenario, encourages residents to pursue economically inferior opportunities in low-tax foreign countries. Moreover, it is also clear that the need to provide U.S. companies with generalized foreign competitive assistance has not been established and that even if competitive assistance were desirable, the territorial system would be a poorly targeted delivery device. In the U.S. context at least, when a territorial system's clear efficiency defects are weighed against its speculative benefits, it seems difficult to make a credible competitiveness case in favor of territoriality.

(e) Redefining Competitiveness

Finally, we question the validity of defining competitiveness in terms of the after-tax profitability of a country's multinational corporations instead of an improved living standard for its citizens.[83] When competitiveness is viewed in that latter way, the linkage, for example, between public investment in education and improved U.S.

Journal (New York City) Sept. 4, 2008, B1; Miriam Jordan, 'Debut of Rival Diet Colas in India Leaves a Bitter Taste', *The Wall Street Journal* (New York City) July 21, 1999, B1.

[81] See text accompanying below n 120.

[82] See Sara Murray, 'Study Finds Sharp Math, Science Skills Help Expand Economy', *The Wall Street Journal* (New York City) March 3, 2008, A2 (reporting on a study concluding that if U.S. students had achieved improvements in math and science called for by the National Governors Associations nearly 20 years ago, U.S. GDP would be 2 percentage points higher today and 4.5 points higher in 2015). See also, Conor Dougherty, 'High-Degree Professionals Show Power', *The Wall Street Journal* (New York City) Sept. 10, 2008, A3 ("In 2007, the median income [in the U.S.] for people with a bachelor's degree was about two-thirds more than those with only a high-school diploma.").

[83] The empirical evidence to date has failed to establish that expansion by U.S. multinationals into low-tax foreign countries results in net employment gains within the United States or net trade gains for the United States. See Martin A. Sullivan, 'Offshore Jobs and Taxes: Will Democrats Attack?' (2008) 119 *Tax Notes* 24; Martin A. Sullivan, 'U.S. Multinationals Moving Jobs to Low-Tax, Low-Wage Countries' (2008) 119 *Tax Notes* 119; Martin A. Sullivan, 'A Challenge to Conventional International Tax Wisdom', (2006) 113 *Tax Notes* 951, 956-58. See also Lawrence H. Summers, 'TCPI's Ninth Annual Tax Policy & Practice Symposium Keynote Address by Lawrence H. Summers' (June 2008) 86 *Taxes* 35, 40 (Statement by former U.S. Treasury Secretary that "I think the basic criterion for measuring national economic policy is what is happening to the growth in the incomes of average families….."); Graetz, Outdated Concepts*,* above n 47, 261, 294-95, 307.

The economic theories of capital export neutrality and capital import neutrality are concerned with maximizing global welfare rather than the welfare of residents of a particular country. See OECD, *Tax Effects,* above n 5, 96-100; Graetz, Outdated Concepts, above n 47, 270-73, 284-85.

competitiveness[84] is far more immediate and powerful than is a tax subsidy tailored to enhance the investment returns of U.S. multinational corporations.[85] Stated differently, it is difficult to see how an exemption system that abandons locational neutrality and encourages U.S. multinational corporations to shift investment capital to the Cayman Islands and Bermuda is improving the living standards of U.S. citizens and residents.

D *The New Ownership Neutrality Defense of Territoriality*

In a series of recent articles,[86] Professors Mihir A. Desai and James R. Hines Jr. have put forward a new theoretical defense of exemption, or territorial, systems under the rubric of ownership neutrality. According to Professors Desai and Hines, capital export neutrality and capital import neutrality — the traditional organizing principles for international tax policy debates — are seriously flawed.[87] Instead, they believe that "tax rules should be evaluated by the degree to which they ensure that the identities of capital owners are unaffected by tax rate differences, thereby permitting the market to allocate ownership rights to where they are most productive."[88] Desai and Hines assert that the ownership neutrality concept yields two welfare benchmarks: capital ownership neutrality (CON) and national ownership neutrality (NON).[89] In their view, "CON requires that tax rules not distort ownership patterns"[90] and "implies that a reduction of U.S. taxation of foreign income [that is, a movement toward exemption, or territoriality] would improve worldwide welfare by moving U.S. taxation more in the direction of other countries that currently subject foreign income to little or no taxation."[91] Also, they assert that "NON…implies that the United States

[84] See Joann M. Weiner, 'Conversations: Harvey S. Rosen' (2007) 117 *Tax Notes* 857, 859 ("Empirical studies…show that the growth in income inequality is largely due to differences in educational attainment…. [T]hose who are less educated fall further behind…. [W]e need to focus on providing more education to these segments of the population.").

[85] See J. Clifton Fleming Jr., Robert J. Peroni and Stephen E. Shay, 'Point: The United States Should Tax U.S. Corporations on Their Worldwide Income' (Fall 2001) *ABA Section of Taxation Newsletter Quarterly* 14, 15; authority cited in above n 82.

An additional way to view competitiveness is to compare full taxation of U.S. corporations that sell only in the U.S. market with exemption treatment for the foreign-source income of U.S. multinational corporations. Both groups of corporations compete for capital and the exemption for foreign-source income gives U.S. multinationals a competitive advantage over U.S. corporations that sell exclusively within the United States. There is no apparent justification for this disparity. See OECD, *Tax Effects,* above n 5, 96.

[86] See Mihir A. Desai and James R. Hines Jr., 'Reply to Grubert' (2005) 58 *National Tax Journal* 275 (hereinafter Desai and Hines, Reply); Mihir A. Desai and James R. Hines Jr., 'Old Rules and New Realities: Corporate Tax Policy in a Global Setting' (2004) 57 *National Tax Journal* 937 (hereinafter Desai and Hines, Old Rules); Mihir A. Desai, 'New Foundations for Taxing Multinational Corporations' (March 2004) 82 *Taxes* 39 (hereinafter Desai, New Foundations); Mihir A. Desai and James R. Hines Jr., 'Evaluating International Tax Reform' (2003) 56 *National Tax Journal* 487 (hereinafter Desai and Hines, Evaluating); See also Staff of Joint Comm. on Tax'n, *The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad,* JCX-68-03 (2003) 21-22 <http://www.house.gov/jct/x-68-03.pdf> (hereinafter Joint Comm., *U.S. Rules II*).

[87] See Desai and Hines, Old Rules, above n 86, 955-957; see also Graetz, Outdated Concepts, above n 47, 269-315.

[88] Desai, New Foundations, above n 86, 46.

[89] See Desai & Hines, Old Rules, above n 86, 956.

[90] Ibid.

[91] Ibid 957; see also ibid 938 ("a movement to reform corporate taxation in the direction of exempting foreign income has a compelling logic"). Professors Desai and Hines have written that CON also could

would improve its own welfare[92] by exempting foreign income from taxation."[93] They conclude by stating that those "ownership based concepts of efficiency imply that national and world welfare would be advanced by reducing U.S. taxation of foreign income, thereby permitting taxpayers and the country to benefit from greater market-based allocation of resources to the most productive owners."[94]

1 *Efficiency Redux*

In our view, however, this new argument in favor of a U.S. exemption system is problematic. Consider the following variation of Example 1, *supra:*

> *Example 2.* U.S. Multinational Inc. (USM) is a U.S. domestic corporation with skilled management and valuable intangibles that can be applied abroad. It pays U.S. tax on its worldwide income at a rate of 35 percent. Mediocre SA is a corporate resident of Country A, which exempts foreign business income from Country A's income tax. Mediocre has no valuable business intangibles and its management is, indeed, mediocre. The assets of a business that earns only foreign-source income are for sale in Country X, a wonderful tax haven that has no tax on corporate profits and no withholding tax regime. A business is also for sale in the United States. USM has the resources to acquire one but not both of those businesses. USM can earn a 20 percent before-tax return on capital invested in the U.S. business and a 15 percent before-tax return if it purchases the assets of the Country X business. Because of Mediocre's weak management and lack of business intangibles, it can earn only a 10 percent return if it purchases the assets of the Country X business.
>
> If USM's only option were to operate the Country X business as a branch so that deferral of U.S. tax on the Country X business income was not available, the 35 percent current U.S. tax on USM's profits from the Country X business would leave it with a 9.75 percent after-tax return.[95] By contrast, Mediocre's after-tax return from that business would equal its 10 percent before-tax return because of the exemption system employed by Mediocre's home country. Thus, Mediocre presumably would outbid USM for the Country X business with the result that the business would

be achieved if all countries use worldwide systems with unlimited foreign tax credits. See Desai and Hines, Evaluating, above n 86, 492, 494. But that is a purely academic point because it is not now the case — and it is unlikely ever to be true — that all the world's countries employ worldwide taxation systems with unlimited foreign tax credits. See Grubert and Mutti, Taxing Multinationals, above n 5, 441.

[92] Desai and Hines define welfare improvement as increases in "tax collections as well as private incomes." Distributional or fairness considerations do not seem to have a role in their approach, see Desai, New Foundations, above n 86, 45, which in our view is a serious defect. Cf Fleming, Peroni and Shay, Fairness, above n 2.

[93] Desai and Hines, Old Rules, above n 86, 957.

[94] Ibid.

[95] 0.15 x (1 – 0.35) = 0.0975.

> wind up in the hands of the less-productive owner.[96] Under Professors Desai's and Hines's concept of ownership neutrality, that is a bad outcome. Of course, if USM operated the Country X business through a CFC, USM could, in a best-case scenario, get close to a 15 percent after-tax return from the Country X investment by taking advantage of deferral.[97] But that pathway to an approximately 15 percent after-tax return can be complex and, according to Professors Desai and Hines, many U.S. taxpayers continue to suffer a substantial U.S. tax burden on their foreign income despite the CFC alternative.[98] Accordingly, they argue that the United States should adopt an exemption system so that in a more certain and straightforward way, USM's after-tax return from investing in the Country X business would equal its 15 percent pre-tax return and USM would outbid Mediocre, which is limited by its mediocrity to a 10 percent return from the Country X business.[99]
>
> Adoption of a U.S. exemption system would mean, however, that USM would prefer the Country X investment to purchasing the U.S. business even though the latter is economically superior to the Country X investment. That is because USM's 20 percent before-tax return from investing in the U.S. business would be reduced to 13 percent by the 35 percent U.S. tax on domestic income[100] while the U.S. exemption system for foreign income would give USM a 15 percent return on its investment in the Country X business. Thus, the exemption system would cause USM to forgo the economically superior purchase of the U.S. business in favor of the economically inferior acquisition of the Country X business.[101]

Exemption systems are usually justified by reference to the doctrine of capital import neutrality (CIN)[102] and the preceding illustration of how a hypothetical U.S.

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[96] See generally Desai and Hines, Evaluating, above n 86, 491-492.

[97] See U.S. Treas. Dep't, *Deferral*, above n 47, x; text accompanying above n 25-30.

[98] See Desai and Hines, Old Rules, above n 86, 943-955. Professors Desai and Hines have stated: "[I]t is useful to assume that current U.S. taxation neutralizes roughly half of the benefit of earning profits in low-tax locations." Desai and Hines, Old Rules 954. But *s*ee Harry Grubert, 'Comment on Desai and Hines, "Old Rules and New Realities: Corporate Tax Policy in a Global Setting"' (2005) 58 *National Tax Journal* 263 (hereinafter Grubert, Comment) (disputing Desai's and Hines's computations).

[99] See Desai, New Foundations, above n 86, 236.

[100] 0.20 x (1 – 0.35) = 0.13.

[101] See Reuven S. Avi-Yonah, 'Globalization, Tax Competition and the Fiscal Crisis of the Welfare State' (2000) 113 *Harvard Law Review* 1573, 1604 n.132 (hereinafter Avi-Yonah, Globalization); Roseanne Altshuler, 'Recent Developments in the Debate on Deferral' (2000) 20 *Tax Notes International* 1579, 1581-1582; Grubert, Comment, above n 98, 271; See also Commission of the European Communities, above n 11, 18.

[102] See OECD, *Tax Effects,* above n 5, 98. The doctrine of CIN holds that all capital income should be taxed at the same rate regardless of the taxpayer's residence country. See, eg, Gustafson, Peroni and Pugh, above n 1, 18. In the example involving USM, CIN would require that income earned by USM from operating the Country X business be exempt from taxation by USM's residence country (the United States) because the income's source would be a country that applied a zero tax rate. See Joint Comm., *Options,* above n 10, 186.

exemption system would cause USM to make the economically less-desirable Country X investment illustrates the classic efficiency objection to CIN and to exemption systems.[103] By contrast, a worldwide system without deferral would cause USM to pay a current 35 percent U.S. residual tax on income from the Country X business (there would be no credit for Country X tax because the Country X rate is assumed to be zero). Thus, USM's 15 percent before-tax return in Country X would be reduced to a 9.75 percent after-tax return[104] and USM would choose to enjoy the 13 percent after-tax return[105] of the economically preferable U.S. business. In other words, the after-tax result of the worldwide system, without deferral, would not disturb the pre-tax superiority of the U.S. investment[106] and taxes would be a neutral factor in USM's choice between purchasing the U.S. business or the Country X business.

2 *What is Neutrality and What Is Distortion?*

Professors Desai and Hines, however, seem to argue that the worldwide system is actually nonneutral in USM's case because it would cause USM to choose the economically preferable U.S. business instead of the deficient Country X business.[107] That raises the question of which is the benchmark for determining the existence of distortion — decisions made by residents under a home country's worldwide system or decisions made by residents under a home country's exemption, or territorial, system? Because it is clear that worldwide taxation of residents is normatively permissible,[108] affirmatively required by fairness considerations,[109] and more closely aligned than is territoriality with the results that would occur in a world where all income and taxpayers were treated uniformly, it is our view that worldwide taxation should be regarded as the benchmark of neutrality and territorial taxation as the distortive approach.[110] Thus, in Example 2, adopting a U.S. exemption system would be a distortive move that would cause a welfare loss to both the United States and the world economy on account of USM's choosing the economically inferior Country X investment.

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[103] See text at above n 68-71; Gustafson, Peroni and Pugh, above n 1, 19.

[104] See above n 95.

[105] See above n 100.

[106] Indeed the relationship of the after-tax returns from the two businesses (0.0975/0.13 = 0.75) would be identical to the relationship of the before-tax returns (0.15/0.20 = 0.75).

[107] "Exempting foreign income from U.S. taxation would be associated with 40 percent greater outbound FDI. . . . U.S. taxation of foreign income impairs the productivity of American firms in the global marketplace . . . since it distorts ownership patterns." Desai and Hines, Old Rules, above n 86, 954, 957; See also Desai and Hines, Reply, above n 86, 275, 277-278; Desai and Hines, Evaluating, above n 86, 491, 494.

[108] See Hugh J. Ault and David F. Bradford, 'Taxing International Income: An Analysis of the U.S. System and Its Economic Premises' in Assaf Razin and Joel Slemrod (eds) *Taxation of the Global Economy* (1990) 11, 31; United States Treasury Department, *Blueprints for Basic Tax Reform* (1977) 99 <http://www.ustreas.gov/offices/tax-policy/library/blueprints> (hereinafter U.S. Treas. Dep't, *Blueprints*).

[109] See Part III.E, below.

[110] See generally Commission of the European Communities, above n 11, 18 (''Resources are misallocated in so far as capital inputs are directed from their most productive uses — that is, those with the highest rates of return before taxes — to locations where such inputs are less productive, but yield greater after-tax returns as a consequence of their relatively favorable tax treatment.'').

3 *Offsets?*

Professors Desai and Hines recognize that a U.S. exemption system would provide USM with a tax incentive to purchase the inferior business in low-tax Country X, but they regard that economic loss as possibly being offset by the fact that the Country X business would be in the hands of the most productive owner, USM. They state their view as follows:

> Whether the cost of having too many factories in the Bahamas [a tax haven] is larger or smaller than the cost of discouraging value-enhancing corporate acquisitions is ultimately an empirical question, though the importance of ownership to FDI [foreign direct investment] suggests that its welfare impact may also be substantial.[111]

But the economic gain from USM's acquisition of the Country X business would offset the economic loss from USM's passing up the U.S. business only if USM could wring a before-tax return from the Country X business that was at least equal to the before-tax return from the U.S. business. And if that were the case, an exemption system would be unnecessary because a worldwide system without deferral would preserve the comparative attractiveness of the Country X business, and therefore the worldwide system would not stand in the way of USM's acquiring that business.[112] More importantly, in the situation where the before-tax return from the Country X business was less than the before-tax return from the U.S. business, a U.S. exemption system would encourage USM to buy the Country X business (if the Country X business had a better *after-tax* return) even though the benefit from USM's doing so would not offset the loss from USM's forgoing the superior U.S. investment.

4 *Foreign Capital Inflows*

Professors Desai and Hines have a tentative response to all that. In their view, it is true that individual U.S. firms are forced by their resource limitations to choose between investment alternatives,[113] just as USM had to choose either the U.S. business or the Country X business in Example 2. But they point out that there is a global pool of capital, and they say that it is "conceivable" that an owner of foreign-invested capital would come forward and make the U.S. acquisition that was forgone by USM in favor of the Country X investment.[114] *If* that happened, and *if* the owner of the foreign-invested capital could squeeze the same 20 percent before-tax return from the U.S. business that USM was capable of, U.S.-source tax on that capital owner's U.S. return would make the Treasury whole and in addition, neither the U.S.

[111] See Desai and Hines, Evaluating, above n 86, 495-496.
[112] See text accompanying above n 103-106.
[113] See Desai and Hines, Reply, above n 86, 277 n.4.
[114] See Desai and Hines, Old Rules, above n 86, 956. That represents a muting of their position in Desai and Hines, Evaluating, above n 86, 496 (emphasis added), in which they said that ''additional outbound foreign investment *does not* reduce domestic tax revenue, since any reduction in home-country investment *is* offset by greater investment by foreign firms.'' (Emphasis added.) Professor Hines, writing alone, repeated this statement in Hines, *Reconsidering,* above n 72, 12. See also Tuerff, Shaviro, Shackleford, McDonald and Mundaca, above n 11, 78 (statement by Daniel Shaviro that "[e]ven if a U.S. multinational does reduce investment at home by reason of its investing abroad, this may create a vacant slot here for someone else to fill."); Jackson, above n 33, 899 (reporting an argument made by some academics that "[w]hen a company moves overseas, it also opens up a slot in the United States into which a foreign firm can move, thereby resupplying the jobs lost from the original shift abroad").

economy nor the global economy would suffer a productivity loss from USM's decision to acquire the inferior Country X investment.

But Professors Desai and Hines are not entirely certain that the foreign-invested capital would, in fact, be shifted to the United States. They soften their analysis with qualifiers as follows:

> The modern view of FDI as arising from productivity differences among firms, with ownership changes taking the form of FDI, raises the *possibility* that greater outbound FDI need not be associated with reduced domestic investment. Indeed, it is *conceivable* that greater outbound FDI is associated with greater domestic investment, either by home country firms undertaking the FDI or by unrelated foreign investors.[115]

Indeed, it seems unwise to assume that foreign-invested capital[116] will invariably make the U.S. Treasury and domestic economy whole regarding decisions by corporations like USM to forgo U.S. investments in favor of less productive investments in other countries. Volatility in the value of the dollar can discourage investment from abroad.[117] Moreover, the necessary foreign capitalists may be exemption-country residents who find tax-free investments in low-tax jurisdictions like Country X more attractive than investing in a U.S. business and incurring a 35 percent U.S.-source tax on the profits of that business. In short, it is less than certain that foreign capital would substantially replace the capital that would be deflected from the more productive U.S. domestic investment if USM were to pursue the inferior Country X investment. And if the alleged disadvantages of U.S. businesses passing into foreign control and shifting their headquarters overseas are true,[118] as many proponents of exemption or territorial systems maintain,[119] having a foreign investor make up for USM's outbound capital flow by acquiring the U.S. business that was passed over by USM is not a happy solution. Finally, even if foreign capital does replace outbound domestic capital, why should the United States provide a tax subsidy to encourage wealthy U.S. multinationals to purchase inferior investments abroad, thereby creating a capital vacuum to be filled by foreign investors? Because of those factors, it seems improvident for the United States to adopt an exemption system that would have the inevitable effect of giving USM a substantial incentive to forgo the U.S. investment in favor of the inferior Country X investment.

5 *Competitiveness Redux*

If, however, USM could squeeze, say, a 25 percent before-tax return out of the Country X investment, it would be economically efficient for USM to forgo the U.S. alternative and acquire the Country X business. In that scenario, a U.S. worldwide taxation system, without deferral, would impose a 35 percent residence-based tax on

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[115] Desai and Hines, Old Rules, above n 86, 956 (emphasis added).

[116] If capital already invested in the United States were used to make the U.S. acquisition that USM declined to undertake, the acquisition would not offset the capital outflow caused by USM's purchase of the Country X business.

[117] See Ian McDonald, 'As U.S. Stocks Stall, Foreign Issues Catch On', *The Wall Street Journal* (New York City) July 14, 2005, C1.

[118] See 'Congress Raises New Roadblock to CNOOC's Path to Unocal Deal', *The Wall Street Journal* (New York City) July 27, 2005, C4; Martin A. Sullivan, 'The Deficit Tax' (2005) 108 *Tax Notes*, 62, 63; U.S. Treas. Dep't, *Corporate Inversion Transactions: Tax Policy Implications* (2002) 20; NFTC, *International Tax Policy,* above n 72, 114.

[119] See Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (1992) 77-94, 131-136.

the 25 percent Country X return, thus reducing it to 16.25 percent after tax. But that would be better than the 13 percent after-tax return USM could earn on the U.S. investment and USM would pursue the purchase of the more productive Country X business.

Nevertheless, USM's pursuit might be unsuccessful, because any exemption-country resident who could produce a greater than 16.25 percent before-tax return from the Country X business could theoretically outbid USM and make the acquisition even though USM, with its 25 percent before-tax return, would be economically preferable to any foreign acquirer whose potential before-tax return fell below 25 percent. That leads to the argument that the U.S. system of worldwide taxation exposes U.S. corporations to being outbid for attractive acquisitions in low-tax countries by exemption-country residents[120] and that the United States should prevent that from happening by adopting an exemption regime even though doing so would also amount to providing U.S. corporations with the above-described incentive to forgo more productive U.S. investments in favor of economically inferior foreign investments.

That argument is rendered dubious, at best, by the extensive overseas success of American businesses[121] and their numerous acquisitions of foreign companies.[122] There is no empirical evidence that U.S. multinational corporations are being consistently outcompeted for acquisitions or customers in low-tax countries by exemption-country residents.[123] Moreover, a program of aiding United States corporations by relieving their foreign-source income from U.S. tax would be a poorly structured tax assistance measure. That is because the tax assistance would be fully available to U.S. corporations that are earning supernormal returns in low-tax foreign countries because they are selling patent- or copyright-protected goods. Also, exemption would be fully available to a U.S. corporation whose principal competitor in a low-tax foreign country is another U.S. corporation. Finally, an exemption system would conflict with the U.S. goal of operating an income tax based on the principle of ability-to-pay because it ignores the taxpaying capacity represented by foreign-source income.[124] Thus, it seems unwise to provide a tax subsidy, in the form of an exemption system, to wealthy U.S. multinationals, particularly when the United States is running large

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[120] See OECD, *Tax Effects,* above n 5, 100; Julie Roin, 'Comments on Mihir A. Desai's New Foundations for Taxing Multinational Corporations' (March 2004) 82 *Taxes* 157, 158 (hereinafter Roin, Comments).

[121] See authorities cited in above n 73.

[122] See Staff of Joint Committee on Taxation, *The U.S. International Tax Rules: Background, Data, and Selected Issues Relating to the Competitiveness of U.S.-Based Business Operations*, JCX-67-03 (2003) 35-36, A-7 <http://www.house.gov/jct/x-67-03.pdf> (hereinafter Joint Comm., *U.S. Rules I*).

[123] See U.S.Treas. Dept., *Deferral,* above n 47, 56-57, 61. Indeed, exemption system countries in Western Europe have not found that the exemption approach alone is sufficient to ensure overall economic success. See Jonathan House and Emma Charlton, 'Gloom Spreads in EU's Economies', *The Wall Street Journal* (New York City) Nov. 1-2, 2008, A8; Marcus Walker, 'Euro Zone Faces Several Hurdles to Steady Growth', *The Wall Street Journal* (New York City) Nov. 16, 2005, A16; Martin A. Sullivan, 'German Unemployment Drives Tax Reform' (2005) 39 *Tax Notes International* 479; 'Euro Zone's Growth Potential Looks to Weaken in Long Term', *The Wall Street Journal* (New York City) July 13, 2005, A13; Marc Champion, Dan Bilefsky, and John Carreyrou, 'A French 'No' Reminds Europe of Many Woes', *The Wall Street Journal* (New York City) May 31, 2005, A1.

[124] See generally Fleming, Peroni and Shay, Fairness, above n 2; Joint Comm., *U.S. Rules II,* above n 86, 3; United Kingdom Inland Revenue, *Double Taxation Relief for Companies* (1999) 11, 14.

deficits that significantly constrain its ability to deal with healthcare, education, homeland security, natural disaster relief and many other similar needs.[125]

The goal of ownership neutrality is to permit the market to allocate ownership of business assets to the most productive players.[126] For Professors Desai and Hines, the phrase ''most productive players'' means those who can produce the largest before-tax returns.[127] Thus, their ownership neutrality concept is internally flawed because it advocates exemption systems,[128] which often drive a wedge between investors and the largest before-tax returns.[129] At the end of the day, the ownership neutrality concept advanced by Professors Desai and Hines suffers from the same economic efficiency and fairness flaws as does CIN and, like CIN, ultimately can be defended only by resorting to a competitiveness argument.[130] In the context of ownership neutrality, the concept of competitiveness means the ability to succeed in bidding for ownership of assets. This is slightly different from the competitiveness concept that is more commonly used to defend exemption systems through reliance on CIN. That latter competitiveness concept focuses on the ability to gain market share. But the difference is not significant with respect to the worldwide taxation versus territorial taxation debate because with respect to both competitiveness concepts there is no convincing evidence of a general competitiveness problem, and both competitiveness concepts produce results that conflict with the ability-to-pay norm[131] and fail under conventional tax expenditure analysis.[132]

6 *Tax Competition*

But what about Country X in the preceding example, whose effort to attract U.S. investors by offering them a zero tax rate is being undermined by U.S. taxation of U.S. residents' foreign-source income? Some commentators argue that adoption of an exemption system is necessary to allow developing countries to use tax holidays to attract badly needed foreign investment.[133] It seems to us, however, that the primary obligation of U.S. tax policy is to improve the well-being of U.S. individuals.[134] The United States has no obligation to facilitate the tax competition efforts of other countries.[135] The United States may, however, find that there are good reasons to do

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[125] See Committee for Economic Development, *A New Tax Framework: A Blueprint for Averting a Fiscal Crisis* (2005) 7-11 <http://www.ced.org/docs/report_tax2005.pdf>; Andy Pasztor, 'Budget Pressures May Imperil Pentagon's New-Breed Satellites', *The Wall Street Journal* (New York City) Nov. 19-20, 2005, A4.
[126] See text accompanying above n 86-99.
[127] See above n 99.
[128] See text accompanying above n 86-94.
[129] See text accompanying above n 68-71, 99-101.
[130] See Roin, Comments, above n 120, 158.
[131] See text accompanying below n 143-212.
[132] See generally, Fleming and Peroni, Tax Expenditure Analysis, above n 10, 547-51. For additional criticism of the ownership neutrality concept, see OECD, *Tax Effects*, above n 5, 101-02.
[133] See, eg, Karen B. Brown, 'Transforming the Unilateralist Into the Internationalist', in Karen B. Brown and Mary Louise Fellows (eds), *Taxing America* (1996) 214; Karen B. Brown, 'Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?' (2002) 23 *University of Pennsylvania Journal of International Economic Law* 45. For criticism of the ultimate effectiveness of tax inducements offered by developing countries, see Christian Aid, 'The Shirt Off Their Backs: How Tax Policies Fleece the Poor', (2005) 40 *Tax Notes International*, 617; Avi-Yonah, Globalization, above n 101, 1639-1648.
[134] See Graetz, Outdated Concepts, above n 47, 277-279, 311.
[135] See Commission of the European Communities, above n 11, 20; OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998) 15.

so with respect to particular countries. If the United States desires to provide badly needed financial assistance to those developing countries that are acting responsibly in terms of human rights, the rule of law, nonaggression toward neighbors and other similar issues (a worthy objective of U.S. foreign policy), bilateral negotiations leading to treaty-based U.S. tax-sparing benefits for those particular countries is a more focused and hence better approach than an exemption system that would indiscriminately benefit all low-tax countries no matter how prosperous, oppressive or hostile they might be.[136] In the alternative, tax expenditure analysis would support using targeted direct grants in lieu of an indirect and unfocused tax subsidy in the form of an exemption system.[137]

7 *Summary*

The ownership neutrality form of analysis purports to identify benefits that make territoriality superior to worldwide taxation. When subjected to close scrutiny, however, those benefits seem unlikely to occur. Thus, territoriality remains in the unacceptable position of imposing costs that are real (i.e., substantial economic distortion) in the hope of achieving competitiveness benefits that are speculative at best.

E *Tax Expenditure Analysis*

To argue that countries should grant a tax exemption for foreign-source income earned by resident companies in order to make those companies more competitive in foreign markets is to argue that resident companies should receive financial assistance through the income tax system. Thus, the competitiveness argument in favor of territoriality is ultimately a confession that a territorial system is a tax expenditure.[138] As such, it should be subjected to the cost/benefit scrutiny demanded by tax expenditure analysis.[139] In our view, the juxtaposition of the undisputed distortive consequences of territorial systems against their doubtful benefits leads to an unfavorable cost/benefit ratio.[140]

Moreover, tax expenditure analysis requires that the revenue loss from tax expenditures should be considered in light of alternative uses for that revenue. In the context of the worldwide versus territoriality debate, this means that the desirability of devoting scarce revenue to increasing the profitability of the foreign operations of residence country companies should be balanced against the benefits to be gained from using that revenue to reduce distortions in the tax system by cutting income tax rates across the board[141] and/or using that revenue for some or all of the following:

[136] See text accompanying below n 230-48; Fleming, Peroni and Shay, Fairness, above n 2, 344-349; Robert J. Peroni, 'Response to Professor McDaniel's Article', (2003) 35 *George Washington International Law Review* 297, 299-300.

[137] See Fleming, Peroni and Shay, Fairness, above n 2, 344-346; Peroni, above n 136, 297-299.

[138] See Fleming and Peroni, Tax Expenditure Analysis, above n 10, 439-40.

[139] See ibid 487-88, 525-27.

[140] See text accompanying above n 50-132.

[141] See OECD, *Tax Effects*, above n 5, 22 ("A low tax rate benefits all corporations, which also reduces incentives to shift activities and tax base offshore."); Michael J. Graetz, *100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States* (2008) 123 ("In my view, the most important corporate tax change Congress could enact—both to stimulate our domestic economy and to increase the competitiveness of U.S. companies throughout the world—would be to lower our corporate tax rate substantially."); Grubert and Altshuler, *Corporate* Taxes, above n 5, 2 ("A lower

improved healthcare funding, improved educational funding,[142] increased assistance to the poor, infrastructure needs and environmental protection. Each country must decide for itself how to balance these competing revenue needs. The important point, however, is that territoriality involves a diversion of scarce tax revenue to a particular use and that there should be a public debate over whether this diversion is appropriate in the light of other uses to which the revenue could be put.

F *Fairness Considerations*

1 *Introduction*

The worldwide versus territoriality debate has been conducted primarily in terms of the economic concept of efficiency. The debate does, however, involve important fairness considerations involving the principle of ability-to-pay. Nevertheless, there has been relatively little discussion in the literature regarding the role of the ability-to-pay fairness concept in analyzing international tax policy issues.[143] This may be because the composition of international investment historically has been dominated by the direct foreign investments of multinational corporations, which pose perplexing issues in evaluating fairness concerns.[144] Even if true, however, this is an inadequate reason to forego analysis of fairness considerations when scrutinizing the important international dimension of a modern income tax.[145] We now turn to an examination

corporate rate reduces the incentives for shifting income out of the United States, which both loses revenue and magnifies the attractiveness of investing in low-tax locations."); Jackson, above n 33, 899 (reporting on a Procter & Gamble financial executive arguing that "the United States must radically cut its corporate tax to attract capital and spur economic growth."); Martin A. Sullivan, 'Beyond the Conventional Wisdom: Rate Cuts Beat Expensing' (2008) 118 *Tax Notes* 456, 465 ("[A] rate cut reduces the incentive to artificially shift profits, and rate cuts equally attract high—and normal—profit investments across national borders."); Joel Slemrod and Jon Bakija, *Taxing Ourselves* (3d ed 2004) 193 ("Other things being equal, lower marginal rates are better for the economy.…"). See also Aviva Aron-Dine, 'Fiscally Responsible Corp. Tax Reform Could Benefit the Economy' (2008) 120 *Tax Notes* 691; Joint Comm., *Alternative U.S. tax Policies,* above n 6, 57 ("[T]he total tax burden on U.S. multinationals in the aggregate could be expected to increase [following replacement of the present U.S. international regime with a well-designed worldwide system] unless adoption of the system is accompanied by a reduction of the U.S. tax rate."). See Grubert and Altshuler, *Corporate Taxes,* above n 5, 5, 34-39 for a proposal to effect a revenue-neutral replacement of the present U.S. international system with a worldwide system.

[142] See Sara Murray, 'Study Finds Sharp Math, Science Skills Help Expand Economy', *The Wall Street Journal* (New York City) March 3, 2008, A2 (reporting on a study concluding that if U.S. students had achieved improvements in math and science called for by the National Governors Association nearly 20 years ago, U.S. GDP would be 2 percentage points higher today and 4.5 points higher in 2015). See also above n 84.

[143] Professor Michael Graetz has challenged "[t]he focus in the international income tax literature on economic efficiency to the exclusion of all other values" as a criterion for U.S. international tax policy and asserted that "deciding to tax income reflects a decision to place issues of fairness at the heart of tax policy debates. That commitment cannot be ignored simply because income traverses national borders." Graetz, Outdated Concepts, above n 47, 294, 307. For an article that focuses on fairness considerations in international taxation, See Nancy H. Kaufman, 'Fairness and the Taxation of International Income', (1998) 29 *Law and Policy in International Business* 145.

[144] See text accompanying below n 176-210.

[145] Moreover, since the 1990s, cross-border U.S. portfolio investment has exceeded U.S. multinationals' cross-border direct investment in volume. See NFTC, *International Tax Policy* above n 72 at 98-99; Graetz, Outdated Concepts*,* above n 47, 263-67. In the decade of the 1990s, cross-border direct investment increasingly was engaged in by private equity partnerships that amassed $1 billion or more from individuals and tax-exempt institutional investors.

of the role that fairness concerns, embedded in the ability-to-pay concept, play in justifying the U.S. policy of taxing U.S. residents on their worldwide incomes.

2 *Ability-to-Pay*

(a) The Deference Accorded to Ability-to-Pay

Ultimately, taxes that support any government and its direct expenditure programs are borne by individuals.[146] In that regard, the U.S. socio-economic consensus recognizes that one of the most important criteria for spreading the income tax burden among individual taxpayers is the proposition that this onus should be allocated on the basis of comparative economic well-being,[147] often referred to as ability-to-pay.[148]

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[146] See United States Treasury Department, *Distributional Analysis Methodology*, OTA Paper No. 85 (1999) 1 <http://www.ustreas.gov/offices/tax-policy/library/ota85.pdf> (hereinafter U.S. Treas. Dep't, *Distributional Analysis*); David F. Bradford, *Untangling the Income Tax* 33-34, 148-49 (1986); Slemrod and Bakija, above n 141, 72-85; George K. Yin, 'The Future Taxation of Private Business Firms', (1999) 4 *Florida Tax Review* 141,153-54 (hereinafter Yin, The Future).

[147] There is currently a sharp debate over whether economic well-being should be measured by reference to income that is both saved and consumed or only by reference to consumption. See, eg, U.S. Treas. Dep't, *Blueprints*, above n 108, 38-42; United States Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth* (1984) vol 1, 198-200 (hereinafter U.S. Treas. Dep't, *Tax Reform*); Joseph M. Dodge, J. Clifton Fleming, Jr. and Deborah A. Geier, *Federal Income Tax: Doctrine, Structure and Policy* (3d ed 2004) 67-76, 138-49; William D. Andrews, 'A Consumption-Type or Cash Flow Personal Income Tax' (1974) 87 *Harvard Law Review* 1113; Joseph Bankman and Barbara H. Fried, 'Winners and Losers in the Shift to a Consumption Tax' (1998) 86 *Georgetown Law Journal* 539: Bruce Bartlett, 'The End of Tax Expenditures As We Know Them?', (2001) 92 *Tax Notes* 413, 420-22; J. Clifton Fleming, Jr., 'Replacing the Federal Income Tax with a Postpaid Consumption Tax: Preliminary Thoughts Regarding a Government Matching Program for Wealthy Investors and a New Tax Policy Lens' (2006) 59 *Southern Methodist University Law Review* 617 <http://ssrn.com/abstract=940699>; John K. McNulty, 'Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform' (2000) 88 *California Law Review* 2095; Alvin C. Warren, Jr., 'Would a Consumption Tax Be Fairer Than an Income Tax?' (1980) 89 *Yale Law Journal* 1081. Moreover, the present income tax is generally recognized as being an income tax with important consumption tax elements. See, eg, U.S. Treas. Dep't *Blueprints*, above n 108, 33-35; Bradford, above n 146, 8, 28-29; Fleming and Peroni, Tax Expenditure Analysis, above n 10, 508-17. The current hybrid nature of the income tax does not, however, affect the analysis in this article because the U. S. income tax is predominantly based on the taxation of both income that is consumed and income that is saved, See Fleming and Peroni, Tax Expenditure Analysis, above n 10, 508-17, and the analysis herein is consistent with such a tax. This article is premised on the assumption that the United States will not in the foreseeable future rely principally on consumption taxes for federal revenue.

[148] See *Report on Double Taxation*, League of Nations Doc. E.F.S. 73.F.19. at 18 (1923), in Staff of Joint Committee on Taxation, *Legislative History of United States Tax Conventions* (1962) vol 4, 4003,4022 (hereinafter *Report on Double Taxation);* U.S. Treas. Dep't, *Blueprints*, above n 108, 1, 24; Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (4th ed, 1984) 232-240; Slemrod and Bakija, above n 141, 62-64, 163; Stephen G. Utz, *Tax Policy* (1993) 31-32, 41; Graetz, Outdated Concepts, above n 47, 295; Robert A. Green, 'The Future of Source-Based Taxation of the Income of Multinational Enterprises' (1993) 79 *Cornell Law Review* 18, 29; Martin J. McMahon. Jr. and Alice G. Abreu, 'Winner-Take-All Markets: Easing the Case for Progressive Taxation' (1998) 4 *Florida Tax Review* 1, 66-71; Robert L. Palmer, 'Toward Unilateral Coherence in Determining Jurisdiction to Tax Income' (1989) 30 *Harvard International Law Journal* 1, 9-10; Joseph T. Sneed, 'The Criteria of Federal Income Tax Policy' (1965) 17 *Stanford Law Review* 567, 574-80; see also U.S. Treas. Dep't. *Distributional Analysis,* above n 146, § 5. For a discussion of the use of fairness considerations in defining income, see Victor Thuronyi, 'The Concept of Income', (1990) 46 *Tax Law Review* 45.

Indeed, the familiar Schanz-Haig-Simons definition of income, see Henry Simons, *Personal Income Taxation* (1938) 50, is principally based on the ability-to-pay concept. See U.S. Treas. Dep't.

There are, of course, many occasions when ability-to-pay must yield to other considerations,[149] but it is usually given great weight in the domestic tax policy process.[150] There is no reason why it should not receive similar deference when international tax provisions are being scrutinized.

One may, of course, dissent from this consensus and contend that the tax burden should be allocated on some basis other than ability-to-pay. Nevertheless, since ability-to-pay is the prevailing fairness dogma under our current income tax system, its implications regarding the issue of worldwide versus territorial taxation should be analyzed even if one might prefer a different doctrinal approach.

(b) Whose Ability-to-Pay?

But whose ability-to-pay is relevant in an international context? Which individuals should be included in the group that bears the portion of government cost funded by the individual income tax? Certainly, individuals should be taken into account if their connection with U.S. society is so substantial that fundamental fairness requires their net incomes to be compared with the net incomes of other U.S. residents for purposes of making an equitable allocation of the tax burden under an ability-to-pay system.[151]

Those who continuously live year-round in the United States easily satisfy this standard but there is less clarity when the connection with the United States is less extensive. Congress has drawn lines to deal with this issue[152] and one can debate

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Blueprints, above n 108, 31; U.S. Treas. Dep't, *Distributional Analysis,* above n 146, § 5.1; Dodge, Fleming, and Geier, above n 147, 137; See also Joseph M. Dodge, 'What's Wrong with Carryover Basis Under H.R. 8' (2001) 91 *Tax Notes* 961, 971 (suggesting that the assignment of income doctrine, a core principle in the U.S. federal income tax, may be based on the ability-to-pay concept).

Ability-to-pay is a foundational principle in the income tax systems of many countries in addition to the United States. See Henry Ordower, 'Horizontal and Vertical Equity in Taxation as Constitutional Principles: Germany and the United States Contrasted', (2006) 7 *Florida Tax Review* 259, 304; Frans Vanistendael, 'Legal Framework for Taxation' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (1996) vol 1, 15, 22-23. The ability-to-pay principle has even been made a constitutional limitation on the power to tax income in Italy, Spain and Germany. See Frans Vanistendael, Legal Framework for Taxation at 15, 22-23. See also *Basic Facts About the United Nations, The United Nations: Organization* (2008) <http://www.un.org/aboutun/basicfacts/unorg.htm> at 30 October 2008 ("The fundamental criterion on which the scale of assessments is based is the capacity of countries to pay.").

For recent criticism of the ability-to-pay concept, see Liam Murphy and Thomas Nagel, *The Myth of Ownership* (2002) 20-30. For a recent vigorous defense of ability-to-pay see Joseph M. Dodge, 'Theories of Tax Justice: Ruminations on the Benefit, Partnership, and Ability-to-Pay Principles' (2005) 58 *Tax Law Review* 399 (hereinafter Dodge, Theories). For a discussion of difficulties that arise when individual utility, or welfare, is used as the principal fairness norm instead of ability-to-pay, see Brian Galle, 'Federal Fairness to State Taxpayers: Irrationality, Unfunded Mandates, and the "SALT" Deduction' (2008) 106 *Michigan Law Review* 805, 842-46.

[149] See 'Forward' in United States House of Representatives Committee on Ways and Means, *Tax Revision Compendium* (1959) vol 2, ix (hereinafter House Comm., *Compendium)*; Eric M. Zolt, *The Uneasy Case for Uniform Taxation*, (1996) 16 *Virginia Tax Review* 39, 99-101. These other considerations include economic efficiency, simplicity and administrability. See U.S. Treas. Dep't., *Blueprints*, above n 108, 1-2; U.S. Treas. Dep't, *International Tax Reform: An Interim Report* (1993) ch I. §§ A, B; U.S. Treas. Dep't, *Tax Reform*, above n 147, 13-20; Sneed above n 148, 567.

[150] See, eg, U.S. Treas. Dep't, *Tax Reform*, above n 147, 25-26; Sneed, above n 148, 579-80,601-02; See also McMahon and Abreu, above n 148, 65-71.

[151] See generally Staff of Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 98th Cong., 2d Sess. (1984) 463-65; *Report on Double Taxation*, above n 148, 18-20; Arnold and Mclntyre, above n 1, at 17; Ault and Arnold, above n 3, 347.

[152] See IRC § 7701(a)(4), (b) (1986 as amended).

whether the lines have been properly positioned.[153] That dispute, however, is outside the scope of this article and it leaves unaffected the basic principle that individuals substantially connected to the United States should have their net incomes taken into account in determining how the income tax will allocate the fiscal burden of the U.S. government. And, if an individual has such a connection, it seems clear that her entire net income[154] must be considered regardless of whether it is derived from U.S. or foreign sources.

(c) Ability-to-Pay and Source of Income

The source of net income is simply irrelevant to ability-to-pay.[155] The U.S. system of taxing the worldwide income of resident individuals is consistent with this

[153] For example, one can entertain good faith doubts about whether an individual who is present in the United States for 183 days in one year, but is never in the United States during any other year and has no ongoing U.S. ties, is properly treated by IRC § 7701(b)(3) (1986 as amended) as a U.S. tax resident for the single year during which she was physically present in the United States. See Cynthia Blum and Paula N. Singer, 'A Coherent Policy Proposal for U.S. Residence-Based Taxation of Individuals', (2008) 41 *Vanderbilt Journal of Transnational Law* 705. Objections can also be raised to treating U.S. citizens as residents when they have not recently lived in the United States. See Pamela B. Gann, 'The Concept of an Independent Treaty Foreign Tax Credit' (1982) 38 *Tax Law Review* 1, 58-69. The right of return to the United States that inheres in a long-term expatriate's retained U.S. citizenship is, however, a valuable privilege, see, eg, *Cook v Tait*, 265 US 45, 56 (1924), and an expatriate's decision not to renounce U.S. citizenship can be seen as evidence that the benefits of citizenship are worth facing an annual U.S. tax on worldwide income. See generally, Michael S. Kirsch, 'Taxing Citizens in a Global Economy' (2007) 82 *New York University Law Review* 443. Such questions of whether the U. S. residency rules are overly aggressive at the margins should not, however, obscure the fact that most individual taxpayers who are treated as U.S. tax residents have sufficient U.S. connections so that the U.S. tax treatment of their total incomes must be compared to that of other U.S. residents for purposes of applying the ability-to-pay concept. With respect to the residence of corporations, see Joseph L. Andrus, 'Determining the Source of Income in a Changing World' (1997) 75 *Taxes* 839, 848.

[154] Fairness considerations arguably are satisfied by allowance of a deduction, as opposed to a credit, for foreign taxes. See Kaufman, above n 143, 177-78 (arguing that both the foreign tax credit and exemption approaches to mitigating international double taxation should be viewed as tax expenditures that are inconsistent with the ability-to-pay principle); see also David Gliksberg, 'The Effect of the Statist-Political Approach to International Jurisdiction of the Income Tax Regime-The Israeli Case' (1994) 15 *Michigan Journal of International Law* 459, 469. Nonetheless, as discussed further in the text at notes 211-12, we believe that the efficiency and diplomatic gains that result from allowance of a foreign tax credit to mitigate double taxation properly supercede application of the fairness criterion in addressing the double taxation issue.

[155] See U.S. Treas. Dep't, *Blueprints*, above n 108, 98-99; Arnold and Mclntyre, above n 1, 4-6; Bradford, above n 125, 16; Ault and Bradford, above n 108, 11, 27, 31, 41; Roy Blough, 'Taxation of Income from Foreign Sources' in House Comm., *Compendium*, above n 149, 2145; Walter J. Blum, 'Tax Policy and Preferential Provisions in the Income Tax Base' in House Comm., *Compendium*, above n 149, 83-84; Gliksberg, above n 154, 468-69, 473: Green, above n 148, 29; Lawrence Lokken, 'The Sources of Income from International Uses and Dispositions of Intellectual Property' (1981) 36 *Tax Law Review* 235, 239 (hereinafter Lokken, Sources); Peggy B. Musgrave, 'Consumption Tax Proposals in an International Setting' (2000) 54 *Tax Law Review* 77, 80 (hereinafter Musgrave, Consumption Tax Proposals); Peggy B. Musgrave, 'Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm; A Comment' (1992) 45 *National Tax Journal* 179,181-82; Peroni, Back to the Future, above n 68, 981 -82. For a view that an ability-to-pay "comprehensive income tax base is, at least theoretically, susceptible to division by source." see Kaufman, above n 143, 174-75.

One commentator offers a dissenting view on this point. See Klaus Vogel, 'World-wide vs. Source Taxation of Income – A Review and Reevaluation of Arguments', in *Influence of Tax Differentials in International Competitiveness* (1990) 117, 157. He argues that foreign-source income should not be taxed by a residence country until it is remitted thereto because before then, it is not enjoyed in the residence country and it remains subject to investment risks in the foreign country. This argument

conclusion;[156] an exemption or territorial system, under which foreign-source income is excluded from the tax base, is fundamentally inconsistent.

To illustrate this point, consider hypothetical individuals A and B who live year-round in the United States. A always earns $8,000 of U.S.-source net income per year as a full-time convenience store clerk while B wholly owns a U.S. limited liability company (a transparent entity whose income is taxed directly to the owner or owners) which always earns $8,000 per year of U.S.-source net income and $10 million per year of net income sourced to active branch operations in low-tax Country X.[157] Under a pure territorial system, only A's and B's $8,000 of U.S.-source income would be taken into account for income tax purposes.[158] Stated differently, a territorial system would allocate the fiscal burden of the U.S. government between A and B as if they had equal abilities-to-pay and both would remit the same amount of tax.

This is clearly the wrong answer.[159] There is nothing about foreign-source income that excuses it from being taken into account in allocating the tax burden between A and B under a tax system based on the ability-to-pay concept. A's and B's comparative abilities to pay can be properly measured only by including B's foreign-

overlooks three critical facts. First, foreign-source income reinvested offshore has an immediate wealth increase effect that enhances the taxpayer's ability-to-pay out of residence country resources. Second, where significant currency controls or other foreign law restrictions prevent the all-events test from being satisfied with respect to foreign-source income of accrual method taxpayers, or prevent the receipt requirement from being satisfied with respect to foreign-source income of cash method taxpayers, the taxpayers will be relieved from recognizing the affected income by the ordinary operation of the U.S. tax system. See, *eg*, Treasury Regulation § 1.451-l(a). If this is not regarded as an adequate remedy for the problem of foreign legal barriers to income repatriation, consideration could be given to a narrowly focused provision that defers inclusion of the income for as long as it is subject to such restrictions. See IRC § 964(b) (1986 as amended). Third, the investment risk objection is relevant to ability-to-pay only if the risk resolves adversely and a loss actually occurs. If this happens, the proper response by the tax system is to allow the taxpayer a deduction when the loss is sustained, provided that the loss represents income that was previously included in gross income under the taxpayer's accounting method.

The exercise of taxing jurisdiction over the foreign-source income of residents is clearly acceptable under international norms. See, eg, American Law Institute, *Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons* (1986) 4-6; American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States* (1987) § 412(l)(a); Ault and Arnold, above n 3, 345; Gustafson, Peroni and Pugh, above n 1, 14-15.

[156] See Peroni, Back to the Future, above n 68, 981-82. The U.S. view is expressed in IRC § 61 (a) (1986 as amended), which defines gross income as "all income from whatever source derived."

[157] A might also receive government transfer payments, including an earned income tax credit, that should be taken into account for purposes of determining whether the allocation of the tax burden between A and B properly reflects their comparative abilities-to-pay. See U.S. Treas. Dep't. *Distributional Analysis*, above n 125, § 5.1; J. Clifton Fleming. Jr., 'Renewing Progressive Taxation by Relying More on Spending' (1993) 60 *Tax Notes* 802; Barbara H. Fried, 'The Puzzling Case for Proportionate Taxation' (1999) 2 *Chapman Law Review* 157, 182-83. Transfer payments would, however, have little effect on the differences between A's and B 's ability-to-pay and they are left out of the analysis to simplify it.

[158] See Gustafson, Peroni and Pugh, above n 1, 19; See also Palmer, above n 148, 15 ("a home country's exemption of income earned through a foreign economic relationship presents greater problems in effectuating the fairness doctrine than does a properly designed foreign tax credit regime").

[159] Because B's income is vastly larger than A's, the ability-to-pay fairness concept clearly would be violated by a U.S. territorial system that imposed identical tax liabilities on A and B. This conclusion is sufficient for our purposes; there is no need to analyze the A-B example in terms of vertical and horizontal equity. However, if other observers would prefer to describe equal taxation of A and B in this example as a violation of the principle of vertical equity, we have no quarrel with their doing so. See, eg, OECD, *Tax Effects,* above n 5, 95; Avi-Yonah, Globalization*,* above n 101, 1616.

source net income in the calculus.[160] Current law accomplishes this result by ignoring the LLC for tax purposes, treating the LLC's entire net income as taxable to B[161] and imposing a much larger tax on B than on A.[162]

(d) Compared to Whom?

One could argue that if individual C is an X Country resident who also earns $10,000,000 of X Country-source business income and pays the low X Country rate thereon, fairness requires the A-B comparison to be replaced with a B-C comparison and requires that B's $10,000,000 X Country-source income be exempted from the U.S. tax base so that this income bears only the low X Country tax paid by C.[163] If, however, the U.S. Congress decides to tax U.S. residents' entire taxable incomes at a high rate (with a credit for foreign taxes) and Country X decides to impose tax at a low rate on its residents and on income sourced within its borders, there is no fairness-based reason why the level of X Country source-based taxation should dictate the U.S. conception of fairness with respect to U.S. residents. Each country has the right to decide the notions of tax fairness that will prevail with respect to members of its society.[164] Moreover, if X Country's tax rate on B's and C's Country X-source income

[160] See authorities cited in above n 155. Although this conclusion is sometimes justified as necessary to prevent avoidance of the individual income tax's progressive rate structure, See U.S. Treas. Dep't, *Blueprints*, above n 108, 99; Vito Tanzi, *Taxation in an Integrating World*, 77-78 (1995); Reuven S. Avi-Yonah, 'The Structure of International Taxation: A Proposal for Simplification' (1996) 74 *Texas Law Review* 1301, 1311-12; Lee Burns and Richard Krever, 'Individual Income Tax' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (1998) vol 2, 495,496-97; Graetz, Outdated Concepts, above n 47, 333: Green, above n 148, 29; Julie Roin, 'Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems' (1995) 81 *Virginia Law Review* 1753, 1761 (hereinafter Roin, Rethinking); 'Introduction' in Victor Thoronyi (ed), *Tax Law Design and Drafting* (1998) vol 2, xxi-xxiii, the conclusion is fully applicable to a single-rate income tax, See Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (1953) xvii; See also below n 162. Many of those who prefer to subdivide the ability-to-pay concept into horizontal and vertical equity components would argue that including B's foreign-source income in the tax base is necessary to satisfy both components irrespective of concerns about progressivity.

[161] See Treasury Regulation §§ 301.7701-3(a), (b)(1)(ii). There are narrow exceptions to this general approach of imposing worldwide taxation on U.S. residents. See, eg, IRC § 911 (1986 as amended) (exclusion of a limited amount of foreign earned income and certain qualified housing amounts).

[162] See generally IRC § 1 (1986 as amended).

The current Internal Revenue Code imposes progressive rates on the incomes of individuals (and on corporations as well, see IRC § 11) (1986 as amended). Although we are supporters of this approach (at least with respect to individuals) we have chosen to defer our advocacy in behalf of progression. Thus, in this article when we assert that B's $10 million of foreign-source net income should be included in her U.S. taxable income and that she should pay a larger tax than A, we are saying nothing about what the rate of should be on A's $8,000 of net income or whether any part of B's income should be taxed at a rate higher than the rate applicable to A's net income. Stated differently, in this article, we do not, and need not, enter the debate over whether tax rates are too low or too high, or the debate regarding whether the income tax should be progressive and if so, how progressive. Instead, we limit ourselves to arguing that because B's income is 1,251 times larger than A's, B should pay a tax that is at least 1,251 times larger than the amount paid by A.

For a sampling of the rich literature on the progressive taxation controversy, see Blum and Kalven, above n 160; McMahon and Abreu, above n 148.

[163] See generally Klaus Vogel, 'The Search for Compatible Tax Systems', in Herbert Stein (ed) *Tax Policy in the Twenty-First Century* (1988) 76, 85; Vogel, above n 155, 156-57.

[164] See American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States* (1987) §§ 411-413; Commission of the European Communities, *Tax Policy in the European Union-Priorities for the Years Ahead* (2001) 9, 25; Avi-Yonah, Globalization, above n 101, 1629; Graetz, Outdated Concepts, above n 47, 277-282; Julie Roin, 'Competition and Evasion: Another Perspective

were higher than the U.S. rate on B's Country X-source income, it would be difficult to find advocates for the view that the B-C comparison compels the United States to raise its rate on B's Country X income up to the Country X rate (so that B would not have any X Country tax in excess of the U.S. credit that could be cross-credited against low foreign taxes on other income or carried back to a prior year or forward to future years).[165]

3 *What if Everybody Can Do It?*

(a) A Self-Inflicted Wound?

Assume that the United States has adopted an exemption system and that U.S. residents E and F each has sufficient capital to invest in a business that will produce before-tax net income of $10 million per year. Assume further that all U.S. residents have ready access to foreign investment opportunities. E chooses to acquire a business in low-tax Country X. Therefore, he pays no U.S. tax on his $10 million of Country X-source income. F could do the same as E but, instead, she acquires a U.S. business. As a result, she pays U.S. tax on her $10 million of U.S.-source income. Some analysts would argue that this disparate treatment of E and F does not contravene the ability-to-pay principle. This is because we are assuming that F had an equal opportunity to make a Country X investment annually yielding $10 million of foreign-source net income. Under this assumption, the fact that the United States imposes a heavier tax on F’s U.S.-source income of $10 million than on E’s foreign-source income of the same amount is due entirely to F’s affirmative choice to earn U.S.-source income instead of exempt Country X-source income. Thus, some commentators would argue that although this hypothetical exemption system is a poorly designed tax expenditure that improperly encouraged E to make a foreign investment that may be economically inferior, F is the victim of a “self-inflicted wound”[166] and is not suffering from a violation of the ability-to-pay norm.[167]

We disagree with this argument because it is impractical to measure ability-to-pay in terms of forgone opportunities. The only feasible way of comparing the abilities-to-pay of separate taxpayers is by looking at their *actual incomes* from all sources.[168]

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on International Tax Competition’ (2001) 89 *Georgetown Law Journal* 543, 597 (hereinafter Roin, Competition); Stanley S. Surrey, ‘Current Issues in the Taxation of Corporate Foreign Investment’ (1956) 56 *Columbia Law Review* 815, 824; Alvin C. Warren, Jr, ‘Alternatives for International Corporate Tax Reform’ (1994) 49 *Tax Law Review* 599,612; See also Dan R. Mastromarco, ‘Department of Treasury Exercises Good Judgment on OECD Initiative’ (2001) 91 *Tax Notes* 1623, 1624; Daniel J. Mitchell, ‘OECD Tax Competition Proposal: Higher Taxes and Less Privacy’ (2000) 89 *Tax Notes* 801, 814-15; U.S. Treasury Secretary Statement on OECD Tax Havens (2001) 22 *Tax Notes International* 2617; Letter from Congressman Dick Armey to Secretary of the Treasury Lawrence Summers (Sept.7, 2000), reprinted in (2000) 88 *Tax Notes* 1539, 1540.

[165] See Mitchell, above n 164, 803-06, 814-15, 821-22; Surrey, above n 164, 825 (“when all of the recommendations of these organizations for eliminating double taxation are added up, the basic jurisdictional rule they suggest is not that of the country of citizenship and not that of the country of source, but rather that of the country with the lowest tax rate.”).

[166] Boris I. Bittker, ‘Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?’ (1979) 16 *San Diego Law Review* 735, 739.

[167] See Ault and Bradford, above n 108, 29-30; Zolt, above n 149, 91-92.

[168] See U.S. Treas. Dep’t, *Blueprints*, above n 108, 3, 159-62; U.S. Treas. Dep’t, *Tax Reform,* above n 147, 14-15, 37-42; Blum and Kalven, above n 160, 64; Bradford, above n 146, 16-19, 155-56. See also Dodge, Theories*,* above n 148, 449 (arguing for taking an objective approach when defining ability-to-pay).

Thus, the predominant approach to measuring ability-to-pay would regard the disparate U.S. taxation of E's and F's equal incomes as violating the ability-to-pay concept.

A more fundamental problem with this "self-inflicted wound" analysis, however, arises from its critical assumption that opportunities to earn foreign-source business income are freely and equally available to all U.S. residents. This is plainly not correct. There are barriers of distance, language, custom and unfamiliar and complex legal regimes that exclude numerous U.S. residents from the opportunity to earn foreign-source business income with anything approaching the foreign income earning facility of other U.S. residents. Consequently, the assumption in the preceding example of equal access to foreign-source income is unrealistic and in the real world, the fact that F pays a heavier U.S. tax on her income than does E cannot necessarily be dismissed as a result of F's bad judgment. This point is especially important with respect to labor income. The wage income that dominates the earnings of most individual taxpayers is far less mobile than other business income. Indeed, most of the international income earned by U.S. residents is from capital – either direct or portfolio investment of capital.[169] Thus, the key premise of the preceding discussion, equal opportunity to earn foreign-source business income, does not really exist so long as there are disparities in wealth among taxpayers that result in some U.S. residents being able to earn foreign-source income from investing mobile capital while many more U.S. residents are effectively limited to earning relatively immobile wage income from U.S. sources.

(b) Portfolio Investment as a Possible Answer

Some would point out at this juncture that although A and F might not have a ready opportunity to earn foreign-source business income from foreign direct investment, there are abundant opportunities for U.S. residents to earn foreign-source portfolio income by purchasing shares in foreign companies and by investing in mutual funds that buy foreign securities.[170] This point is not responsive, however, because the advocates of a U.S. exemption system do not ordinarily contemplate that the system would cover foreign-source passive income.[171] This reluctance is probably due to the fact that a generally available zero U.S. rate for offshore passive income would be seen as inconsistent with a fundamental feature of an income tax, as opposed to a consumption tax, namely, that income from capital should be taxed.[172] Moreover, the exemption of foreign-source portfolio investment income from U.S. taxation would

[169] For 1998, aggregate U.S. income receipts on non-government U.S. assets owned abroad were $252,247,000,000, while employee compensation earned abroad by Americans was $1,857,000,000. See United States Department of Commerce, *Statistical Abstract of the United States* (1999) 790; See also Avi-Yonah, Globalization, above n 101, 1617-18; Green, above n 148, 60.

[170] See Ault and Bradford, above n 108, 29-30.

[171] U.S. Treas. Dep't, *Approaches,* above n 2, 54-63; Advisory Panel, *Proposals,* above n 18, 134. Indeed, countries that have adopted exemption systems have typically excluded foreign-source portfolio income from their exemption regimes. See Ault and Arnold, above n 3, 372-73.

[172] See Dodge, Fleming and Geier, above n 147, 138-49; Grubert and Newlon, above n 10, 623 ("[I]ncome from passive, or portfolio, foreign investment could not realistically be exempted without leading to substantial erosion of the taxation of capital income"); Stephen E. Shay and Victoria P. Summers, 'Selected International Aspects of Fundamental Tax Reform Proposals' (1997) 51 *University of Miami Law Review* 1029, 1032-33.

likely encourage U.S. residents to effect a large shift of passive investments from the United States to low- or zero-tax rate foreign jurisdictions.[173]

(c) Implicit Taxes as a Possible Answer

But suppose the exemption system adopted by the United States causes internationally sophisticated U.S. residents to engage in so much direct investment in Country X that the before-tax rate of return on B's active business investments in Country X is driven down to a point where B's after-tax return on those investments equals the after-tax rate of return available to A on U.S. investments. Exemption system advocates could argue that the ability-to-pay objection to the hypothetical U.S. exemption system has been eliminated because B is now paying an implicit tax[174] on her Country X income, in the form of a decreased before-tax rate of return, that results in her greater income bearing a larger aggregate tax than A's smaller income.

The problem with this line of argument is that implicit taxes are not collected by governments. Thus, the implicit tax paid by B, in the form of a lower before-tax rate of return on her Country X investment, does not go to the U.S. Treasury and, therefore, it does nothing to increase the portion of the cost of the U.S. government borne by B vis-a-vis A. Stated differently, the implicit tax borne by B fails to correct the misallocation of the U.S. tax burden that exists between A and B if A pays the same amount of U.S. tax as B. Nor does the implicit tax go to the Country X Treasury where it would support a claim by B against the United States for double taxation relief.[175] In short, the implicit tax suffered by B does not solve the ability-to-pay objection to the hypothetical U.S. exemption system. Thus, there seem to be no market dynamics undermining the critical observation that the ability-to-pay principle requires B's larger income to bear a greater U.S. tax than A's smaller income and that an exemption system produces a contrary result.

[173] Of course, many types of modern business income are also quite mobile and that is one key reason why an exemption system for foreign business income would likely lead to tax-motivated business investment in low-tax foreign countries. See U.S. Treas. Dep't, *Deferral*, above n 47, 44-45,182-84,197-209.

[174] For explanations of implicit taxes, see U.S. Treas. Dep't, *Blueprints*, above n 108, 152-53; George Cooper, 'The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance' (1985) 85 *Columbia Law Review* 657, 698-99; Fleming and Peroni, Tax Expenditure Analysis, above n 10, 446-47, 461-68; Harvey Galper and Dennis Zimmerman, 'Preferential Taxation and Portfolio Choice: Some Empirical Evidence' (1977) 30 *National Tax Journal* 387, 388; Calvin H. Johnson, 'Inefficiency Does Not Drive Out Inequity: Market Equilibrium and Tax Shelters' (1996) 71 *Tax Notes* 377, 381-82; Stanley S. Surrey and Paul R. McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974' (1976) 17 *Boston College Industrial and Commercial Law Review* 679, 702-06; Edward Yorio, 'Equity, Efficiency, and the Tax Reform Act of 1986' (1987) 55 *Fordham Law Review* 395, 397-400. On these facts, of course, the exemption system produces an inefficient result in the sense that it induces U.S. residents to over-invest in Country X. See Altshuler, above n 101, 1581; Avi-Yonah, Globalization, above n 101, 1604-05; Zolt, above n 149, 92.

[175] Moreover, it is doubtful that the flow of direct investment capital into low-tax foreign countries would be sufficient to result in a convergence of after-tax rates of return. See NFTC, *International Tax Policy,* above n 72, 116. With respect to the failure of after-tax rates of return on tax exempt municipal bonds and taxable bonds to converge, see Johnson, above n 174, 377. But see Hines, *Reconsidering,* above n 72, 34 (arguing that implicit taxes redress fairness concerns even if the implicit taxes inure entirely to the benefit of non-governmental parties).

4 *U.S. Corporations and Ability-to-Pay*[176]

(a) The Need for an Anti-Deferral Device

Some commentators apparently concede that the preceding analysis establishes a persuasive case for worldwide taxation of U.S. resident individuals but, nevertheless, they are attracted to U.S. exemption treatment for the foreign-source income of U.S. resident C corporations.[177] (In U.S. federal income tax law, a C corporation is a company that is subjected to a corporate-level income tax and whose income is not taxed to its shareholders until distributed as dividends.) This raises the question of whether the preceding ability-to-pay analysis is applicable to income earned through C corporations.

A useful way to pursue an answer is to revisit the preceding example in which U.S. resident individual B owns a U.S. LLC earning $8,000 per year of U.S.-source net income and $10 million per year of active business net income in low-tax Country X. Now assume that B converts her wholly owned LLC into a U.S. C corporation named USCo. B then sells half of her new USCo stock in a public offering to 10,000 residents of Country X and donates the stock sales proceeds to her favorite law school as an endowment for a tax law chair. Thereafter, the shares of USCo are traded on an established securities market. On these facts, B's amounts of U.S.-source and foreign-source income are reduced by half to $4,000 and $5 million respectively (she owns only 50% of the USCo stock), but both amounts should be taken into account for U.S. income tax purposes in measuring B's ability to pay vis-a-vis low-income A. This result would be achieved directly if C corporation income were taxed to shareholders under a pass-through integration regime based on the principles of Subchapter K or S.[178] This is not, however, the way that the United States generally taxes C corporations. The income of a U.S. C corporation[179] is typically subjected to both a corporate-level tax as it is earned by the corporation and also to a shareholder-level tax at the, perhaps distant, time when the shareholders receive the income from the corporation or sell their shares.[180]

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[176] For the sake of simplicity, we assume throughout the remainder of this article that all shareholders are individuals unless otherwise stated. Thus, we reserve for a future article a discussion of the extent to which look-through rules are appropriate where stock is owned by juridical entities.

[177] See Herman B. Bouma, 'Further Support for Territorial Taxation' (2000) 87 *Tax Notes* 580; Graetz, Outdated Concepts, above n 47, 325-31, 333-35; Tuerff, Shaviro, Shackelford, McDonald and Mundaca, above n 11, 76-78.

[178] See IRC §§ 702(a), 1366(a) (1986 as amended); Jeffrey L. Kwall, 'The Uncertain Case Against the Double Taxation of Corporate Income' (1990) 68 *North Carolina Law Review* 613, 629. For a description of such an integration scheme, see U.S. Treas. Dep't *Blueprints*, above n 108, 69-73, 98-100. Some of the most prominent recent integration proposals have, however, regarded this approach to integration as unfeasible and have advocated schemes that rely on a corporate-level tax. See United States Treasury Department, *Integration of the Individual and Corporate Tax Systems* (1992) 39-49 (hereinafter U. S. Treas. Dep't, *Integration*); American Law Institute, *Integration of the Individual and Corporate Income Taxes* (1993) 92-94 (hereinafter American Law Institute, *Integration*).

[179] In the example in the text, the number of shareholders and the nonresident alien status of 10,000 of them will prevent taxpayer B from using a Subchapter S election to get her corporation out of C status. See IRC § 1361(b)(1) (1986 as amended). Moreover, if B had forgone conversion of her LLC to a C corporation and had, instead, sold half her interest in profits and capital to 10,000 investors, the probable public trading in the ownership interests of taxpayer B's LLC would prevent the LLC owners from avoiding C status by failing to formally incorporate the LLC. See IRC § 7704 (1986 as amended) and assume that IRC § 7704(c) (1986 as amended) is inapplicable.

[180] See IRC §§ 11, 61(a)(3), (7) (1986 as amended). The shareholder-level tax is not reduced by credits reflecting corporate-level tax. Thus, the corporate-level and shareholder-level income taxes function as

This taxation scheme cannot be explained on ability-to-pay grounds because liability under the corporate-level tax is calibrated to the taxable income of the corporation and bears no necessary relationship to the respective abilities to pay of any individuals.[181] Thus, several rationales other than ability- to-pay have been proposed as justifications for the corporate-level tax and there is disagreement regarding which of these is the "best" and, indeed, whether the basic concept of a separate, unintegrated corporate income tax is defensible at all.[182] The merits of this controversy are outside the scope of this article. More importantly, in spite of this dispute over the theoretical justification for a separate, unintegrated tax on corporate income, there is broad agreement that because pass-through treatment cannot be practically imposed on corporations with large numbers of shareholders[183] and because Congress is quite unlikely, in the near term, to adopt other means of currently taxing shareholders on corporate income through integration of the corporate and individual income taxes, the present corporate-level tax must be maintained as a crude, second-best anti-deferral device.[184] Otherwise, C corporation shareholders

independent, cumulative levies. This article assumes that this classical double taxation of C corporation income will continue as the general pattern under the Internal Revenue Code for the foreseeable future even though we believe that integration of the corporate and shareholder income taxes would be a desirable policy move.

Double taxation is avoided in the cases of domestic C corporations reporting their income with a parent corporation on a consolidated return, see IRC §§ 1501-1504 (1986 as amended), and certain wholly owned domestic subsidiaries of S corporations, see IRC § 1361(b)(3) (1986 as amended).

[181] See IRC § 11(a), (b)(1); M. Slade Kendrick, 'Corporate Income Tax Rate Structure' in House Comm., *Compendium*, above n 149, at 2289, 2297; Yin, The Future, above n 146, 152. Because the corporate-level tax is generally regarded as borne by living taxpayers and not the entity itself, the question of a C corporation's ability-to-pay is commonly viewed as irrelevant. See U.S. Treas. Dep't, *Blueprints*, above n 108, 4; Graetz, Outdated Concepts, above n 47, 301-02; See also Katherine Pratt, 'The Debt-Equity Distinction in a Second-Best World' (2000) 53 *Vanderbilt Law Review* 1055, 1113-14.

[182] See Calvin H. Johnson, 'Replace the Corporate Tax with a Market Capitalization Tax' (2007) 117 *Tax Notes* 1082; American Law Institute, *Integration*, above n 178, 44-46; American Law Institute, *Taxation of Private Business Enterprises* (1999) 51-55, 59-63; Bradford, above n 146, 103; Jeffrey A. Maine, 'Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises' (2000) 62 *University of Pittsburgh Law Review* 223, 241-44, 253-57: Pratt, above n 181, 1100-03, 1109-10. With respect to the historical origins of the corporate-level tax, see Stephen A. Bank, 'Entity Theory as Myth in the Origins of the Corporate Income Tax' (2001) 43 *William and Mary Law Review* 447; Majorie E. Kornhauser, 'Corporate Regulation and the Origins of the Corporate Income Tax' (1990) 66 *Indiana Law Journal* 53.

[183] See Graeme S. Cooper and Richard K. Gordon, 'Taxation of Enterprises and Their Owners' in Victor Thuronyi (ed), *Tax Law Design and Drafting* (1998) vol 2, 811, 817 ; Pratt, above n 181, 1112-13; George K. Yin, 'Corporate Tax Integration and the Search for the Pragmatic Ideal' (1992) 47 Tax Law Review 431, 434 (1992) (hereinafter Yin, Ideal); see also U.S. Treas. Dep't, *Integration*, above n 178, 27-35. Among other things, large numbers of shareholders imply frequent trading in a corporation's stock which creates difficulties in allocating income and losses to the shareholders. For contrary views asserting that a pass-through system can be constructed for corporations with large numbers of shareholders, see U.S. Treas. Dep't, *Blueprints*, above n 108, 69-74; Yin, The Future, above n 146, 195-96.

[184] See OECD, *Tax Effects*, above n 5, 95-96; U.S. Treas. Dep't, *Integration*, above n 178, 189 n.1; U.S. Treas. Dep't, *Tax Reform*, above n 147, 118-21; J.D.R. Adams and J. Whalley, *The International Taxation of Multinational Enterprises in Developed Countries* (1977) 8; American Law Institute, *Integration*, above n 178, 94; Bradford, above n 146, 55; Jane G. Gravelle and Thomas L. Hungerford, *Congressional Research Service Report for Congress, Corporate Tax Reform: Issues for Congress* (2007) 4; Joseph A. Pechman, *Federal Tax Policy* (5th ed. 1987) 136; Slemrod and Bakija, above n 141, 275; Ault and Bradford, above n 108, 37; Cooper and Gordon, above n 183, 812-13; Malcolm Gammie, 'The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement' (1994) 49 *Tax Law Review* 615, 628-29; Graetz, Outdated Concepts, above n 47, 302;

would be able to completely defer taxation until they withdrew the corporations' earnings (or sold their shares), thus achieving a deferral of U.S. tax that is not available to the owners of closely held businesses[185] taxed under the Subchapter K or S pass-through regimes. Indeed, we believe that the anti-deferral effect of the present U.S. corporate income tax is the only persuasive reason for a large, unintegrated levy on corporate earnings.

(b) The Overbreadth of the Corporate Income Tax

The corporate-level income tax, however, is indeed a crude anti-deferral instrument for three reasons. First, its rates (15% to 35%) bear no direct relationship to the length of time that the shareholder-level tax is deferred. Thus, the corporate-level tax is usually either greater than, or less than, the amount necessary to offset the economic benefit gained from deferring the shareholder-level tax. Second, the corporate-level tax in the preceding example may be partially shifted to investors in the noncorporate sector and to USCo's customers and suppliers of materials and labor,[186] none of whom are engaged in deferring shareholder-level tax on shares of USCo's income.[187] Finally, USCo may satisfy the 80% active foreign business requirement of Sections 871(i)(2)(B) and 881(d) so that the part of the dividends received by USCo's foreign shareholders that is proportionate to the corporation's foreign-source gross income would be exempt from U.S. tax.[188] To that extent, the foreign shareholders are not engaging in deferral of investor-level tax with respect to USCo's income and they are not proper targets of the corporate-level anti- deferral regime. Moreover, a pass-through tax regime modeled on Subchapter K would relieve the foreign shareholders from paying tax on the $5 million of USCo's foreign-source net income that is attributable to them.[189] Therefore, it is inappropriate to apply a corporate-level anti-deferral tax to that income even if USCo does not satisfy the 80% foreign business

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Kwall, above n 178, 629-30; see also U.S. Treas. Dep't, *Deferral*, above n 47, 4; Utz, above n 148, 177-78; Pratt, above n 181, 1115; Rebecca S. Rudnick, 'Who Should Pay the Corporate Tax in a Flat Tax World' (1988-89) 39 *Case Western Reserve Law Review* 965, 1066-69; Joseph A. Snoe, 'The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distribution Tax' (1993) 48 *University of Miami Law Review* 1, 43; David A. Weisbach, 'The Irreducible Complexity of Firm-Level Income Taxes' (2007) 60 *Tax Law Review* 215, 217.

Of course, if the corporate-level tax were integrated with the shareholder-level tax, the corporate-level tax could continue to serve its anti-deferral function without imposing the double tax result that characterizes the present approach to taxing C corporations. There is, however, no near-term likelihood of such an integration scheme being adopted in the U.S.and this article assumes continuation of the current regime of C corporation taxation, no matter how ill-advised that may be from a tax policy standpoint.

[185] Generally speaking, only closely held businesses can qualify for the Subchapter K or S passthrough regimes.

[186] See U.S. Treas. Dep't, *Blueprints*, above n 108, 4-5; U.S. Treas. Dept, *Distributional Analysis*, above n 146, § 6.4; U.S. Treas. Dep't, *Integration*, above n 178, 146-47; William M. Gentry, *United States Treasury Department Office of Tax Analysis Paper 101, A Review of the Evidence on the Incidence of the Corporate Income Tax* (2007) <http://www.ustreas.gov/offices/tax-policy/library/ota101.pdf>; Bradford, above n 146, 136-39; Slemrod and Bakija, above n 141, 76-77; William A. Klein, 'The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics', 1965 *Wisconsin Law Review* 576; Pratt, above n 181, 1108; Roin, Competition, above n 164, 576-77.

[187] See Kwall, above n 178, 635 n.115.

[188] See IRC §§ 861(c), 871 (i), 881 (d) (1986 as amended).

[189] See IRC §§ 871, 881 (1986 as amended); Treasury Regulation § 1.1441-5(b)(2)(i); Rev. Proc. 89-31, 1989-1 C.B. 895.

requirement. Nevertheless, under current law the foreign shareholders' entire portion of USCo's income bears U.S. corporate-level tax to the extent that the tax burden is not shifted to others.

We should note, however, that the first two of these criticisms (the lack of relationship between the corporate-level tax rates and the deferral period and the partial shifting of the corporate-level tax) apply even if a C corporation's income is entirely from U.S. sources. Only the third criticism (that the corporate-level tax reaches foreign stockholders' shares of foreign-source corporate income) is directly relevant to the issue of whether a U.S. corporation's foreign-source income is properly subject to the corporate-level tax. Moreover, the cure for this third criticism (as well as the first two) lies in the United States adopting a responsive integration system. Thus, the imprecision of the corporate-level tax does not present a case for exempting the foreign-source income of U.S. C corporations.[190] Instead it presents a case for a corporate integration regime that would (1) relieve foreign shareholders of U.S. tax on their portion of corporate foreign-source income, but (2) also uphold the ability-to-pay principle by imposing current U.S. tax on all corporate income (foreign-source as well as U.S.-source) attributable to U.S. resident shareholders.[191]

(c) Searching for the Lesser Evil

Unfortunately, the United States has not adopted the necessary integration scheme and is unlikely to do so in the near future. Thus, the federal income tax system continues to require a corporate-level tax that functions as a second-best anti-deferral device. This means that although exempting foreign-source income of U.S. C corporations from the corporate-level tax would cure the over breadth of that tax with respect to foreign-source income attributable to foreign shareholders, it would do so at the cost of allowing U.S. stockholders to substantially remove their shares of corporate foreign-source income from the U.S. tax base by causing U.S. C corporations to defer distributions until the present value of the shareholder-level tax shrinks to insignificance.[192] This would effectively defeat the ability-to-pay principle, which requires that both U.S.-source and foreign-source income be included in determining a U.S. resident's appropriate share of the expense of government. Stated more broadly, granting exemption from the corporate-level tax for all foreign-source income of U.S. C corporations would allow U.S. resident individuals to escape the

[190] See also U.S. Treas. Dep't, *Deferral*, above n 47, 35; Avi-Yonah, Globalization, above n 101, 1609.

[191] For a description of such an integration regime, See U.S. Treas. Dep't, *Blueprints*, above n 108, 69-73, 98-100.

[192] Neither the U.S. domestic nor international anti-deferral regimes are serious threats to this tax planning approach. See generally Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (7th ed, 2000) ch. 7; Joel D. Kuntz and Robert J. Peroni, *U.S. International Taxation* (5th ed, 1992) vol 1, chs. B2, B3; Peroni, Fleming and Shay, Getting Serious, above n 20, 460-64. Moreover, as discussed recently by the U.S. Treasury Department, exempting a C corporation's foreign-source income from U.S. tax while maintaining an entity-level tax on U.S.-source income would distort investment behavior by corporations:

> [R]educing only the tax on foreign investment income would cause domestic corporate investors to favor a foreign investment over a domestic alternative that has a higher pretax return. The tax bias against corporate investment [because of the U.S. double tax regime], by itself, does not provide a compelling reason to favor foreign or domestic corporate investments if the overall goal is to minimize distortions in investment decision.

U.S. Treas. Dept, *Deferral,* above n 47, 35. In other words, the appropriate solution to the overbreadth problem of the U.S. corporate tax is not lowering or eliminating the tax on only foreign-source income.

inclusionary requirement of the ability-to-pay principle by interposing a U.S. C corporation between themselves and their foreign-source income. By contrast, maintaining an unintegrated corporate-level tax on the worldwide income of U.S. C corporations would uphold the ability-to-pay principle with respect to U.S. shareholders but, as explained above,[193] would incorrectly tax the portion of the foreign-source income of U.S. C corporations that is attributable to foreign shareholders.

This difficult dilemma should be resolved in favor of sustaining the ability-to-pay principle with respect to U.S. shareholders by imposing U.S. corporate-level tax on the foreign-source income of U.S. corporations regardless of the presence of foreign shareholders. This is burdensome to the foreign shareholders but not unfair because the corporate-level tax is a clearly disclosed element of the U.S. tax system and nonresidents purchase the shares of U.S. corporations with their eyes wide open.[194]

(d) Defining Corporate Residence and Pursuing Runaway Corporations and Shareholders

In the preceding discussion, we have referred to corporations taxed by the United States on their worldwide incomes as "U.S. corporations" and "U.S. C corporations" without further explanation. We recognize that in taking this approach, we have oversimplified matters by acting as if the identification of such corporations were an obvious, non-controversial matter. We did so because this is, in fact, a difficult and complex issue and a thorough analysis would substantially detract from our focus on the international implications of the ability-to-pay principle. Nevertheless, the problem of identifying the corporations that should be subjected to U.S. taxation of their worldwide incomes has important implications regarding the ability-to-pay principle and a brief discussion is appropriate at this point.

A corporation is treated as a U.S. resident, taxed by the United States on its worldwide income, if it satisfies the Internal Revenue Code's definition of a "domestic corporation"—i.e., if it is incorporated under the laws of the United States, one of the 50 states or the District of Columbia.[195] Commentators have argued that when this place-of-incorporation rule is coupled with the U. S. worldwide taxation system, it creates the indefensible possibility of a corporation with no U.S. shareholders, no U.S. assets and no U.S.-source income incurring U.S. tax on its foreign-source income merely because it was incorporated in a U.S. jurisdiction.[196]

We recognize that when U.S. resident status is bestowed on a corporation owned exclusively by foreign shareholders and earning its income entirely outside the United States, the result is overtaxation of the foreign shareholders by the United States. We do not view this as a significant practical problem, however, because the universe of

[193] See text accompanying above n 186-91.

[194] This issue was presented in 1876 to the Exchequer Court under the British regime which taxed the worldwide income of British resident corporations. In upholding the imposition of this tax on the foreign-source income of a British resident corporation whose shares were owned primarily by nonresidents, Chief Baron Kelly stated, "that if a foreigner residing abroad ... thinks fit to come and invest his money in this country, and so to obtain the broad shield of protection of the law to his property, he must take it with the burdens belonging to it." *Calcutta Jute Mills Co v Nicholson and Cesena Sulphur Co v Nicholson*, (1876) 1 Reports of Tax Cases 83, 88,102.

[195] IRC §§ 11, 7701(a)(4), (5) (1986 as amended).

[196] See Herman B. Bouma, 'Two Arguments Against an Alternative View of Deferral' (2000) 20 *Tax Notes International* 875; H. David Rosenbloom, 'The David R. Tillinghast Lecture: International Tax Arbitrage and the "International Tax System"' (2000) 53 *Tax Law Review* 137, 139.

domestic corporations with no U.S. shareholders, no U.S. assets and no U.S.-source income is surely very small and nearly always the result of informed planning.[197]

A related suggestion has been made that the combination of the U.S. approach to defining corporate residency and the U.S. system of worldwide taxation will drive U.S. resident corporations to incorporate their new ventures (say Intel's development of its next-generation processor) in low-tax offshore jurisdictions.[198] The new corporations would then be foreign residents that escape current U.S. taxation of their foreign-source income. However, if runaway corporations are truly a threat to the U.S. income tax base, the problem can be properly addressed by expanding the definition of "domestic corporation." To be specific, if U.S. resident corporations incorporate their new product developments offshore, the United States could counter that tax-avoidance strategy by enlarging the definition of "domestic corporation" to include entities whose stock is held in significant percentages by U.S. residents.[199] Even better, the United States could totally end deferral of U.S. tax on income earned by U.S. shareholders through foreign corporations by applying a pass-through regime to such income.[200]

More importantly, the concept of corporate residence is critical to a system of worldwide taxation because only residents are taxed by their residence country on their worldwide incomes. Recently, Professor Michael Graetz has cast doubt on whether any definition of corporate residence, including the stock ownership approach suggested immediately above, is defensible or practical. His specific statements are:

> [I]n the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied with legal niceties….[201]
>
> …
>
> It is precarious to turn significant U.S. tax consequences on the status of a corporation as a resident or nonresident, given the difficulty of assessing the "true" residence of corporations, except in the case of closely-held companies where the residence of the owners easily can be determined. Linking corporate residence to the residence of its owners simply does not seem practical in the context of multitiered multinationals. On the other hand, insisting that a corporation's residence is the same as that of its managers or officers seems difficult to justify.[202]

Professor Graetz uses these assertions regarding the difficulty of formulating a defensible and feasible definition of corporate residence as an element in constructing a case for seriously considering exemption treatment of corporate foreign-source income by the United States.[203] We agree that any definition of corporate residence is inevitably artificial because corporations themselves are artificial beings. But as

[197] See Joel Slemrod, 'The Taxation of Foreign Direct Investment: Operational and Policy Perspectives' in James M. Poterba (ed), *Borderline Case* (1997) 11, 31. For example, towards the end of the boom in technology stocks, Israeli technology start-up companies were routinely formed as U.S. corporations in anticipation of issuing Nasdaq-traded stock in the United States.

[198] See Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 1, 8-9, 11, 56; Herman B. Bouma, 'The Tax Code and Reality: Improving the Connection' (1999) 85 *Tax Notes* 811, 813; Ryan J. Donmoyer, 'Multinationals Beg Finance to Simplify International Laws' (1999) 82 *Tax Notes* 1539; Roin, Competition, above n 164, 589 n.151, 590; Yin, Reforming, above n 19, 177; see also Avi-Yonah, Globalization, above n 101, 1594, 1665-66, 1670; Graetz, Outdated Concepts, above n 47, 328-29.

[199] The Australian definition of resident corporation employs the shareholder residence approach as an alternative. See Income Tax Assessment Act 1936, § 6(1).

[200] For a proposal to do so, see Peroni, Fleming and Shay, Getting Serious, above n 20, 507-16.

[201] Graetz, Outdated Concepts, above n 47, 320.

[202] Ibid 323.

[203] See ibid 331.

previously noted, failure by the United States to tax U.S. corporations on their worldwide incomes would allow U.S. resident individuals to materially avoid U.S. taxation through interposing a corporation between themselves and their foreign-source income.[204] This would significantly undermine the ability-to-pay principle. The United States should not go down this road unless it is clearly established that there is no feasible and defensible definition of U.S. corporate residence. We do not believe that this is the case.

As explained above, a principal purpose of the U.S. tax on corporate income is to serve as an anti-deferral device that preserves the efficacy of the shareholder-level tax on the worldwide incomes of U.S. shareholders.[205] This suggests that a definition of corporate resident is defensible if it is constructed to reach corporations with substantial numbers of U.S. resident shareholders. A definition grounded on place of incorporation (the present U.S. approach) or place of management (an approach commonly used in British Commonwealth countries[206]) might satisfy this requirement because it seems quite possible that most corporations that are incorporated or managed in the United States are substantially owned by U.S. residents. This is, unfortunately, an empirical question for which we do not have the definitive answer but which could be usefully investigated with empirical research techniques.

It is clear, however, that defining corporate residence in terms of the level of share ownership by U.S. residents would be consistent with the role of the U.S. corporate income tax as a device to protect the shareholder-level tax. Granted, if the required level of U.S. ownership were set at any point less than 100%, foreign shareholders would be overtaxed on their portion of the U.S. corporation's foreign-source income. But for the reasons stated above,[207] this is an acceptable result in a decidedly second-best world. Moreover, the imperfection of this second-best answer makes out a case for integration, not exemption. In this second-best context, defining a U.S. resident corporation as one in which U.S. residents own some considerable percentage of the stock of the corporation, e.g., more than 50% of the vote or value of the stock, strikes us as about right.[208]

The suggestion has also been made that taxing U.S. resident corporations on their worldwide incomes is rendered indefensible by the fact that U.S. resident individuals can obtain the benefits of exemption treatment of corporate income simply by purchasing portfolio investments in the shares of corporations located in exemption

[204] See text accompanying above n 181-94.
[205] See text accompanying above n 181-94.
[206] See Ault and Arnold, above n 3, 349-50.
[207] See text accompanying above n 191-94.
[208] One commentator has suggested that using a shareholder residence test for defining corporate residence is unworkable in the case of corporations whose shares are publicly traded, particularly where the trading occurs in more than one country. See Avi-Yonah, Globalization, above n 101, 1666, 1670. Nevertheless, it would seem that if the U.S. ownership threshold were set at a substantial level, say more than 50% of the vote or value of the stock, public trading would rarely create a situation in which a corporation drifted into or out of residency qualification. Cf, eg, IRC § 884(e)(4) (1986 as amended) ("qualified resident" includes more than 50% ownership by residents of a country, with a special rule for publicly traded corporations that looks to regular trading on an established securities market in that country). The problem of foreign corporations that refuse to provide information concerning the U.S. residency of their shareholders could be addressed by a presumption that each foreign corporation that solicited U.S. investors, either by registering shares for sale to U.S. persons with the Securities and Exchange Commission (SEC) or by offering shares to U.S. persons under a private placement exemption from SEC registration, is a U.S. resident under the shareholder residence test unless the corporation proves otherwise.

system countries.[209] However, this runaway shareholder problem could be addressed by adopting a system of currently taxing U.S. resident stockholders on their shares of foreign corporate income regardless of how small their percentage of stock ownership might be.[210]

In summary, we conclude that the challenges of constructing a defensible and feasible definition of corporate residence, or of dealing with U.S. residents who become portfolio investors in foreign corporations, do not rise to a level that justifies compromising the ability-to-pay principle by adopting an exemption regime with respect to the foreign-source income of U.S. corporations.

5 The Foreign Tax Credit and Ability-to-Pay

Preceding portions of this article have argued that the ability-to-pay principle requires foreign-source income of U.S. residents to be included in the U.S. tax base to the same extent as U.S.-source income. Is this argument undermined by the U.S. policy of employing a foreign tax credit to mitigate international double taxation of U.S. residents' foreign-source income?

To illustrate this issue, assume that if USCo, a U.S. resident corporation, builds its next plant in the United States, it will earn a 10% before-tax rate of return on the invested capital but that if the plant is built in Country D, the before-tax rate of return will be 15%. Clearly, the Country D investment is economically superior. Now assume that Country D taxes income earned therein at 35%, that the United States applies the same rate to its residents' worldwide incomes and that there is no United States-Country D income tax treaty. If double taxation is not ameliorated, the U.S. plant will produce a 6.5% rate of return after the 35% U.S. tax (.10 x [1 - .35]) but the Country D plant will yield a only a 4.5% rate of return (. 15 x [1 - .70]) after the combined 70% U.S. and Country D taxes. In these circumstances, the tax system will push USCo to choose the economically inferior U.S. investment. There is broad agreement that this is an inappropriate result and that because the United States is the residence country and there is no tax convention in force that remedies the problem, the United States should act unilaterally to relieve USCo's double taxation.[211]

If fairness were the only consideration, we would advocate that the United States handle USCo's tax payments to Country D like any other business expense—i.e., as allowable deductions in calculating net income. Under this approach, U.S. taxpayers would pay the same rate of U.S. tax on their aggregate U.S.- and foreign-source income.

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[209] See NFTC, *International Tax Policy*, above n 72, 123. See also, Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 2.

[210] For a proposal to do so, see Peroni, Fleming and Shay, Getting Serious, above n 20, 507-16.

[211] See Gustafson, Peroni and Pugh, above n 1, 19-21; Green, above n 148, 23-24; see also Staff of Joint Committee on Taxation, *Description and Analysis of Present-Law Rules Relating to International Taxation* JCX-40-99 (1999) 26 <http://www.house.gov/jct/x-40-99.htm> (hereinafter Joint Comm., *Description*); U.S. Treas. Dep't, *Deferral*, above n 74, 25-42. But see Richard L. Doernberg, 'Electronic Commerce: Changing Income Tax Treaty Principles a Bit?' (2000) 21 *Tax Notes International* 2417, 2423 (suggesting that international double taxation is not objectionable where the sum of the two taxing countries' marginal tax rates does not exceed 10%).
The need for remedial action by the United States as the residence country is so well-settled, and so powerfully driven by the capacity of source countries to effectively claim priority for their income taxes vis-a-vis the income taxes of residence countries, that we accept it as given that the United States must act unilaterally (in the absence of an applicable income tax treaty) to mitigate international double taxation when the United States is in the residence country role.

Although allowing only a deduction for foreign taxes would satisfy the ability-to-pay criterion, it would, however, leave USCo with a substantial tax disincentive to pursue the superior Country D investment. To illustrate this fact, assume that in the preceding example, USCo is deciding between investing $1,000 in a U.S. plant (with a 10% before-tax rate of return) and $1,000 in a Country D facility (with a 15% before-tax rate of return) and that the United States treats Country D tax payments as a deductible business expense. The $1,000 Country D investment would produce $150 of before-tax net income for Country D tax purposes ($1,000 x .15) and a $52.50 tax ($150 x .35) would be paid to Country D. For U.S. tax purposes, however, before-tax net income in this case would be $150 - $52.50 = $97.50 and $34.13 would be payable to the U.S. Treasury ($97.50 x .35). Thus, after payment of both taxes, USCo would have $63.37 of its $150 left. By contrast, investment of the $1,000 in a U.S. plant would produce $100 of before-tax net income ($1,000 x. 10) and $65 after the 35% U.S. tax ($100 x [1 - .35]). All other factors being neutral, USCo would invest in the economically inferior U.S. plant because of its higher after-tax return. In other words, the U. S. decision to treat the Country D tax payment as a business expense deduction in this case would not overcome the double-tax barrier to USCo's making the superior Country D investment and would not remedy the double-tax problem in a wide range of other cases.

Thus, the United States has been faced with a choice between (1) pursuing a tax system that is totally faithful to fairness concerns (i.e., that treats foreign tax payments as income tax deductions) but that leaves international double-taxation substantially in place as a barrier to its residents' foreign business and investment activities, or (2) finding a way to ameliorate the double-tax barrier while preserving the ability-to-pay tax base to the greatest extent possible.

The first alternative has been judged unacceptable and it is difficult to quarrel with this outcome. The issue then is which of the generally accepted methods to ameliorate double taxation is superior from a fairness perspective. For reasons given in previous parts of this article, we submit that adopting a foreign tax credit system while prohibiting deferral of any residual U.S. tax remaining after allowance of the foreign tax credit is the preferred way to achieve fairness and efficiency objectives.[212]

6 *Creeping Towards Consumption Taxation*

Consumption tax devotees might object to this conclusion. This is because corporate income is not taxed under a theoretically pure cash-flow consumption tax[213] and although corporations appear to be taxpayers under a value added tax or a retail

[212] "Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign-source income." Joint Comm., *Description*, above n 211, 26.

We use the term "residual tax" in its conventional sense—i.e., the residence country tax liability remaining after allowance of a credit for source country tax that was levied at a lower rate than the residence country tax.

Deferral of residual tax refers to the feature of many residence country tax systems that generally allows payment of residual tax on income earned through a foreign corporation to be postponed until residents receive dividends or sell their stock. Deferral reduces the present value of residual tax and allows residents who defer for lengthy periods to achieve the approximate result of an exemption system.

For a discussion of why a deduction is sufficient to achieve fairness objectives, see Kaufman, above n 143, 177-78.

[213]See U.S. Treas. Dep't, *Blueprints,* above n 108, 133; U.S. Treas. Dep't, *Tax Reform*, above n 147, 208.

sales tax, those levies are actually borne by consumers with corporations serving as mere collection agents for the government.[214] Thus, consumption tax advocates might see the near-zero U.S. corporate tax that can be achieved through deferral of U.S. tax on controlled foreign corporation income as a welcome incremental step towards a comprehensive consumption tax regime.[215]

We submit, however, that granting consumption tax treatment to income earned through a controlled foreign corporation (as well as to other items such as IRA contributions), while generally maintaining an income tax regime with respect to domestic income-producing activities, creates unacceptable distortions in taxpayer investment decisions. If a consumption tax regime is the right approach for providing most of the federal government's revenues (we believe that it is not), then Congress should adopt a comprehensive consumption tax instead of including ad hoc, distortive consumption tax features in the income tax. In making this argument, however, we recognize that administrability concerns may require consumption tax treatment of certain items (e.g., unrealized appreciation) with the result that the federal income tax likely will continue to be a hybrid income-consumption tax regime. Nevertheless, the distortion and unfairness that result from deferral of controlled foreign corporation income persuasively argue against including the feature of deferral in the U.S. income tax regime.

7 *Tax Competition and Exemption*

Many countries offer low general income tax rates or specific income tax incentives, such as tax holidays for set periods, to attract investments within their borders by nonresidents. This approach to international economic development has recently become identified as "tax competition."[216]

(a) Tax Competition and the Incentive to Invest Abroad

In an international context, the tax competition strategy is negated to the extent that capital exporting residence countries maintain systems of worldwide taxation without deferral. This is because such a residence country collects a current residual tax equal to the excess of its regular tax over the low taxes paid by its residents to tax

[214] See Congressional Budget Office, *The Economic Effects of Comprehensive Tax Reform* (1997) ch. 2; Staff of Joint Committee on Taxation, *Description and Analysis of Proposals to Replace the Federal Income Tax,* JCS-18-95 (1995) 51-55 <http://www.house.gov/jct/s-18-95.pdf> .

[215] For a more detailed examination of the parallels between a consumption tax regime and deferral of U.S. tax on income earned through a controlled foreign corporation, see Peroni, Fleming and Shay, *Getting Serious,* above n 20, 466-68.

Some have argued that changes in the U. S. federal income tax over many years have effectively converted it into a consumption tax or a hybrid income-consumption tax. See, eg, Stuart Karlinsky and Hughlene Burton, 'America's Inexorable Move to a Consumption-Based Tax System, or Why Warren Buffett Is Winning the Class Tax War' (2004) 105 *Tax Notes* 699. We strongly disagree and argue that the U.S. federal income tax is primarily a tax on income with targeted tax expenditures that have consumption tax characteristics. See Fleming and Peroni, Tax Expenditure Analysis, above n 10, 511-17.

[216] See Avi-Yonah, Globalization, above n 101, 1575-76. In 1998, the OECD Council adopted a report identifying certain practices as harmful tax competition. See OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998). In this report, the OECD made a number of recommendations, including that countries enact controlled foreign corporation and passive foreign investment company regimes in order to combat harmful tax competition. See OECD, *Harmful Tax Competition: An Emerging Global Issue*; see also Gustafson, Peroni and Pugh, above n 1, 600.

competitors. Thus the investment inducing effect of low source taxes is negated by the residual tax.[217] However, the deferral of U.S. tax on foreign-source income that is permitted under the present U.S. system substantially reduces the impact of the U.S. residual tax and permits U.S. residents to capture a significant part, if not all, of the benefit from low tax rates offered by countries as investment incentives.[218] If the United States adopted an exemption system with an explicit zero tax rate on the foreign-source income of U.S. residents, the enjoyment of low foreign tax rates by U.S. residents who invest in countries offering these tax incentives would be accomplished more directly. Thus, a defense of tax competition can be seen as an integral part of building the case in favor of deferral and exemption.[219]

Advocates of tax competition argue that it promotes capital formation by creating worldwide pressure for lower taxes[220] and that it causes governments to be less wasteful.[221] They further argue that tax competition enhances worldwide economic efficiency by encouraging the nations of the world to arrange themselves into a menu of countries with varying mixes of tax burdens and government service levels from which investors can choose the combinations that most appeal to them.[222]

By contrast, the critics of tax competition argue that it forces countries to shift their taxes from wealthy owners of mobile capital to relatively immobile and less wealthy workers, and to reduce taxes and to cut back services and benefits so that the unfortunate members of society receive less protection from a meaner globalized world.[223] The popular description of this phenomenon is the "race to the bottom."[224]

Both the claimed benefits and asserted harms of tax competition must be regarded as significantly speculative at present.[225] What is clear, however, is that the combination of tax competition and the current U.S. system of worldwide taxation with deferral distorts the decision making of U.S. residents by encouraging them to locate their income earning activities in low-tax countries instead of in the United

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[217] See Gustafson, Peroni and Pugh, above n 1, 368-69; Alan R. Rado, *United States Taxation of Foreign Investment: The New Approach* (1963) 51; Avi-Yonah, Globalization, above n 101, 1642; William W. Park, 'Fiscal Jurisdiction and Accrual Basis Taxation: Lifting the Corporate Veil to Tax Foreign Company Profits' (1978) 78 *Columbia Law Review* 1609, 1637; Roin, Competition, above n 164, 547. In the United States, the term "tax competition" previously was associated principally with competition among sub-national political jurisdictions. Within the United States, constitutional restrictions on burdens on interstate commerce limit the ability of States to combat tax reduction incentives of other States other than by matching the tax reduction. As discussed in the text, in an international context it is permissible for a residence country to counteract source country income tax incentives by imposing tax on the same income.

[218] See Peroni, Fleming and Shay, Getting Serious, above n 20, 464-66; Surrey, above n 164, 823.

[219] See generally Mastromarco, above n 164; Mitchell, above n 164, 814; Patti Mohr, 'Armey Asks O'Neill to Reverse U.S. Policy on OECD Tax Haven Strategy' (2001) 90 *Tax Notes* 1765; Center for Freedom and Prosperity, 'Center for Freedom and Prosperity Praises U.S. Administration's Policy Towards OECD's Harmful Tax Initiative' (2001) 22 *Tax Notes International* 2621, 2622.

[220] See Mitchell, above n 164, 805.

[221] See ibid.

[222] See Roin, Competition, above n 164, 554-61.

[223] See Avi-Yonah, Globalization, above n 101, 1575-79.

[224] See Roin, Competition, above n 164, 549.

[225] See John E. Anderson and Robert W. Wassmer, *Bidding for Business, The Efficacy of Local Development Incentives in a Metropolitan Area* (2000); Avi-Yonah, Globalization, above n 101; Mitchell, above n 164; Beverly I. Moran, 'Economic Development: Taxes, Sovereignty, and the Global Economy' in Karen B. Brown and Mary Louise Fellows (eds), *Taxing America* (1996) 197; Roin, Competition, above n 164; Vito Tanzi and Howell H. Zee, 'Tax Policy for Emerging Markets: Developing Countries' (2000) 53 *National Tax Journal* 299, 315-19; Edwin van der Bruggen, 'Momentum Builds in Asia to End Tax Holidays' (2000) 21 *Tax Notes International* 2565.

States.[226] Adoption of a generally applicable exemption system would only worsen this situation. Indeed, one tax competition advocate[227] has recognized this weakness in an exemption system and suggested mitigating the problem with a partial exemption system.[228] We believe that this is not a workable solution, however.[229]

Finally, it is also clear that deferral and exemption violate the ability-to-pay norm. The use of the mantra of tax competition to bring about back-door pressure for reductions in U.S. tax rates does not provide sufficient justification for the United States to either continue deferral or explicitly exempt foreign-source income from the income tax base.

(b) Assistance to Poor Countries

If the foregoing were the sum and substance of the tax competition debate, this article's discussion of the subject would be concluded. However, tax competition advocates advance another important argument for their position. They contend that in a world where direct aid from prosperous countries to impoverished nations is small in relationship to needs, the only practical way for desperately poor countries to get essential economic development funds is to engage in tax competition that attracts investments of privately held capital from corporate and individual residents of comparatively high-tax countries.[230] For the reasons explained above,[231] the immediate residual tax resulting from a worldwide taxation system without deferral would be deadly to the tax competition strategy of poor nations. This suggests the argument that the United States should maintain deferral as an accommodation to impecunious countries and that, even better, the United States should facilitate the tax competition efforts of poor nations by moving to an across-the-board exemption system.[232]

Of course, the sovereign status of the United States means that it is free to tax its residents without regard to the impact of the U.S. revenue regime on the development strategies of impoverished countries.[233] Thus, to argue that the United States should assist developing countries through deferral or exemption is to argue that the United States should provide discretionary foreign aid, and that it should do so through a tax expenditure program[234] instead of a direct appropriation scheme.

The wisdom of maintaining deferral, or of adopting a general exemption system, to provide assistance to foreign countries that engage in tax competition can be usefully tested by assuming that the universe of tax competitors consists of the following four nations:

> **Celtica** - an economically developed country with per capita gross domestic product in the top third of all nations but which,

[226] See text accompanying notes 68-71.
[227] See Roin, Competition, above n 164, 588-89, 591-93.
[228] See Fleming, Peroni and Shay, Fairness, above n 2, 334-35.
[229] See ibid.
[230] See Robert Goulder, ‘Heritage Foundation Criticizes OECD War Against Tax Havens’ (2000) 21 *Tax Notes International* 1628, 1630; Mitchell, above n 164, 810, 814-15; Roin, Competition, above n 164, 559, 585; Letter from Congressman Major R. Owens to Treasury Secretary Paul H. O'Neill (February 7, 2001); Letter from Congressman Charles Rangel and 25 others to Treasury Secretary Paul H. O'Neill (March 14, 2001).
[231] See text accompanying above n 217.
[232] See Roin, Competition, above n 164, 586; Surrey, above n 164, 823-24.
[233] See authorities cited in above n 164.
[234] See generally, Fleming and Peroni, Tax Expenditure Analysis, above n 10.

nevertheless, maintains a general corporate tax rate of 12% to attract investment from other countries.

Hostilia - a poor country that is unfriendly to the United States and its allies, that provides bases for terrorist groups and that is using its limited resources to develop weapons of mass destruction.

Incorrectia - a poor country that is ruled by a corrupt dictator and a small group of cronies. Incorrectia oppresses women and racial and religious minorities and generally circumscribes civil liberties. It has a general tax rate for resident corporations of 30% but it attracts foreign investment with a zero corporate tax rate for 5 years and a 5% rate thereafter. Incorrectia also trumpets its minimal environmental and worker safety rules and the availability of child labor as further reasons for foreign multinationals to operate on its soil. Additionally, it is on the Financial Action Task Force's list of countries that have failed to take adequate steps to prevent money-laundering.[235]

Freelandia - a poor democratic country with full civil liberties and equality for all residents, environmentally friendly policies and progressive worker safety and child labor rules. Freelandia applies a 5% tax rate to both foreign and domestic corporations. One of its major political parties, however, has begun to argue that Freelandia should cut back on enforcement of environmental, child labor and worker safety rules so that it can afford to offer a five-year tax holiday like Incorrectia's.

If the United States were considering a program of direct economic development foreign aid to these four countries, a plausible outcome is that no assistance would be provided to the first three and that Freelandia would receive aid only if it gave assurances that it would not significantly degrade enforcement of its environmental, child labor and worker safety regulations.[236] Therefore, a tax expenditure scheme should not be substituted for the direct aid program unless the tax expenditure plan allows the kinds of nuanced distinctions between candidate countries that would be features of a direct aid program.[237] Neither a general exemption system nor a broad deferral system satisfies this criterion because both approaches would confer assistance on all four of these countries indiscriminately.

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[235] See Cordia Scott, 'FATF Releases New Money-Laundering Blacklist' (2001) 23 *Tax Notes International* 8.

[236] It is not our purpose here to engage in a debate with those who regard economic assistance to poor countries as unwise. See, eg, Steven E. Landsburg, 'The Imperialism of Compassion', *The Wall Street Journal* (New York City) July 23, 2001, A14.

> Being poor means making hard choices.... Third Worlders are making pretty much the same choices that Americans and other westerners made back in the 19th century when we were poor: They're not worrying a whole lot about the quality of their environment, and they're not spending a lot of quality time with their families. Instead, they're working long, hard, dirty hours to earn enough to eat. And they're putting their children to work, just as poor people have always done.

We only wish to illustrate the point that if a decision is made to provide economic aid to poor countries, a direct economic aid program will make distinctions, hopefully rational ones, among countries that are potential aid recipients.

[237] See generally Karen B. Brown, Transforming the Unilateralist into the Internationalist, in *Taxing America*, above n 225, at 214, 217-18, 230; Graetz, Outdated Concepts, above n 47, 309.

The logical response to the preceding concerns is to engage in negotiated tax sparing.[238] If a foreign country offers a concessionary tax rate to foreign investors that is below the country's normal rate, the tax sparing concept would have the United States give a foreign tax credit equal to the amount of the country's generally applicable tax.[239] Where the selected country employs a low general tax rate without special concessions for foreign persons, the tax sparing concept would require a U.S. foreign tax credit that combines both the foreign tax paid and at least part of the difference between the low foreign rate and the U.S. rate.[240] This system could be established by congressional enactment of a list of approved low-tax countries or a set of criteria that defines countries eligible for tax sparing.[241] This approach, however, would inevitably prove awkward in dealing with the diverse array of developing countries and with changes in their tax systems.

A better method would be for the United States to negotiate tax sparing provisions in bilateral tax treaties with low-tax countries.[242] This latter method would allow

[238] The Organization for Economic Co-Operation and Development (OECD) has issued a report on tax sparing, which seeks to develop among the OECD countries "a more coherent position on the granting and design of tax sparing provisions." OECD, *Tax Sparing: A Reconsideration* (1998) 3. The OECD report states: "[t]his report does not suggest that OECD and other countries which have traditionally granted tax sparing should necessarily cease to do so." OECD, *Tax Sparing: A Reconsideration*, at 42. The OECD report, however, did identify "a number of concerns that put into question the usefulness of the granting of tax sparing relief." including (1) the vulnerability of tax sparing to taxpayer abuse; (2) the effectiveness of tax sparing as a method for providing foreign aid and promoting economic development; and (3) "general concerns with the way in which tax sparing may encourage countries to use tax incentives." OECD, *Tax Sparing: A Reconsideration*, at 41; see also Gustafson, Peroni and Pugh, above n 1, 370.

For a sampling of the commentary on tax sparing, see Timo Viherkentta, *Tax Incentives in Developing Countries and International Taxation* (1991); William B. Barker, 'An International Tax System for Emerging Economies, Tax Sparing, and Development: It Is All About Source!' (2007) 29 *University of Pennsylvania Journal of International Law* 349; Mary Bennett, 'Reflections on Current U.S. Policy for Developing Country Tax Treaties' (1990) 2 *Tax Notes International* 698; B. Anthony Billings and Gary A. McGill, 'Tax Sparing on U.S. Multinationals' (1990) 48 *Tax Notes* 615; Karen Brown, 'Missing Africa: Should U.S. International Tax Rules Accommodate Investment in Developing Countries?' (2002) 23 *University of Pennsylvania Journal of International Economic Law 45*; Richard D. Kuhn, 'United States Tax Policy with Respect to Less Developed Countries', (1963) 32 *George Washington Law Review* 261; Damian Laurey, 'Reexamining U.S. Tax Sparing Policy with Developing Countries: The Merits of Falling in Line with International Norms', (2000) 20 *Virginia Tax Review* 467; Jeffrey Owens and Torsten Fensby, 'Is There a Need to Reevaluate Tax Sparing?' (1998) 16 *Tax Notes International* 1447; Pugh, above n 74, 267, 270-71.

[239] This is the usual situation in which the tax sparing issue arises. See Gustafson, Peroni and Pugh, above n 1, 368-70; Roin, Competition*,* above n 164, 547 n.17.

[240] The question of whether to grant tax sparing does not usually arise in this situation because countries usually engage in tax competition through narrowly targeted tax incentives rather than by adopting a low general rate. However, one of the objections to tax sparing is that it abets the distortion that results when a foreign country creates exceptions to its generally applicable tax rate by conferring concessionary rates on a narrow class or classes of activities. See Joint Comm., *Description*, above n 211, 87. Thus, if a developing country responds to this objection by choosing to attract foreign investment through lowering its generally applicable tax rate instead of creating narrow tax concessions, its candidacy for tax sparing should be regarded as enhanced.

[241] See IRC §§ 901(j), 999 (1986 as amended).

[242] Of course, the United States does not presently have income tax treaties with many low-tax developing countries. Our recommendation would require a change on this point.

One of the traditional U.S. objections to tax sparing through bilateral treaties has been that tax sparing amounts to giving the affected foreign-source income a lower tax burden than domestic-source income and that this ought not to be accomplished through the treaty process. See Staff of Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, JCS-6-91 (1991) Part Two §II.H.1. (hereinafter Joint Comm., *International Competitiveness*). The logic of this position is

appropriate distinctions to be made among nations and would assist the United States in negotiating appropriate reciprocal tax concessions for its residents.[243] It also would allow a sunset feature to be included in the tax sparing article of the Freelandia treaty so that the article could be revisited periodically and changed if Freelandia "cheats" on the deal by significantly compromising its concern for children, the environment and the safety of its workers.[244]

The United States has historically resisted tax sparing.[245] One of the principal reasons for doing so is the fear that granting tax sparing would encourage poor countries to engage in tax competition by lowering their rates and sacrificing needed revenues.[246] In addition, the cost effectiveness of this form of foreign aid is highly questionable. The U.S. domestic experience with former section 936 of the Internal Revenue Code is instructive. Income tax incentives in the form of reduced tax rates favor the highest profit margin industries, such as pharmaceuticals and electronics. In Puerto Rico, the U.S. General Accounting Office found that before the amendments to severely restrict section 936 in 1996,[247] the tax subsidy for an electing section 936 corporation in the pharmaceutical industry was $70,788 per worker, which was 267% of the average wages paid to pharmaceutical workers.[248] This experience suggests that, to be cost effective, there would have to be a close monitoring of the effects of the subsidy.

Our purpose, however, is not to provide a full analysis of tax sparing in this article. Instead, the larger point to be drawn from this discussion is that if a full consideration of the costs and benefits establishes that the United States should assist poor countries by accommodating tax competition, bilateral tax sparing agreements are a better approach for doing so than deferral or exemption. Stated differently, the tax competition strategies of impoverished countries do not establish a case for compromising the ability-to-pay principle by maintaining the current deferral system or by adopting a generally applicable exemption system for foreign-source income of U.S. residents.

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not convincing, assuming that the United States decides that tax sparing is a desirable way to assist low-tax developing countries.

[243] See Peggy Brewer Richman, *Taxation of Foreign Investment Income: An Economic Analysis* (1963) 70.

[244] See Richman, above n 243, 70. However, one of us has previously cautioned that use of tax penalty or "negative tax expenditure" provisions as a means of achieving nontax policy objectives should undergo a cost-benefit analysis. See, eg, Peroni, Back to the Future, above n 68, 1010. This author would also apply the same caution to use of tax sparing provisions as a means of achieving child protection, worker safety or environmental protection goals.

[245] See Gustafson, Peroni and Pugh, above n 1, 369-70; Brown, above n 237, 224-25.

[246] See Joint Comm., *Description*, above n 211, 87.

[247] See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1601,110 Stat. 1755, 1827. The 1996 legislation terminated the § 936 credit for new claimants and phased the credit out over a 10-year period for existing claimants.

[248] See United States General Accounting Office, *Pharmaceutical Industry Tax Benefits of Operating in Puerto Rico*, reprinted in 138 Cong.Rec. 11376, 11377 (May 14,1992). For critiques of the cost effectiveness of § 936 as a tax subsidy device, see Thomas R. Barker, 'Ending "Welfare As We Know It" (Corporate Welfare, That Is): International Taxation and the Troubled History of Internal Revenue Code Section 936' (1997) 21 *Suffolk Transnational Law Review* 57; Nancy H. Kaufman, 'Puerto Rico's Possessions Corporations: Do the TEFRA Amendments Go Too Far?' 1984 *Wisconsin Law Review* 531; Camilla E. Watson, 'Machiavelli and the Politics of Welfare, National Health, and Old Age: A Comparative Perspective of the Policies of the United States and Canada' 1993 *Utah Law Review* 1337, 1402.

G *VAT or GST Comparison*

VAT or GST regimes are typically based on the destination principle—i.e., they tax imports but apply a zero rate to export sales[249]. They also provide rebates of VAT/GST paid on inputs that were incorporated into exported items.[250] This is a form of territorial, or exemption, treatment.[251] Professor James R. Hines, Jr. has argued that because efficiency and fairness objections have not been raised with respect to this feature of the typical consumption tax regime, the efficiency and fairness arguments that we have made above with respect to territorial income taxation are without merit. He states:

> The same fairness argument that favors subjecting foreign income to domestic income taxation would also favor subjecting foreign value added to domestic value added taxation, foreign sales to domestic sales taxation, and similarly extending other domestic taxes to foreign activities. Why is there not a groundswell of fairness-motivated objection to the territoriality of value added taxes…?[252]

Double consumption taxation is, indeed, an issue with respect to export sales. If exporting country A adopts the so-called origin principle, thereby applying its VAT/GST to export sales but not to imports, and if other countries follow the destination principle practice of applying their VATs/GSTs to imports, the result will be a double tax on A's export sales and A's exporters will be competing against local sellers whose transactions bear only a single VAT/GST. Thus, a country that organizes its VAT/GST on the basis of the origin principle effectively allows every other country in the world to erect a double tax barrier against its export sales[253] and this barrier could have untoward effects for its economy.[254] Thus, an origin principle VAT/GST, which is roughly the consumption tax analogue to worldwide taxation of income without a foreign tax credit, is unattractive for prudential reasons.[255] That fact gives exporting countries an incentive to look for other double taxation mitigation approaches when designing their VATs/GSTs.

In theory, a possible alternative would involve an exporting country mitigating double VAT/GST taxation by crediting the importing country's consumption tax against the exporting country's consumption tax. In the real world, however, this is a problematic solution because consumption taxes are applied on a transactional basis

[249] See Slemrod and Bakija, above n 141, 139, 235-37; Victor Thuronyi, *Comparative Tax Law* (2003) 318-19; Liam Ebrill, Michael Keen, Jean-Paul Bodin and Victoria Summers, *The Modern VAT* (2001) 176-77, 184.

[250] See authorities cited in above n 249.

[251] See Ebrill, Keen, Bodin and Summers, above n 249, 179-80.

[252] Hines, *Reconsidering,* above n 72, 34-35.

[253] This double tax barrier is permitted by WTO rules. See Staff of Joint Committee on Taxation, *Impact on Individuals and Families of Replacing the Federal Income Tax* JCS-8-97 (1997) 71-72 <http://www.house.gov/jct/s-8-97.pdf> (hereinafter Joint Comm., *Impact*).

[254] The negative effects could include reduced domestic wages and reduced export sales due to sluggishness in exchange rate adjustments. See Joint Comm., *Impact,* above n 253, 96-98.

[255] Moreover, the origin principle VAT/GST has the appearance of being a barrier to export sales because it taxes them. By contrast, the destination principle VAT/GST has the appearance of an export promotion scheme because of its zero rating of export sales coupled with its rebates for VAT/GST paid on inputs incorporated into exported items. Economists insist that these appearances are substantially illusory, see Slemrod and Bakija, above n 125, 139-40; Grubert and Newlon, above n 10, 628-30. However, the economists' argument is not easy for politicians to explain in brief sound bites and for voters to grasp and so the export-friendly appearance of the destination-principle VAT/GST probably gives it an advantage in the realm of practical politics. See Slemrod and Bakija, above n 141, 139, 237; Grubert and Newlon, above n 10, 628.

and it is difficult to account for a multitude of separate foreign consumption tax payments. Thus, a destination or territorial approach—i.e. applying a zero VAT/GST rate to exports—is the more feasible alternative.[256] By contrast, income taxes are imposed on an aggregate basis that ultimately produces a single annual credit for a residence company with respect to all of its foreign profits. This practical distinction between a VAT and an income tax indicates that the international custom of operating consumption taxes on a territorial basis seems to have a utilitarian explanation that does not impeach the arguments in favor of worldwide income taxation.

IV CONCLUDING OBSERVATIONS: WEIGHING THE FACTORS

Exemption system advocates are inclined to ask why, if some other countries directly confer the advantages of an exemption system on their residents, should the United States treat its residents less favorably by holding to a worldwide system?[257] The answer is that the United States might choose to do so because it gives higher priorities to locational neutrality and to fairness in the design of its income tax rules than is implied by the choice of an exemption system.

To be specific, the U.S. income tax is heavily grounded on the fairness notion that taxpayers should contribute to the cost of government in relationship to their comparative economic wellbeing or ability-to-pay.[258] Territorial taxation facially conflicts with this norm to the extent that it excludes foreign-source income from the ability-to-pay calculus. This point is not the end of the matter, of course, because the goals of simplicity, economic neutrality/efficiency and economic growth must also be taken into account and may require that fairness concerns be somewhat circumscribed.

With respect to simplification, exemption system proponents argue that an exemption regime would advance the goal of reducing complexity in the tax system.[259] After all, what could be simpler than not taxing foreign-source income at all? Adoption of an exemption regime might, indeed, simplify the U.S. system for taxing its residents' foreign-source income, but the amount of simplification to be gained by the switch from a worldwide approach is uncertain and may not be great. This is largely due to the fact that adoption of a regime that provides an explicit zero rate of tax for foreign-source income will heighten the importance of those elements of the system dealing with the distinction between U.S.-source and foreign-source net income. Thus, the sourcing rules, transfer pricing rules and expense-allocation rules will inevitably assume a greater role under an exemption regime than under the present worldwide system. We should expect that these rules would all be tightened in the exemption context, thereby becoming more complex and more productive of controversy between taxpayers and the IRS.[260]

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[256] Moreover, a destination principle VAT/GST avoids transfer pricing problems that are inherent in an origin principle VAT/GST. See Grubert and Newlon, above n 10, 620, 639.

[257] See generally, NFTC, *International Tax Policy,* above n 72, 126-27.

[258] See authorities cited in above n 148.

[259] See Chorvat, above n 68, 850-53.

[260] See generally Joint Comm., *Alternative U.S. Tax Policies,* above n 6, 36-37, 40-41; U.S. Treas. Dep't, *Approaches,* above n 2, 60; Michael J. Mclntyre, 'Thoughts on the IRS's APA Report and More Territorial Taxation' (2000) 87 *Tax Notes* 445, 446; Peter R. Merrill, 'International Tax and Competitiveness Aspects of Fundamental Tax Reform' in James M. Poterba (ed), *Borderline Case* (1997) 87, 103; Peroni, Back to the Future, above n 68, 985; David R. Tillinghast, 'International Tax Simplification' (1990) 8 *American Journal of Tax Policy* 211-12.

Moreover, to mitigate fairness and economic efficiency/neutrality concerns, some countries exclude both passive income and low-taxed foreign-source business income from their exemption systems (indeed, most countries exclude passive income from their exemption systems) and employ a worldwide system (with a foreign tax credit) for this excluded income.[261] If the United States went down this road and preserved its worldwide system (with its complex foreign tax credit) for passive and low-taxed foreign-source income, the simplification gains from an exemption system could be slim indeed.[262]

In addition, some exemption countries have determined that although a resident's foreign-source income should be excluded from the tax base, it should, nevertheless, be taken into account for purposes of determining the progressive tax rate that applies to the resident's domestic-source income. This principle is generally referred to as exemption-with-progression.[263] If the United States were to adopt this approach, the issue of whether or not to recognize unrepatriated controlled foreign corporation income when implementing exemption-with-progression would be critically important and might well result in the preservation of complex antideferral regimes for this purpose. If so, the simplification gains from converting to an exemption system would be significantly reduced.

An exemption system is also a highly distortionary departure from the goal of economic neutrality. At its worst, an exemption system can cause an investment in a low-tax foreign country to be preferred to a U.S. investment even though the U.S. investment has a higher before-tax rate of return and is, therefore, economically superior.[264] It is difficult to see how the economic well- being of the United States is furthered by distorting taxpayer decisions in this manner.

With respect to economic growth, exemption advocates contend that exemption systems create greater worldwide economic well-being than do worldwide taxation systems.[265] The empirical and theoretical support for this proposition is, however, so mixed and debatable that the claimed economic growth virtues of the exemption approach must be regarded as speculative at best.[266]

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[261] See Ault and Arnold, above n 3, 372-75, 378-79; Chorvat, above n 68, 855-59; Graetz, Outdated Concepts, above n 47, 324, 329; See also H. David Rosenbloom, 'From the Bottom Up: Taxing the Income of Foreign Controlled Corporations' (2001) 26 *Brooklyn Journal of International Law* 1525, 1549-50; Tillinghast, above n 260, 209-10.

[262] See Joint Comm., *Alternative U.S. Tax Policies*, above n 6, 38-41; Charles I. Kingson, 'The Foreign Tax Credit and Its Critics' (1991) *American Journal of Tax Policy* 1, 52-55; Peroni, Back to the Future, above n 68, 986. Although Australia generally employs an exemption regime for foreign-source income, it taxes certain foreign-source income under a worldwide system that features an anti-deferral regime described as "very complex." Robin Woellner, Steven Barkoczy, Shirley Murphy and Chris Evans, *Australian Taxation Law* (17th ed. 2006) 1,465.

[263] See Ault and Arnold, above n 3, 372-73. The United States actually employs the exemption-with-progression principle in its limited exemption for foreign-source personal service income. See IRC § 911(f)(1986 as amended).

[264] See text accompanying notes 68-71 *supra*; Avi-Yonah, Globalization, above n 101, 1604 n. 132; See also Jane G. Gravelle, 'Foreign Tax Provisions of the American Jobs Act of 1996' (1996) 72 *Tax Notes* 1165,1166; Mitchell, above n 164, 804; Peroni, Back to the Future, above n 68, 983; Peroni, End It, above n 68, 1613-14.

[265] See, eg, Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (1992) 57-59.

[266] See, eg, Staff of Joint Committee on Taxation, *Overview of Present-Law Rules and Economic Issues in International Taxation*, JCX-13-99 (1999) §IV.D <http://www.house.gov/jct/x-13-99.htm>; U.S. Treas. Dep't, *Deferral*, above n 47, 25-54; Altshuler, above n 80, 1585; James R. Hines, Jr., 'The Case Against Deferral: A Deferential Reconsideration' (1999) 52 *National Tax Journal* 385, 401-02; Rousslang, above n 68, 595-97.

Likewise, the claims that adoption of an exemption system by the United States is necessary to keep U.S. businesses on a competitive footing in foreign markets are rendered dubious, at best, by the extensive overseas success of those businesses.[267] Advocates of the competitiveness view have failed to provide convincing empirical evidence for their claims that worldwide taxation undermines the ability of U.S. individuals and corporations to compete in the global marketplace.[268]

In addition to the preceding points, Part III.E.7 has discussed ways to overcome objections to worldwide taxation that are based on a desire to accommodate the tax competition strategies of poor countries.[269]

Thus, it is quite rational for the United States to conclude that when the significance of the ability-to-pay fairness principle is weighed against an exemption system's distortionary effects, uncertain simplification benefits[270] and speculative economic growth consequences, and against the generally strong competitive performance of U.S. businesses abroad, worldwide taxation is the preferred option. This holds true regardless of the fact that other countries, with other ideas regarding the relative importance of fairness and efficiency, countenance generous deferral of foreign-source income or employ exemption systems.[271]

Although the application of the ability-to-pay fairness principle to international income taxation is complicated by the presence of foreign taxpayers, by income earned through C corporations and by the claims of other governments to tax cross-border income, it is nonetheless possible, and indeed important, to analyze international tax policy in terms of fairness in addition to efficiency. As the foregoing discussion demonstrates, we believe that both fairness and efficiency considerations support the conclusion that a properly designed worldwide income tax regime is superior to either the current U.S. hybrid worldwide system[272] or an exemption system.

[267] See U.S. Treas. Dep't, *Deferral,* above n 47, 56.
[268] See U.S. Treas. Dep't, *Deferral,* above n 47, 56-57, 61.
[269] See text accompanying above n 238-44.
[270] See text accompanying above n 259-63.
[271] See Reuven S. Avi-Yonah, 'Tax, Trade, and Harmful Tax Competition: Reflections on the FSC Controversy' (2000) 21 *Tax Notes International* 2841, 2843 (arguing that an exemption system, as typically constructed, is a prohibited export subsidy under the General Agreement on Tariffs and Trade). For a more cautious view on this point, see Richard Westin and Stephen Vasek, 'The Extraterritorial Income Exclusion: Where Do Matters Stand Following the WTO Panel Report?' (2001) 23 *Tax Notes International* 337, 341-44.
[272] See Summers, above n 83, 39 ("[W]hen given the choice between the continuation of the status quo—which seems to me to permit very large amounts of abuse in which income is caused to be located in jurisdictions that do not seek to maintain serious tax systems and to remain there for very long periods of time—and the end of deferral, it is not clear to me that the status quo is to be preferred.").