MICHAEL J. GRAETZ

Follow the Money

Essays on International Taxation

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by Michael J. Graetz

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Foreword

Mihir Desai*

Several years ago, I asked my friend Michael Graetz why he hadn't produced a book on international taxation that matched his efforts on estate taxation, energy policy and tax reform. His answer was humble, almost uncharacteristically so. He replied that such a book was not feasible as, "I just don't know how it would end." Such ignorance doesn't stop everyone so I am delighted that Michael has provided the next best thing: a curated collection of his writings over his prolific and distinguished career.

As a collection of previously published works, it reminds me of the feat achieved by Mark Twain in his *Innocents Abroad, or a New Pilgrims Progress*. Cobbling together his previously published columns on his expedition to the Holy Land, Twain provided a hugely entertaining and enlightening guide to the world filled with historical wisdom, deep dives into territory seldom explored, and wisdom on the ways of world. In this volume, we are provided with a similar treat: a compendium of Michael's reports from various journeys into the economic and legal terrain that we are still mapping as we find our way in this highly integrated world.

As with any good travel guide, Michael reminds us that we can't understand the future without a thoughtful recounting of the history that has brought us here. By highlighting the considerations that motivated the architects of our international tax regime, Michael ensures that we will remember that our seemingly novel problems are long-standing and that historical contingencies often dominate policy formulation. This emphasis on history also reminds us that Michael is an ambassador-at-large of sorts willing to leave the law for economics and history or whatever discipline will help him make sense of the world.

Of greatest value, perhaps is Michael's foresight in highlighting the most treacherous parts of the terrain we face. His articles on intellectual property and interest expense pinpoint precisely the most vexing issues we face. How will highly mobile income with associated spillovers that are sought by all jurisdictions be taxed? How should interest expenses be allocated around the world for a global firm? How can a federation of states design taxation regimes that advance alternative norms? Rather than provide strict answers, Michael charts the tradeoffs and practices that are evolving on the most important issues.

Michael is also somewhat disdainful of the larger venues that preoccupy most travelers. In his Tillinghast Lecture, he encourages us to move past what he views as tourist traps—grand theories and slippery notions of welfare. As such, Michael ridicules the search for a polestar that only theory can provide. Here, I struggled. How can we find our way to the Holy Land without a polestar? Simply by stumbling around in the dark? But, I confess that my opinion may well be shaped by my ownership of what Michael would surely regard as a tchotchke stand.

The perspectives afforded by Graetz's journeys are sorely needed today. We live in times dominated by grand efforts (e.g., the OECD's Base Erosion and Profit Shifting initiative), grand ideas (e.g., the global wealth tax proposed in Thomas Piketty's Capital), and grand rhetoric (e.g., "tax loopholes that ship jobs overseas"). We continue to grope for our path forward and are often confronted with naïve characterizations and simplistic answers to complex problems.

Graetz's travel guide provides the perspective that only an adventurous intellect willing to traverse domains and confront thorny questions can provide. Indeed, his collected efforts provide a perspective, like travel, that is "fatal to prejudice, bigotry, and narrow-mindedness, and many of our people need it sorely on these accounts. Broad, wholesome, charitable views of men and things cannot be acquired by vegetating in one little corner of the earth all one's lifetime." Michael's peripatetic journeys across disciplines and topics provides the best possible antidote to the parochialism we are susceptible to and will surely provide the foundation for whatever comes next.

For travel through the world to the Holy Land, it is hard to imagine a better companion than Twain and *Innocents Abroad*. And for a journey through our world to wherever we may end up, there is no better companion than Graetz and this volume. Bon voyage!

*Mizuho Financial Group Professor of Finance, Harvard Business School.

Introduction

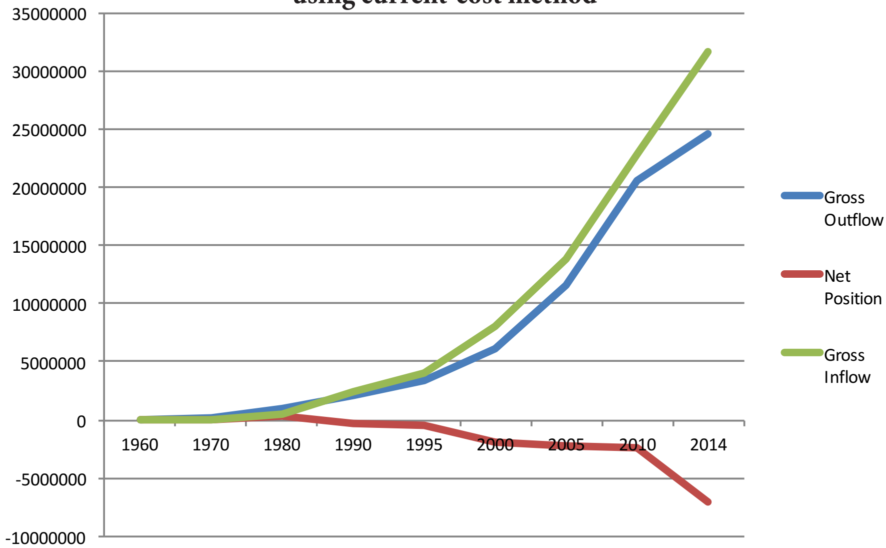
Overview

Since this book begins with history, let me begin with a dollop of my own. As late as 1990, when I returned to the tax policy office of the Treasury, international taxation remained something of a backwater among U.S. tax experts. The subject was outside the ken of virtually all public finance economists and was dominated in the legal community by a relatively small faction of specialists, many of whom had learned international tax at the Treasury in the 1960s.

This has all changed. As Figure 1 shows—beginning in the 1980s and rapidly accelerating by the late 1990s—international capital flows both in and out of the U.S. exploded. The enormous increase in both international direct investments and portfolio flows brought issues of international tax policy and international tax law into the mainstream of tax accountants, lawyers, and economists.

Figure 1

US owned assets abroad, foreign-owned assets, and net position of US using current-cost method



Source: For 1960-1995, Survey of Current Business, July 2000, "The International Investment Position of the United States at Yearend 1999" by Russell B. Scholl, and Survey of Current Business, October 1972, Volume 52, Number 10, "The International Investment Position of the United States: Developments in 1971" by Russell Scholl. For 2000-2014, Bureau of Economic Analysis, U.S. International Investment Position, 2000, 2006, 2010., 2014. http://www.bea.gov/iTable/iTable.cfm?ReqID=62&step=1#reqid=62&step=5&isuri=1&6210=5

The United States, which had long been a large exporter of capital, like other industrialized countries around the world, now both exports and imports large amounts of capital. For the first time—due principally to large inflows of portfolio debt—the U.S. in the 1980s became a net capital importer. The post-World War II worldwide economic dominance of the United States and of U.S. multinational corporations has past—a transformation unforeseen by the 1986 Tax Reform Act, our most recent major tax reform legislation.

Moreover—as will become clear in the pages that follow—the dominant analytical framework used by policymakers to evaluate international tax policy is archaic. Most tax policy experts long insisted that U.S. international tax policy be designed to promote "worldwide economic efficiency" by being neutral about a U.S. resident individual's or business's choices between domestic and foreign investments producing the same pre-tax rate of return (a policy known as "capital export neutrality" or CEN). Surprisingly—especially given our long struggle to limit federal budget deficits—this indifference about where investments are made is coupled with unconcern about which country obtains the tax revenues from the income of the investments.

U.S. multinationals are naturally more attracted by improving their "international competitiveness" throughout the world. This has generally led them to urge policies reflecting "capital import neutrality" (CIN), which insists that income from all investments in a particular country should be taxed the same whether made by a domestic or foreign business or individual.

By 1992, when I left the Treasury and returned to teaching, it had become clear that CEN and CIN can both be met simultaneously only when income is taxed the same in all countries. This requires identical tax systems, including an identical tax base and rates. That has never happened and it never will. But, in its absence, any system for taxing international income can be described as a "compromise" between the two principles of CEN and CIN. This is a recipe for political misbehavior, and it also inevitably produces complaints of disadvantage, accompanied by calls for change. Given the shortcomings of the existing normative framework for evaluating international tax policy, I began my international tax research by trying to find out how and why our nation (and others) had arrived at the extant policy structure—in other words, to begin with history. After that, I turned to policy and implementation.

This book collects nine essays on international income taxation originally published between 1997 and 2015. Many of these have been widely read and have had influence in the evolution of international tax policy analysis and proposals for change. By pulling them together in one volume (and moving the abundant law review footnotes to endnotes), I am hopeful that readers might benefit from the conjoint insights they contain. At a minimum, they offer a roadmap of the most important international tax policy issues on the current reform agenda of the United States and our trading partners. A brief summary follows.

Part I: History

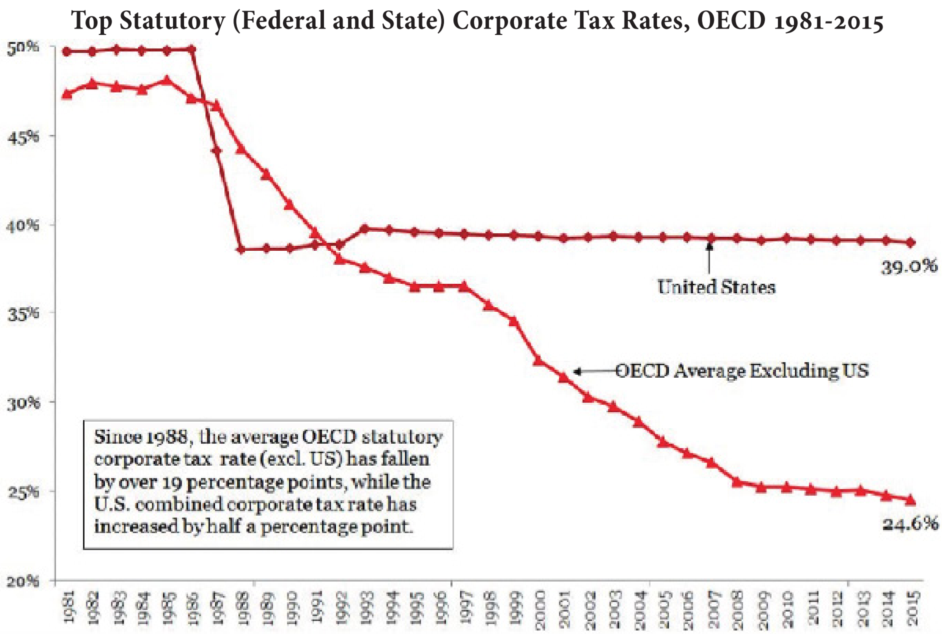
Nearly a century ago, during the decade 1919-1928, the United States regime for taxing international income took shape. While most OECD nations have recently moved away from foreign tax credit provisions of the sort enacted unilaterally by the United States in 1918, these rules, at least for now, remain at the center of the U.S. law taxing income earned abroad by U.S. businesses and individuals. Likewise, despite many changes in the details, the fundamental structure of the model bilateral income tax treaties produced by the League of Nations in 1928 undergirds the thousands of bilateral income tax treaties now in place throughout the world. These developments are the subject of Chapter 1. The major reexamination of international tax policy conducted by more than 80 countries in the "Base Erosion and Profit Shifting" (BEPS) project under the auspices of the OECD between 2013 and 2015 adhered to the basic concepts developed in the 1928 model treaty (see Chapter 7).

While Chapter 1 has been widely read, cited, and reproduced in various collections, Chapter 2 has been seldom seen. It was written for a volume on international tax policy published in 2001 by the National Foreign Trade Council. This chapter describes President John Kennedy's efforts to tax currently foreign business income of U.S. multinationals and to enact "tax laws which do not favor investment in other industrialized nations or tax havens."[1] Rather than embracing Kennedy's effort to make CEN the linchpin of U.S. international tax policy, however, the Revenue Act of 1962 settled for the narrower anti-abuse rules of Subpart F of the Internal Revenue Code. These rules subsequently became a touchstone elsewhere for taxing controlled foreign corporations (CFCs). Harkening back to the Kennedy proposals, President Obama recently urged enactment of a minimum tax rate applicable to the earnings of foreign subsidiaries of U.S. corporations.[2]

Part II: Business Income

Since the 1990s, there have been a multitude of changes in the international business income tax laws of the United States and of countries around the world, most recently in connection with the OECD efforts to curb income tax avoidance by multinational business entities. (See Chapter 7.) Many changes have been spurred by aggressive competition among nations for investment and innovation (and, in some cases, a slice of revenues from mobile income). The sharp decline in nations' business income tax rates—with the notable exception of the United States—is the most obvious manifestation of this inter-nation competition. Figure 2 depicts the trend over time.

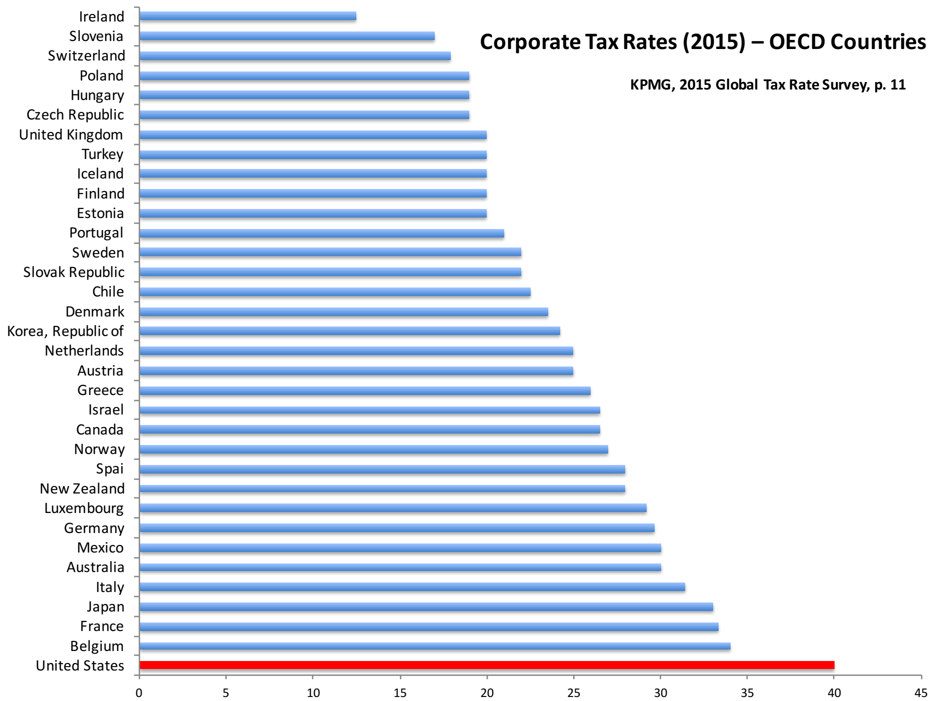
Figure 2



Source: OECD tax database (April 2015)

The United States now has the highest statutory corporate tax rate in the OECD, as Figure 3 shows.

Figure 3

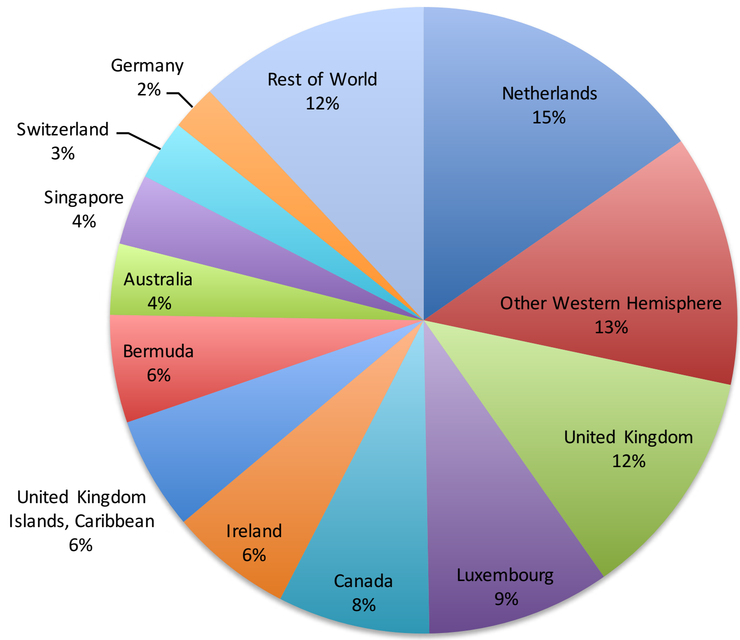


Multinational corporations, to be sure, pay effective rates substantially lower than the statutory rates, but the statutory rates are important. Deductions—principally for interest and royalties—migrate to the high-tax countries, while income—especially mobile income from intellectual property—flows to the low-tax countries. I have elsewhere offered a major tax reform that would get the corporate rate down to 15 percent.[3]

Anyone who doubts the central role of taxes in business investment decisions need only glance at Figures 4 and 5. As Figure 4 shows, there is far more foreign direct investment by U.S. companies in Switzerland, Singapore, Bermuda, Ireland, Luxembourg, and the Netherlands than, for example, in Germany.

Figure 4

Percentage of US Direct Investment Abroad, by selected nations in 2014

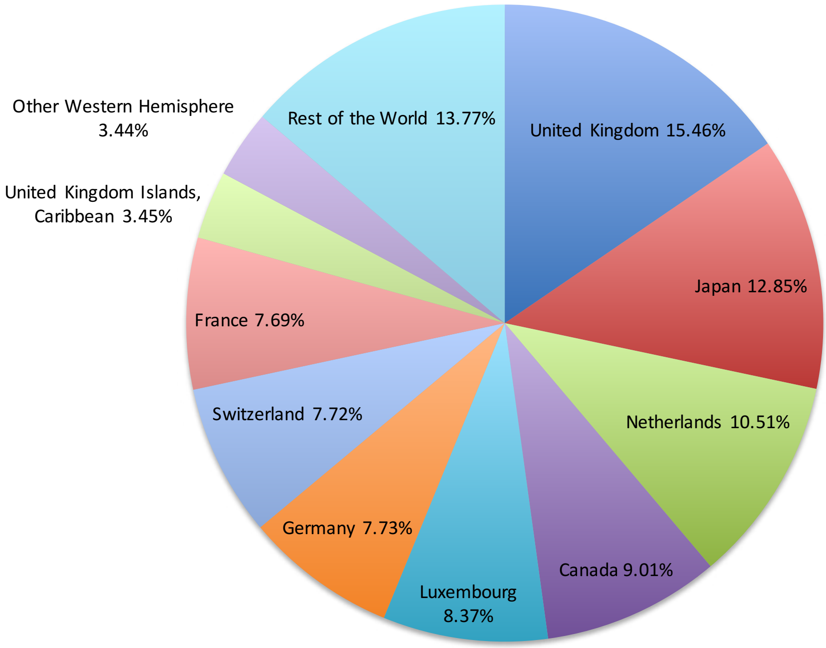


Source: United States Department of Commerce, Bureau of Economic Analysis, U.S. Direct Investment Abroad.
http://www.bea.gov/international/di1usdbal.htm

Figure 5 makes clear that not just U.S. multinationals engage in tax planning. Foreign direct investment into the U.S. is also disproportionately weighted in favor of tax-advantaged countries, such as Luxembourg and Switzerland.

Figure 5

Percentage of Foreign Direct Investment in the United States by selected nations, 2014



Source: United States Department of Commerce, Bureau of Economic Analysis, "Annual Data,"Foreign Direct Investment in the U.S.: Balance of Payments and Direct Investment Position Data.
http://www.bea.gov/international/di1fdibal.htm

The essays of Part II address the fundamental principles and concepts undergirding the taxation of international business income and examine a number of the most important current issues. Chapter 3 reproduces my David R. Tillinghast lecture, delivered at New York University Law School in October 2000, in which I urged a fundamental reexamination of international income tax laws and the principles and concepts on which they are based. Tracing the limitations of CEN and CIN as inadequate guides to policy, this chapter argues for a national, rather than worldwide, perspective in international taxation—recognizing both the reality and appropriateness of national governments looking to the effects of international tax laws on the welfare of their citizens and residents. This chapter also looks beyond economic efficiency as the sole basis for international taxation, taking into account, for example, the impact of international income taxation on a fair distribution of taxes among nations and across individuals. Turning to the foundational building blocks of international income taxation—the source of income and corporate residence—the chapter raises important questions about the continuing viability of longstanding rules determining the allocation of income among nations.

Chapters 4, 5, and 6 apply the lessons of Part I and Chapter 3 to three of the most important and vexing issues of international income taxation: the taxation of income from intellectual property, the allowance of deductions for interest expenses, and the appropriate structure of an exemption system for dividends paid out of foreign source business income. After evaluating the economics literature concerning subsidies for developing and exploiting intellectual property, Chapter 4 argues that international taxation of such mobile income should be based substantially on the location of customers rather than where the intellectual property is owned or produced. Given the mobility of borrowing and lending, Chapter 5 provides an analytical frame for the appropriate international taxation of interest expenses. It urges allocation of such expenses based on the location of assets or income. Insights of this chapter have been reflected in reform proposals of the Obama Administration and in the OECD's initial BEPS proposals.[4] Finally, the design of a dividend exemption system described in Chapter 6 has been influential in proposed legislation in the U.S.[5]

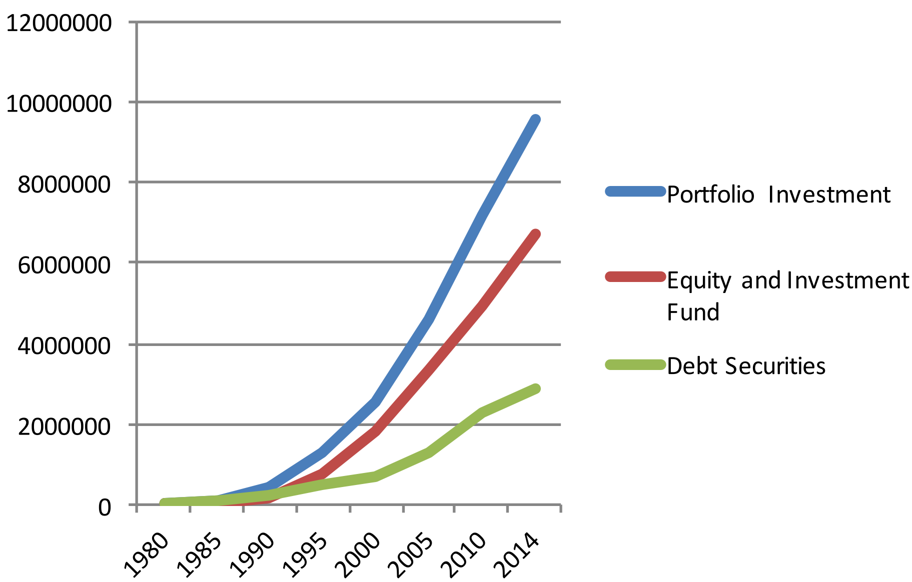
Chapter 7 is the most recently published essay of this collection. It reviews the contemporary challenges of international tax policy, as set forth in my Parsons Lecture, delivered to the University of Sydney Law School in April 2015. After describing the decisionmaking choices and flexibility of multinational corporations and the pressures of inter-nation tax competition, the chapter explains why our 20th Century international tax system is poorly equipped to cope with the 21st Century's technologically driven, integrated global economy. The chapter concludes with a number of predictions about directions international tax policy is likely to take. These include continued inter-nation tax and economic competition; greater application of anti-avoidance rules; greater conflict between taxpayers and tax administrators; broader consumption taxes; and ongoing taxation of capital in the context of retention of politically popular, economically problematic, corporate income taxes.

Part III: Portfolio Income

Chapter 8 reproduces a 2003 article on the taxation of international portfolio income—an issue largely neglected in the literature, despite its ever-increasing importance. Figure 6 displays the tremendous increase in portfolio investments into the United States since the 1980s.

Figure 6

U.S. Portfolio Investments into the United States, 1980-2014

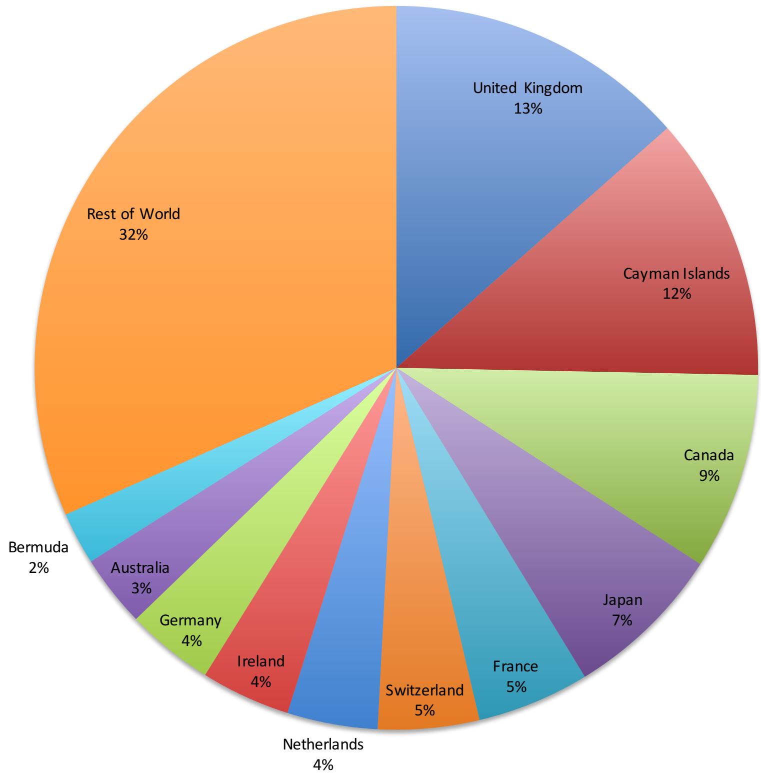


Source: Table 1.2. U.S. Net International Investment Position at the End of the Period, Expanded Detail, Bureau of Economic Analysis.
https://www.bea.gov/scb/pdf/2015/01%20January/0115_international_investment_position_tables.pdf

Figure 7 shows that tax considerations are also very important to the locations of portfolio investments. Once again, places like the Cayman Islands, Bermuda, Ireland, the Netherlands, and Switzerland play an outsized role.

Figure 7

Market Value of U.S. Portfolio Holdings of Foreign Securities, by Country, 2014



Source: Treasury International Capital System (TIC), Securities, (c): Annual Cross-U.S. Border Portfolio Holdings.
https://www.treasury.gov/resource-center/data-chart-center/tic/Pages/fpis.aspx

Chapter 8 contends that U.S. tax policy toward foreign portfolio investments of U.S. citizens and residents, which has long been similar to the taxation of foreign direct investment, should be de-linked. Only a deduction, rather than a credit for foreign taxes, may be appropriate.

This chapter's special concern with widespread underreporting and evasion of income taxes from portfolio assets abroad, especially in locations with bank secrecy, has been ratified by recent revelations.[6] The 2010 enactment of the Foreign Account Tax Compliance Act (FATCA) and the many bilateral and multilateral agreements that it has spawned, along with major inroads into bank secrecy and arrangements for automatic sharing of financial information, are making headway in redressing these problems. But the fundamental policy issues raised in Chapter 8 remain unaddressed.

Part IV: Europe

Chapter 9 reproduces the first—and most widely read and cited—of three co-authored articles concerning the impact on European income tax laws and policies of the European treaty guarantees of freedoms of movement of goods, services, persons, and capital. The treaty-based institutional and decisionmaking arrangements now governing income taxation in Europe have cut a broad swath through the income tax rules of the member states of the European Union. This chapter demonstrates that the jurisprudence of the Court of Justice of the European Union is ultimately incoherent because it quests for an unattainable goal in the absence of harmonized income tax bases and rates: to eliminate discrimination based on both the origin and destination of economic activity. The chapter also compares the ECJ's jurisprudence with the resolution of related issues of international taxation elsewhere and to the U.S. taxation of interstate commerce. Chapter 9 describes important shortcomings of the European Union in its fiscal powers and democratic decisionmaking. As the recent financial crisis has demonstrated, these deficiencies extend far beyond international tax policy, especially in the Eurozone where currency realignments in response to changing economic and fiscal circumstances are impossible.

Conclusion

Mihir Desai, in his very generous forward to this volume, correctly answers for readers the question why I have published this volume of essays rather than a monograph on international income taxation. As Chapter 7—borrowing from Sting—says, shaping international tax policy is like trying to write on the surface of a lake: too many constantly moving pieces. So having no ending, only the beginning and middle of a monograph, I have settled for pulling together this book of essays.

Desai's main criticism is that I have offered no "polestar" to guide international tax policymaking. As he puts it, “How can we find our way to the Holy Land without a polestar?” This is hardly surprising. Mihir Desai himself has offered such a polestar: “capital ownership neutrality” (CON) which “promotes global efficiency whenever the productivity of an investment differs based on its ownership” and, as an alternative, “national ownership neutrality” (NON), which promotes “the profitability of domestic firms.”[7] CON can be satisfied, he claims, if all countries either exempt foreign income from tax or tax foreign income while providing foreign tax credits. NON requires that foreign income be exempted from tax.

CON and NON were advanced by Desai and his co-author James Hines in an article published in 2003, subsequent to the publication of Chapter 3, which discusses the limitations of CEN and CIN as policy polestars. As Desai knows, had CON then been on the table, I would have expressed similar doubts about that norm as a sole guide to international tax policy. NON, as a national rather than global guide to policy (grounded in an economic efficiency claim) is more consonant with my emphasis in Chapter 3 on national governments looking to the effects of their international tax laws on the wellbeing of their citizens, but I remain unconvinced that the “profitability of domestic firms” should be the sole criterion for enhancing that welfare.

The problem, as it turns out, is that rather than having no polestar, international tax policy has too many. With each nation focused on improving its own welfare, it is hardly surprising that various nations’ interests are pulling international tax policy in many different directions. So far, as Chapter 7 laments, international tax competition dominates international tax lawmaking. The recent BEPS effort endeavored to substitute multilateral cooperation for such competition, but with only limited success. There are, to be sure, gains to be had from more multilateral cooperation, but disparities in different countries’ circumstances and interests make ongoing inter-nation competition far more likely than substantially more robust international cooperation—at least for the foreseeable future. Ultimately, as Chapter 4 suggests, this may well push (at least large market countries) in the direction of greater international income taxation based on the location of consumers. That, for now, is as close to an ending as I have to offer—unsatisfying as it may be.

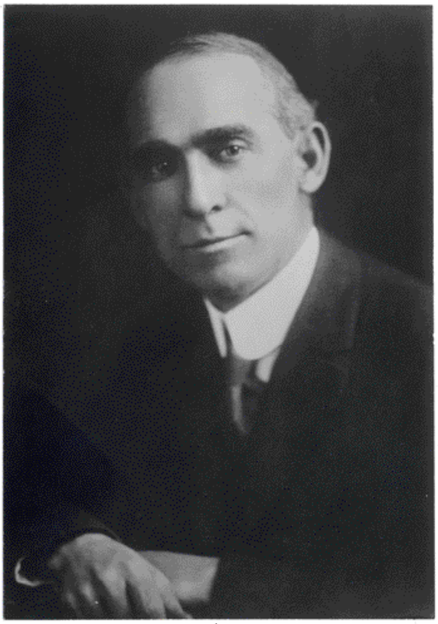
Michael J. Graetz
February 2016

Part 1

History

Chapter 1

The "Original Intent" of U.S. International Taxation



T.S. Adams
Images of Yale Individuals, Sterling Memorial Library Manuscripts and Archives, Yale University

Introduction

The Sixteenth Amendment took effect on February 25, 1913, permitting Congress to tax income "from whatever source derived,"[1] and on October 3rd of that year, Congress approved a tax on the net income of individuals and corporations.[2] The United States regime for taxing international income took shape soon thereafter, during the decade 1919–1928. In the Revenue Act of 1918, the United States enacted, for the first time anywhere in the world, a credit against U.S. income for taxes paid by a U.S. citizen or resident to any foreign government on income earned outside the United States.[3] The Revenue Act of 1921, the first major tax enactment following World War I, introduced a limitation on this foreign tax credit (FTC) to ensure that a taxpayer's total foreign tax credits could not exceed the amount of the U.S. tax liability on the taxpayer's foreign source income.[4] While details of the foreign tax credit have changed and the methodology for determining the foreign tax credit limitation has varied from time to time, these two provisions still constitute the linchpin of U.S. law taxing income earned abroad by U.S. citizens and residents.

A few years later, in 1928, the League of Nations issued draft model bilateral income tax treaties for the reciprocal relief of double taxation of international income.[5] Today, the League of Nations model still serves as the basis for the model income tax treaties of the Organization for Economic Cooperation and Development (OECD), the United Nations, and the United States.[6] Although treaty articles have become more complex, commentaries more detailed, and some apparent loopholes have been closed, almost all the major industrial nations—the members of the OECD—have bilateral tax treaties with one another based on the 1928 League of Nations model.[7] Indeed, the fundamental structure for international taxation of income announced nearly seven decades ago in the 1928 League of Nations Model Treaty forms the common basis for more than twelve hundred bilateral tax treaties now in force throughout the world.[8]

Despite massive changes in the world economy in the last seventy years, the international tax regime formulated in the 1920s has survived remarkably intact. To be sure, the complexities of current U.S. tax law governing international transactions would shock a tax practitioner of the 1920s, and the international network of bilateral income tax treaties could not have been imagined by the handful of men who fashioned the League of Nations' model treaty of 1928. Nor could policymakers of the 1920s have foreseen the integration of the world economy or the dramatic expansion of international capital flows we take for granted today. But, despite such developments, the basic structure of both the 1928 model treaties and the United States' international tax law of the 1920s governs the income tax consequences of international transactions today.

This remarkably stable regime now threatens to come unglued, however. Calls for major restructuring of the United States regime for taxing international income are commonplace. Some claim that the recent emergence of regional trading blocs, such as through the North American Free Trade Agreement (NAFTA), and the economic and political integration of the European Community demand major revision of the taxation of international income.[9]

Others believe that the international tax system has been rendered archaic by the international expansion of capital flows, especially of portfolio investments, the emergence and widespread use of new financial instruments, particularly financial derivatives, and the expansion of international activities by large multinational businesses.[10] These developments have enhanced fears of a multinational "race to the bottom" in the taxation of capital income.[11] Some analysts now call for an exemption from U.S. tax of foreign source income either on the grounds of simplification or to improve the international competitiveness of U.S. multinationals.[12] Such an exemption is used by many European nations.[13] Exempting foreign source income was the proposal advanced in 1996, for example, by the Kemp Commission on Tax Reform, a commission appointed by then Senate Majority Leader Bob Dole and Speaker of the House Newt Gingrich, and headed by former Congressman and Vice Presidential candidate Jack Kemp.[14]

Probably the greatest impetus for major change in the taxation of international business income is that the "classical" system of taxing corporations no longer exists in many industrial nations. The United States retains a classical corporate tax, under which business income earned by a corporation is taxed twice: first when it is earned by the corporation, and again when it is distributed to shareholders as dividends. Many of our trading partners, however, have moved in recent years to eliminate or substantially reduce this double taxation.[15] The international tax regime, however, is predicated on the existence of a double corporate tax. It generally allocates the corporate level tax to the country where the businesses' income is earned and the personal tax on dividends to the country where the recipients reside.[16] A country's unilateral decision to eliminate either the corporate or individual level of tax upsets this equilibrium and demands fundamental reconsideration of the international consensus about how this income should be taxed. Today, some countries, such as the United States and the Netherlands, retain a classical corporate tax while others, such as England, France, Germany and Australia, do not.[17] In such circumstances, adjusting the international tax regime in a manner acceptable to all parties is made even more difficult.[18]

All of these developments motivate calls for a fundamental reexamination of U.S. taxation of international income; as a result, proposals for change have flooded the literature.[19] Some call for taxation of international income only by the source country (the country where the income is earned);[20] others call for taxation only by the residence country (the country where the investor resides).[21] Many call for retaining the present structure—here we call it the 1920s compromise—but with substantial revisions.[22]

In moving forward, we need to be clear about what is baby and what is bathwater. It would be foolish to deny the successes of the existing regime. The system for taxing international income put in place seven decades ago has witnessed, indeed facilitated, a massive expansion in international capital flows. The current clamor for change therefore makes this a propitious moment to look back to see what the originators of this remarkably stable and successful system of international taxation had in mind. Surprisingly, this has never been done before.[23]

We endeavor here to set the historical record straight by setting forth the "original intent" of the U.S. system of taxing international income. This project serves several purposes. It has become commonplace to attribute—we claim to misattribute—the key role in fashioning the modern international tax regime to a 1923 report prepared for the League of Nations by four economists under the leadership of the Columbia University economist Edwin R.A. Seligman.[24] This reading of history overstates the role played by the 1923 Report and, in doing so, it misleads modern policy analysts about the relative historical importance of the tax claims of countries of residence at the expense of countries of source. Our analysis brings to light the central role played in the original formulation of U.S. international tax policy by Thomas Sewall Adams, an economics professor at the University of Wisconsin and Yale University and, crucially, the key Treasury tax advisor during this period. If there was a founder of the U.S. system of international taxation, it was T.S. Adams.

The international tax rules put into place by Congress, largely at Adams' behest—particularly the foreign tax credit—were not, as some modern analysts seem to think, enacted to advance the goal of worldwide economic efficiency by making Americans indifferent about investing domestically or abroad, although they certainly narrowed the pre-existing differences in making such investment choices.[25] Today's common attribution to the U.S. international tax regime, by both economists and lawyers, of a deliberate policy of "worldwide efficiency" or "capital export neutrality"—a policy of taxing U.S. residents identically whether they invest here or in a foreign country[26]—overlooks the original primacy given by T.S. Adams and the U.S. international tax regime to source-based taxation.

Modern policy advocates, of course, may reject the primacy of taxation by countries of source, but they cannot properly claim that such a rejection is simply a continuation of the original U.S. tax policy toward international income.

Adams' purposes, reasoning, and deep understanding of how international income should—he would say "must"—be taxed not only reveal the original intent of U.S. international taxation but also provide important counterpoints to the consensus views of modern economists about international tax policy today. We make no claim here, however, that the original intent of international taxation should necessarily constrain today's policies. We have no desire to become the Bob Bork and Ed Meese of international taxation.[27] Nevertheless, taking a careful look at Adams' attitude in fashioning U.S. international tax policy at the beginning of the twentieth century provides useful lessons for reevaluating this nation's international tax policy at the century's end, notwithstanding the nature and scope of the changes in the world economy that have taken place in the intervening years. Ignoring the wise and practical views of Adams, the person most responsible for putting this remarkably successful and durable system into place, could well be folly. He has much to teach us about making international tax policy today.

I. Who Was T.S. Adams, Anyway?

Thomas Sewall Adams was born in Baltimore, Maryland on December 29, 1873. After obtaining his Ph.D. in economics from Johns Hopkins in 1899, Adams collaborated with his professor, Richard T. Ely, and two others in producing the most widely-used pre-World War I economics textbook, Outlines of Economics (published in 1908).[28] He also was the co-author with Helen L. Sumner of the successful treatise Labor Problems (1905), but Adams was far better known for his role in shaping tax policy, particularly during the early days of the income tax, than for his scholarly publications.[29]

While he was a professor of economics at the University of Wisconsin from 1901–1915, Adams helped formulate and write the Wisconsin Income Tax Law, the first successful progressive income tax in the United States. The Wisconsin income tax became a model both for other states' income tax statutes and the 1913 federal income tax law. Adams served as a Wisconsin Tax Commissioner from 1911–1915.[30] In 1916, after a brief interlude at Cornell, Adams became a professor of economics at Yale, concentrating principally on public finance and advanced economic theory. In collaboration with Edwin R.A. Seligman, Adams drafted New York's first income tax statute that year.[31] From 1917 until his death in 1933, Adams combined his teaching at Yale with advice to the federal and state governments and to private organizations.

From 1917, when he was appointed tax advisor to the Treasury Department by President Wilson, until 1923, he served as the Treasury's principal advisor on issues of tax policy and administration. During much of the period we are concerned with here, Adams was Treasury's spokesman before the House Ways and Means Committee and the Senate Finance Committee whenever tax legislation was being formulated. From 1923 until his death in 1933, Adams served as the key spokesman for the United States in the international tax treaty movement. Notwithstanding the dramatic political shift marked by the election of Republican Warren G. Harding to the White House, Harding's incoming Treasury Secretary, Andrew Mellon, retained several high-ranking Treasury officials from the Wilson administration, including Adams—a testament to their reputation for nonpartisan expertise.[32] A contemporary observed that "Professor Thomas S. Adams has been the principal Treasury expert and adviser of Secretaries of the Treasury, Ways and Means Committees, and Finance Committees" under both Democratic and Republican regimes, and that his influence was "remarkable" in light of the "bitter election campaign of 1920."[33] Having previously served three Treasury Secretaries (William G. McAdoo, Carter Glass and David F. Houston) under President Wilson, Adams became one of Andrew Mellon's closest advisers during his early years in office.[34] President Harding apparently cared little, and understood less, about tax issues, gladly leaving these difficult matters to his experts at Treasury.[35] Harding once declared, "I can't make a damn thing out of this tax problem. I listen to one side and they seem right, and then—God!—I talk to the other side and they seem just as right."[36]

Reading the transcripts of executive sessions of the tax-writing committees reveals both the scope of Adams' knowledge and the extent to which Congress relied on him. Adams went through draft legislation subsection by subsection explaining proposed rules and the reasons for them. He advised Congress not only on the substance of the law but also on the best style for drafting the legislation. He often explained to the committees legal issues involving Supreme Court opinions, opinions of the Attorney General, and IRS regulations.[37] It should be noted that, at this time, Congress had no tax staff of its own. The Joint Committee on Taxation, which has long provided a professional tax staff to the Congress, did not come into existence until 1926. The description of Adams as the "father" of the 1921 Act does not seem overstated.[38] Adams had no rivals for the committees' attention. During hearings on the 1921 Revenue Act, Senator LaFollette remarked to Adams: "I have the greatest confidence in you and I think you know more of the subject [of taxation] than anybody else in the world."[39] John Witte, the leading chronicler of the political evolution of the income tax, describes Adams as "the leading tax expert of his time."[40] The tax historians W. Elliott Brownlee and Sidney Ratner also emphasize Adams' great influence.[41]

Adams also enjoyed the great respect of his peers in the economics profession. He served as president of the National Tax Association in 1923, and also of the American Economic Association in 1927.[42] He apparently was the only person to hold both positions until that feat was repeated by the Brookings Institute economist Joe Pechman in the 1970s and 1980s.[43]

At his death in 1933, friends, colleagues and numerous present and former government officials paid tribute to Adams.[44] Henry Rainey, Speaker of the House, described him as the "greatest expert" on taxes he ever knew, and three former Treasury Secretaries, who had served under four different Presidents, David F. Houston (who served under President Wilson), Andrew W. Mellon (Presidents Harding, Coolidge and Hoover) and Ogden D. Mills (President Hoover), praised his enduring contributions to the field of public finance and to the nation's tax law.[45] Most revealing, however, were two tributes from fellow public finance scholars at Columbia University, his friend and sometimes rival Edwin Seligman and Robert M.

Haig. Professor Seligman wrote:

> If there ever was a scholar in politics, Adams is a shining example . . . He wrote, indeed, only little, but every essay that came from his pen was thought-provoking. His greatest qualities however, were his administrative and executive gifts, and his practical common-sense, which enabled him to thread his way so successfully amid the maze of conflicting opinions and which made him so valued a counselor to statesman…In his influence on the fiscal policy of the United States he will live as a fit successor to David A. Wells, who played a similarly prominent part in the Civil War.[46]

Robert Haig was also effusive, and, along with several others, referred specifically to Adams' accomplishments in the field of international taxation:

> However, closest to his heart during this period has been the daring conception of international harmony and cooperation in taxation,. . . [a] prize . . . to be won only by overcoming almost insuperable obstacles. How substantial has been his progress toward a solution I realized only when I sat with such men as Blau in Bern and Dorn in Berlin, watched their eyes kindle with enthusiasms and admiration for Adams and heard their expression of eagerness to assist in the forwarding of his plans. For, by the force of his knowledge and his personality, he won the complete respect and loyalty of this polyglot committee of the League of Nations. Let us hope that its work will be crowned with complete success. He would desire no nobler monument.[47]

While "complete success" in the field of taxation is difficult to know, much less achieve, Adams did succeed in putting in place the fundamental structure of both the U.S. tax law governing international taxation and the original model for bilateral tax treaties, the two building blocks which have governed U.S. taxation ever since.

The early formation of American public policies in many instances has depended on the special talents and roles played by a few leading individuals. In each such case, these leader s were masters of both design and implementation. With the exception of the Constitution's founders, about whom probably too much has been said, little is known of such men and the critical roles they played in shaping American public policy. T.S. Adams was such a person, a "prophet" in the field of taxation.[48]

Adams' influence is well-illustrated by an anecdote from the 1922 annual conference of the National Tax Association. The following was to be printed on the official program's schedule of speeches: "How federal taxes are made, by Thomas S. Adams, Yale University." However, a preliminary program read: "How Taxes Are Made by Dr. T.S. Adams of Yale University." Noting Adams' power and influence in Washington, the speaker introducing Adams' talk joked, "I don't know which subject is to be discussed this afternoon."[49]

II. The Essential Dilemma of International Taxation

Despite the seismic changes in the world economy that have occurred in the last seven decades, the fundamental dilemma of international taxation that confronted Thomas Sewall Adams, his Treasury colleagues, and the Congress in the infancy of the income tax remains essentially unchanged. When income is earned in one country by a citizen or resident of another country, both the country where income is earned (the source country) and the country where the investor or earner resides (the residence country) have legitimate claims to tax the income. The basic task of international tax rules is to resolve the competing claims of residence and source nations in order to avoid the double taxation that results when both fully exercise their taxing power. Capital-exporting and capital-importing nations have conflicting financial interests: capital importers have the most to gain from taxation at source, capital exporters from taxation of residents. Absent agreement, residence countries remain unable to limit the unilateral actions of source nations.

It is nevertheless surprising that the solutions to these problems first accepted by this nation in the 1920s—largely at the behest of Adams—have remained so stable. Not only have the scale and scope of international transactions changed dramatically, but the Treasury's views about the relative priorities properly accorded the claims of residence and source countries have also shifted substantially since Adams' time. In its 1977 *Blueprints for Basic Tax Reform*, the Treasury made clear its preference for residence-based taxation.

> There are two basic prototype approaches to the taxation of international flows of income. The first is the residence principle, under which all income, wherever earned, would be defined and taxed according to the laws of the taxpayer's own country of residence. The second prototype is the source principle, which would require the taxpayer to pay tax according to the laws of the country or countries in which his income is earned, regardless of his residence . . .
>
> A number of considerations point to the residence principle as the more desirable principle to establish. First, the concept of income as consumption plus change in net worth implies that distinctions based on the geographical origins of receipts are inappropriate. Income, by this definition, is an attribute of individuals, not of places. Second, if owners of factor services are much less mobile internationally than the factor services they supply, variations among countries in taxes imposed by residence will have smaller allocation effects than tax variations among places of factor employment. Third, the income redistribution objective manifested by the use of progressive income taxes implies that a country should impose taxes on the entire income of residents. The usual concept of income distribution cannot be defined on the basis of income source.
>
> For these reasons, the model plan recommends that the United States seek, as a long-run objective, a world wide system of residence principle taxation.[50]

In 1996, the Treasury reiterated its preference for residence-based taxation:

> The United States, as do most countries, asserts jurisdiction to tax based on principles of both source and residence. If double taxation is to be avoided, however, one principle must yield to the other. Therefore, through tax treaties, countries tend to restrict their source-based taxing rights with respect to foreign taxpayers in order to exercise more fully their residence-based taxing rights....
>
> In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item

> of income with a specific geographic location. Therefore source-based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere. An individual is almost always a resident of somewhere and, at least under U.S. law, all corporations must be established under the laws of a given jurisdiction.[51]

In both of these statements, the Treasury echoes views of Edwin Seligman, as expressed in the 1923 Economists' Report to the League of Nations, which plainly viewed source-based taxation as illegitimate because it is not based on the taxpayer's full ability to pay, or "faculty." The 1923 Report rejected the notion of an exchange where the government offers services for payments of taxes, stating that "the entire exchange theory has been supplanted in modern times by the faculty theory or theory of ability to pay."[52] Seligman's Report ascribed source-based taxation to "administrative cowardice or frailty"[53] and argued that "as semi-developed countries become more industrialized...the principle of personal faculty at the place of residence will become more widely under stood and appreciated."[54]

However, neither Seligman's views nor those of the present-day Treasury Department were shared by Adams and the Treasury Department of the 1920s. Adams did not believe in the superiority of residence and, although he rejected theoretical dogmatism on both sides of the issue,[55] he was clear about the primacy of the claim of the country where the income was earned—the source country—over the country whose residents supplied the investment capital—the residence country. Adams endorsed source-based taxation "[a]s a matter of both principle and administrative convenience."[56] Adams wrote, "The income tax is really a dual thing: first, upon individuals levied in rough accordance with their ability to pay; and second, upon income where it is earned."[57] Indeed, Adams insisted that "[t]he strongest reason for the retention and perfection of business taxation is found in experience and fiscal history."[58] From "political and moral standpoints," he offered this "plain" justification for business taxes:

> A large part of the cost of government is traceable to the necessity of maintaining a suitable business environment.... Business is responsible for much of the work which occupies

> the courts, the police, the fire department , the army and the navy. New business creates new tasks, entails further public expense...The relationship between private business and the cost of government is a loose one . . . The connection, however, is real . . . [B]usiness ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.[59]

Indeed, Adams regarded the "state and community. . . as silent partners in every business enterprise." The state, he argued, was entitled to a "prior claim . . . upon profits which public expenditures or the business environment maintained by the state have in part produced."[60] He was clear that the U.S. should not and would not forego taxation of business income earned in the United States regardless of the residence of the business owners.[61] "Business competes with business, not owners with owners."[62] He added :

> Income must to some extent be taxed where it is earned, at rates and by methods determined by the conditions under which it is earned—not by the conditions under which it is spent . . . [C]orporations and other business units derive benefits and compete with one another as units, in the jurisdictions in which they do business.[63]

Edwin Seligman was never convinced. In sharp contrast, Seligman argued that the income tax was only about ability-to-pay and the progressivity principle. He insisted: "[N]othing is more firmly established than the substitution of the ability theory for the old benefit theory in taxation. To do as Professor Adams now attempts, and to blur these sharp distinctions, is to reopen the Pandora 's box of confusion."[64]

Ultimately, in addition to his view that source-based taxation was justified by the benefits that the country of source provided to private enterprise, Adams' respect for the power of economic self-interest and his insistence on solutions which were practical and could be stable over the long-term help explain his preference for taxation by countries of source over taxation by countries of residence. Adams declared: "Every state insists upon taxing the non-resident alien who derives income from source within that country, and rightly so, at least inevitably so."[65] Adams viewed source-based taxation as just and inevitable—most nations exercised jurisdiction over source and there was little value in trying to talk them out of it. He further argued, "In the long run the business unit or source will yield more revenue to the public treasury than the individual; and the place where the income is earned will derive larger revenues than the jurisdiction of the person."[66] Adams was committed to taxing business income, and viewed source-based taxes as more effective at doing so than residence-based taxes.[67] He viewed nations that insisted on residence-based taxation as imposing an affirmative disadvantage on themselves, hobbling the competitiveness of their businesses abroad.[68] Finally, while governments had a profound responsibility to relieve residents of the injustice of double taxation, the more attenuated relationship between governments and nonresidents did not dictate such accommodation.[69] Thus, in Adams' mind, the case for source over residence was even stronger in cases of double taxation than it was in the abstract.

Adams' preference for source had a defensive, as well as an affirmative, aspect; he insisted that the right of the United States to tax its own domestic-source income must not be sacrificed. As we shall see, this caused him to ask for a limitation on the foreign tax credit in 1921 so that U.S. residents and citizens could not use the credit to offset U.S. taxes on domestic income.[70] Adams was not willing to imperil his own nation's ability to collect taxes on income produced within its borders.

Although Adams insisted that residence defer to source in cases of double taxation, he never rejected residence-based taxation altogether. Adams viewed residence as an important backstop to source-based taxation, which is why he generally favored credits for foreign-source taxes paid abroad, rather than exemptions for foreign-source income.[71] Residence only deferred to source if source *in fact* exercised its jurisdiction.[72] In Adams' view, the need for residence-based taxation as a backstop lay in his concern over tax avoidance,[73] which he found to be a problem of equal weight to double taxation.[74]

Adams also saw value in residence-based taxation as a means to protect progressive income tax rates, but he clearly felt that some of his peers, including Seligman, exaggerated the importance of graduated rates. Adams characterized "the will to tax progressively" as "a sound enough objective within a limited field, but a sorry substitute for the complex aims and objectives of tax systems considered as systems."[75] Ultimately Adams concluded that "the attempt to make the income tax do the work of social reform is apt to spoil the income tax . . . It is at best a substitute for taxes which exercise a positively deleterious effect upon the distribution of wealth."[76] Nevertheless, Adams did not regard doing business abroad as an appropriate avenue to escape progressive rates on individual residents.[77] Adams knew well that progressive taxation of individuals was not possible under an exclusively source-based system, since it would require source nations to obtain a great deal of personal information about residents of other countries.[78] Adams thus felt that progressive taxation was best handled by the nation of residence through a credit for foreign-source taxes paid abroad.[79]

Notwithstanding Adams' view that residence-based taxation had a valid role to play as a backstop, it is quite clear that Adams accorded a primary importance to source-based taxation. Adams' contemporaries recognized that the foreign tax credit, Adams' primary innovation was a rejection of the primacy of residence-based taxation.[80] During the War, the United States had shifted from a debtor to a creditor nation but, as a result of Adams' leadership, the United States did not argue—as did Great Britain, for example—that the country of residence should have the first claim to tax the income. Edwin Seligman described the American approach as the "extreme converse" of purely residence-based taxation.[81] Thus, modern claims that the U.S. international tax regime gives primacy to residence-based taxation should be understood as a repudiation—not a continuation—of its original intent.[82]

III. The "Original Intent" of U.S. Tax Law Governing International Transactions

In the early days of income taxation, during the period 1913–1918, before Thomas Sewall Adams made his appearance on the federal scene, U.S. tax law allowed only a deduction from income of taxes paid to a foreign government.[83] The direct offset of U.S. taxes by foreign taxes paid—the foreign tax credit—did not appear until the Revenue Act of 1918.[84] Although there was no talk about such a notion then, economists today view a system of taxing worldwide income with only a deduction for foreign taxes as furthering what they label "national neutrality."[85] Although this is a form of neutrality in that all net receipts received by persons in the United States are taxed the same regardless of whether they have also been taxed by another nation, this label is somewhat misleading. What "national neutrality" means in this context is that U.S. tax policy should favor U.S. investments over equally productive foreign investments.[86] National neutrality regards the domestic investment as better because the U.S. Treasury gets the revenue. In such a regime, the United States will capture the benefit of the entire pre-tax return on the domestic investment, either in taxes or in private after-tax returns to U.S. residents. According to this view, U.S. tax policy should encourage U.S. individuals and companies to prefer U.S. investments whenever the U.S. pre-tax rate of return exceeds the return on a foreign investment net of the foreign country's taxes.[87] Thus, such a policy treats foreign taxes as costs of investing U.S. capital abroad and allows foreign taxes to be deducted in computing taxable income, the same treatment as for other costs of earning income.

This normative perspective contrasts sharply with a policy directed toward achieving "worldwide efficiency," which would be neutral about a U.S. resident's choice between a domestic and foreign investment producing the same pre-tax rates of return. A policy of neutrality toward such an investment choice (also known as "capital export neutrality") is indifferent not only about where such investments are made but also about which country collects the tax revenues from the income of the investment. Many economists and other tax policy analysts criticize a policy of national neutrality, claiming that the nation's tax policy goal should instead be worldwide economic efficiency. But it is hard to convince a U.S. President or members of Congress to put aside "narrow" national interests to fashion U.S. tax policy in a manner that is indifferent to whether taxes flow into U.S. coffers or the treasury of some foreign nation. This is particularly true when the foreign nation whose treasury will be enhanced is selected as a private investment decision of U.S. investors, rather than as a reflection of the foreign policy goals of the United States. To take but one instance among many, Kansas' Senator Curtis objected in hearings on the 1921 Act to a relief provision for Americans doing business abroad, stating, "Our people get the worst of it, and they ought to, if they go to another country to invest. Let them invest in their own country."[88]

More persuasive in the policymaking arena has been the claim that "national neutrality"—allowing only a deduction for foreign income taxes—is doomed to fail on its own terms.[89] Here the argument shifts from the contention that worldwide economic efficiency is a more worthwhile goal than national well-being to an assertion that, when one takes the likely responses of foreign governments into account, a U.S. tax policy that prefers U.S. investments, at least in the long term, will fail; a self-centered international "beggar-thy-neighbor" contest will lower not only worldwide economic output but also the national output of the United States itself. This claim echoes the argument for favoring free trade over high tariffs on imports, that a policy that seems to further the national self-interest in the short-term will be self-defeating in the long run. This shifts the political debate from normative disputes over goals to empirical claims about consequences and to contentions that the interests of the United States will be best furthered by an international tax regime designed to promote worldwide economic efficiency.[90] Indeed, this constitutes much of the modern debate and, not surprisingly, claims about consequences are often expressed in multiple empirical models of daunting complexity.[91]

A. The Revenue Act of 1918—Enacting the Foreign Tax Credit

Just as the enactment of a deduction for foreign taxes occurred in 1913 without any talk of "national neutrality," the move away from this deduction to a foreign tax credit in the 1918 Act took place without any political decision to shift U.S. tax policy to favor "worldwide efficiency" or "capital export neutrality." The Sixteenth Amendment permitting a federal income tax had recently been sold to the American people on fairness grounds, and, in 1918, arguments grounded in tax equity remained far more persuasive politically than notions of promoting more economically efficient investments. T.S. Adams was then just beginning to create the institutional capacity within the Treasury and Internal Revenue Service to analyze the social and economic consequences of fiscal and monetary policies.[92] A politically persuasive case for free trade policies loomed only in a distant future. Throughout the early part of this century, America's trade policy viewed imports unfavorably, and Congress was soon to raise its already substantial protective tariffs.[93]

Then, as now, international tax policy was "something of a stepchild" in the tax legislative process.[94] The big issue before the Congress was finding the means to finance the war, in particular the question whether to impose a war profits or excess profits tax.[95] Indeed, Adams initially joined the Treasury Department to assist with the massive tax increases that would be necessary to fund the United States' war effort.[96]

This tax-raising occasion was an odd time for Adams to succeed in making the foreign tax credit (FTC) his first enduring contribution to international tax policy. But, because the United States insisted on taxing the worldwide income of its citizens, the pre–1918 arrangement permitted a form of double taxation, with foreign-source income being fully subject to taxation both at home and abroad. In 1913, when the American income tax was first implemented, tax rates were low and this double taxation may have been a comparatively minor nuisance. In 1918, however, with the world at war and tax rates inflating rapidly around the globe, international double taxation was becoming a far more serious burden on Americans doing business or investing abroad.[97] The top marginal rates on individuals in the United States reached 77 percent, and although the basic corporate rate was only 10 percent, an excess profits tax at rates from 8 to 60 percent also applied to many large companies.[98] In such circumstances, additional layers of taxation from other nations were potentially confiscatory. Relief became a matter of some urgency.

In this context, Adams presented an extraordinary proposal: the foreign tax credit, which he described as "one of the most striking departures" in the 1918 Act.[99] Under the FTC, Americans could claim a *credit* against their American taxes for taxes paid to other countries; taxes paid abroad would reduce American tax revenue dollar for dollar.[100] The FTC represented what was an extraordinarily generous measure for its time: the United States was assuming sole responsibility for the costs of reducing the double taxation of its residents and citizens. As Edwin Seligman remarked, "[T]he United States is making a present of the revenue to other countries."[101] In so doing, the U.S. unilaterally renounced a potentially important bargaining chip in convincing other nations to forego taxing their residents on U.S. source income. Adams expected his proposal to be turned down because the press of wartime financing made tax relief generally inappropriate in 1918:

> In the midst of the war, when the financial burden upon the United States was greater than it had ever been, I proposed to the Congress that we should recognize the equities... by including in the federal income tax the so-called credit for foreign taxes paid . . . I had no notion . . . that it would ever receive serious consideration.[102]

Such generosity was virtually unprecedented. Great Britain, for example, limited its relief from double taxation, also a foreign tax credit, to taxation within the British Empire and, in legislation in 1920, the British further limited its FTC to a maximum of one-half of the British taxes on the foreign income.[103] Yet Adams pursued his scheme because he felt that "it touched the equitable chord or sense, and because double taxation under the heavy war rates might not only cause injustice but the actual bankruptcy of the taxpayer."[104]

To Adams' surprise, the FTC provoked little opposition (or indeed notice) and became law in 1919.[105] Adams attributed the success of his proposal to the fact that legislators are particularly sensitive to the charge of double taxation.[106] Adams later observed, "In my experience with legislative bodies I have found that you can accomplish more for equity and justice in taxation in the name of eliminating or preventing double taxation, than with any other slogan or appeal."[107]

At bottom, Adams objected to double taxation because it offended his sense of fairness.[108] From 1918 until his death in 1933, Adams maintained a nearly continuous involvement in one project or another to alleviate international double taxation.[109] Even legislators, whose wisdom Adams sometimes doubted, responded to what Adams perceived as the manifest injustice of double taxation:

> There is something in the legislative mind which recognizes that if one taxpayer is being taxed twice while the majority of men similarly situated are being taxed only once, by the same tax, something wrong or inequitable is being done which, other things being equal, the legislator should correct if he can.[110]

Adams framed the problem of double taxation not as an issue of economic efficiency, but as a matter of invidious discrimination. Adams identified the ultimate culprit causing this discrimination as the nation of residence: “More double taxation of the unjust variety is inflicted upon the taxpayer by his own government than by foreign governments.”[111] He elaborated:

> Every state insists upon taxing the non-resident alien who derives income from sources within that country, and rightly so, at least inevitably so. Now, then, in due course of time, citizens of the home state inevitably invest abroad and derive income from foreign sources. The average state refuses to acknowledge in this situation the right of its own citizen to a proper exemption on income derived from foreign sources. It . . . refuses to recognize when one of its own citizens or nationals gets income from a foreign source that he inevitably will be taxed abroad.[112]

Given the predictability and the justness of taxation abroad, in Adams’ view, the nation of residence wronged its taxpayers by levying an additional tax upon foreign-source income, thereby discriminating unfairly against residents who happened to earn their income abroad.[113]

Though Adams felt, as a matter of principle, that nations should work to alleviate the double taxation of their residents, and, during the limited discussion of the measure, members of Congress focused on the great burden of double taxation and the urgency of relieving it given wartime tax rates, other factors also played a role. In particular, there was a growing recognition of a need to encourage private investments by Americans in Europe. Adams also believed that the United States would reap practical benefits from providing relief to its own taxpayers; he was convinced that a discriminatory tax system that imposed unconscionably high rates on some taxpayers would ultimately prove to be unenforceable.[114]

Moreover, Adams generally shared the sentiments about business of the Administrations for which he worked;[115] he believed American prosperity depended in large measure on the competitiveness of American business abroad.[116] Certain members of Congress also depicted the FTC “as a method to encourage foreign trade and to prevent revenue loss through incorporation of foreign subsidiaries or expatriation.”[117] Trade abroad was considered crucial to the nation’s economic well-being and was thought to require appropriate support from the government.[118] Relief from double taxation constituted just such appropriate support.[119] And there is some evidence that Adams had this policy in mind in his international tax efforts. His close associate, Mitchell Carroll, characterized Adams' FTC in this way:

> The American credit system is ideal for a wealthy nation that desires to encourage the expansion of its foreign trade, and is willing to afford relief from double taxation to its own citizens or residents....The United States says, in effect, to its citizens—go abroad and trade. If you have to pay tax on your earnings in foreign countries, show me your tax bill and I will give you relief.[120]

Adams himself made clear that some of the reforms he presented in the 1921 Act had the competitiveness of American businesses in mind.[121] And he carried similar concerns with him into his tax treaty work:

> [Legislation authorizing U.S. negotiation of tax treaties] will enable the businessmen of this country to compete on somewhat fairer terms with the businessmen [sic] of those foreign countries which have the benefit of conventions or treaties of this kind protecting them from the burdens of international double taxation.[122]

Perhaps such concerns over international competitiveness explain Adams' statement during the League of Nations' international tax treaty process that "[e]ach State should be eager, for selfish and economic reasons, to relieve its own nationals and residents from that measure of double taxation which is due to its own legislation."[123] For Adams, political principle and national self-interest coalesced around the issue of international double taxation. Particularly in light of the global increase in tax rates due to World War I, he found it imperative to relieve such taxation, first by adopting the bold measure of the FTC.

By the end of 1918, the United States had another reason to favor relief for Americans investing abroad: A variety of American economic and diplomatic interests required that a substantial quantity of American capital be channeled to rebuild post-war Europe. The United States was owed eleven billion dollars by allied governments for wartime loans;[124] somehow Europe would need access to American dollars to pay off this debt.[125] Europe would also need American dollars to purchase American exports—a central goal of American economic policy.[126] Given the U.S. antipathy to imports and its high tariffs, it was difficult for Europeans to sell goods to the United States. Moreover, the wartime devastation of Europe's human, physical, and financial capital made serious competition in American markets unlikely. If dollars could not be raised through sales, another possibility was loan forgiveness or other public financing of European recovery by the American government. However, domestic politics in the United States were very different after World War I than after World War II. Americans wanted smaller government, lower taxes, and fewer international entanglements. Americans would not tolerate loan forgiveness, much less a Marshall Plan, to aid Europe at a time when the United States government was itself sagging beneath what it considered an enormous wartime debt.[127] In sum, if Europe was going to get the dollars necessary for the repayment of its debts, the purchase of American exports, and the economic stability necessary for peace, the source would have to be private investment.[128]

Accordingly, the United States undertook a number of initiatives in 1918 and 1919 to encourage investment abroad.[129] Perhaps the most noteworthy initiative, in addition to the foreign tax credit, was the Edge Act, passed by Congress in late 1919, which promoted the development of federally-chartered banking enterprises designed to channel private domestic capital to European reconstruction.[130]

Ultimately the foreign tax credit was only a small part of a large, complex, and ultimately controversial bill. In addition to sharp increases in corporate and individual income taxes (though not sharp enough for some progressives), the 1918 Act introduced a brand new war profits tax to limit war profiteering, a provision that provoked much attention and debate, and which clearly overshadowed the FTC in importance.[131] Although the 1918 Act constituted the largest single tax increase of the war years, because it was not actually enacted until after the Armistice, this legislation also incorporated a number of long-term tax relief provisions, such as automatic phased-in reductions in corporate and individual tax rates beginning with the 1919 tax year.[132] Thus, the FTC, while an anomalous tax relief provision pre-Armistice, was rather more consistent with the overall spirit of the

1918 Act by the time it became law.

B. The 1921 Act—Limiting the FTC and Enacting Specific Source Rules

With the FTC, Congress put into place the centerpiece of an American international tax scheme that persists to this day: the United States taxes non-residents on U.S.-source income,[133] and residents and citizens on world-wide income, but allows the latter to offset their U.S. tax liability with a credit for income taxes paid abroad to alleviate double taxation. Though the Revenue Act of 1921 retained this basic structure, Adams returned to Capitol Hill once again as spokesman for the Treasury Department to urge a number of significant refinements to the mechanism.

The most important of these reforms was a limitation on the FTC. As originally devised, the FTC could be used to offset up to the full amount of any U.S. "income, war profits and excess-profits taxes" owed by an American taxpayer.[134] Thus, an American with substantial investments abroad, particularly if made in a high-tax nation (or nations), might eliminate his entire tax bill to the United States. Such an unlimited feature of a foreign tax credit in fact furthers the principle of capital export neutrality because, under such a regime, decisions about where to make investments turn only on comparing pre-tax rates of return even when the foreign tax rate is higher than the domestic tax rate. But neither Adams nor Congress was thinking about achieving such neutrality during this period, and both regarded the limitless FTC in 1921 as creating the potential for "abuse."[135] With the high U.S. tax rates obtaining in 1918 and 1919, the ability of the FTC to erase U.S. tax liability was not readily apparent. By 1921, however, U.S. rates had fallen considerably and were in the process of being reduced further.[136] Meanwhile, European nations maintained their higher rates. For instance, in 1921, the "normal tax" (i.e., the base rate applied to the lowest income categories) was 10 percent in the United States, but 30 percent in Great Britain.[137] Under such circumstances, an American investing in Great Britain might easily wipe out his entire U.S. tax liability even though the lion's share of his income was from U.S. sources.

Adams justified a limitation on the FTC to the Senate Finance Committee as follows:

> [The unlimited FTC] is subject to this...rather grave abuse: If the

> foreign taxes are higher than our rate of taxes, that credit may wipe out taxes which fairly belong to this country.... [W]e know of instances where big corporations whose income was derived largely from this country have had their tax wiped out, so far as this country is concerned , because the English tax rates are three times as high as ours.[138]

Specifically, Adams requested and Congress enacted what we now call an "overall limitation": the amount of FTC available to any given taxpayer was limited to a proportion of the taxpayer's overall U.S. tax liability equal to the proportion of the taxpayer's global income derived from foreign sources. For instance, an American obtaining 10 percent of his income from foreign sources could use the FTC to offset a maximum of 10% of his total U.S. tax liability on his worldwide income; the taxpayer would thus have to bear an increased tax burden for investing in foreign countries with higher average taxes than the United States. To the Senate Finance Committee, the case for such a limitation was so strong that there was no need even to discuss the proposal.[139] The repeal of the U.S. excess profits tax in 1921 made such a limit even more compelling. Contemporary critics derided the limitless FTC as an instance of unjustified "prodigality" on the part of the American government.[140]

The fundamental purpose of the 1921 foreign tax credit limitation was to protect the ability of the U.S. to collect tax on U.S. source income, but the limitation on the foreign tax credit also has had a number of effects on the investment decisions of U.S. residents. Generally, under such a limitation, if a foreign country's tax rate is higher than the U.S. rate, a U.S. investor will prefer a domestic investment to a foreign investment with an identical pre-tax rate of return. For an investor who has already made some foreign investments, however, the limitation's averaging of foreign taxes of high-tax and low-tax countries might create advantages for investments in low-tax countries (to average against the high-tax foreign country's taxes as a way of offsetting U.S. tax) or indifference about investments in high tax countries (because, due to investments in low tax countries, the limitation may not be reached). The limitation enacted in 1921 clearly eliminated the pure neutrality as between foreign and domestic investments with the same pre-tax rates of returns that had existed under the unlimited earlier version of the FTC.[141]

In addition to capping the FTC, Adams sought also to establish clear source rules in the 1921 Act. The distinction between domestic and foreign-source income had become a central organizing feature of the American international tax system. It required determining the "U.S. source" income on which foreigners could be taxed and the "foreign source" income on which Americans could claim the FTC. The 1918 Act, however, had failed to specify any rules for determining which income was foreign and which was domestic source. In the absence of any statutory direction, the Attorney General had established source rules through written opinions.[142]

The Justice Department's judgment, however, differed from that of Adams and the Treasury Department on at least two significant issues. First, the Attorney General decided that business income followed sales, regardless of where a product was manufactured or through whose hands it traveled to its final selling point. According to the Attorney General, who was guided more by common law traditions than tax policy considerations, only the nation in which the sale was concluded could levy a tax on income arising from the sale.[143] Adams objected that such a rule denied the United States authority to tax much income that was, in essence, produced domestically, and that such a rule was open to taxpayer manipulation:

> An English corporation which owns timberland in Arkansas cuts the trees, roughly fashioning the timber, and cutting them into rough implement form here, completing the final process of manufacture in Scotland and selling from London, would be held to derive no part of the profit here. The present law is to this effect—that a Canadian corporation, for instance, can set up a factory here, go through all of the business transactions except final sale, and the income will follow the place of sale.
>
> The danger of all that is that it is possible within limits to consummate sales wherever you wish. You can conclude the sale wherever you want to, abroad or here, frequently at your option.[144]

In response to Adams' argument, Congress transferred discretion over the allocation of business income to the Commissioner of Internal Revenue. The Commissioner was to promulgate regulations apportioning such income between foreign and domestic sources in a manner more accurately reflecting their relative contributions than the simple sales rule.[145]

The second major departure from Department of Justice policy sought by Adams concerned the source rule for interest income. The Attorney General, again guided by common law, allocated interest to the residence of the creditor. In contrast, Adams sought allocation to the residence of the debtor.[146] Adams derived this rule from the practices of the American states with their income taxes.[147] The rule Adams preferred not only would strengthen source-based taxation, but also would reassure American lenders in Europe that the European taxes on their interest income would be credited against their U.S. tax liability. Adams reported to the Congress the "very active interest" of the Departments of State and Commerce in the provision, suggesting that the channeling of private capital to Europe was at least one motivation for the reform.[148] The interest source rule advanced by Adams was accepted by Congress.[149]

Though the interest and business income rules represented the most significant departures from existing practices (as established by the Attorney General), Adams offered Congress a full range of source rules, governing income from real property, intellectual property, personal services, and dividends. Adams assured Congress that these rules were derived from existing domestic and international practices, and reassured the Senate Finance Committee that the source rules were the most thoroughly researched provision of the 1921 Act.[150] As a result, Congress enacted an extensive set of detailed source rules in the 1921 Act, specifically covering interest, dividends, rents and royalties from real, personal and intangible property, personal services, gains from the sale of real and personal property and the manufacture and sale of personal property.[151] Adams' views concerning the need for explicit and clear source rules and about the proper rules, as reflected by the 1921 Act, would also play a significant part in his subsequent efforts to shape the source rules of a model international income tax treaty.[152]

C. The Foreign Traders and Possessions Corporations Provisions of the 1921 Act—Exempting Foreign Source Income

The FTC mechanism, enacted in the 1918 Act and refined in the 1921 legislation, effectively gave priority to source-based taxation, while retaining residence-based taxation as a backstop.[153] The residence-based safeguard was generally relevant only to taxpayers who had income from foreign tax havens or who otherwise managed to dodge foreign taxes on their foreign-source income. This safeguard worked reasonably well for non-business income, but by 1921, certain problems had emerged in the treatment of business income.[154] Businesses that derived much income from jurisdictions with low income taxes had a tax incentive to trade in their American charters, reincorporate in a foreign jurisdiction, and thereby avoid American taxes.[155]

Even in the early days of income taxation, experience was proving that the corporate form could and would be easily manipulated in order to escape residence-based taxation. In the 1920s, such manipulation not only circumvented the residence backstop, but also was considered a threat to American prestige and economic power; many successful American businesses abroad might ultimately be transformed into foreign enterprises. Moreover, those American businesses that remained incorporated in the United States claimed they were being handicapped in competition with foreign firms from countries that exempted all foreign source income from any domestic taxation.[156]

Adams also was concerned with the potential for related corporations to manipulate intercompany prices to reduce their combined tax burdens. Adams described such concerns during the hearings on the 1921 Act in urging a provision to give the Bureau of Internal Revenue the authority to consolidate the returns of affiliated corporations for the purpose of properly apportioning profits. This was the precursor to the still-controversial modern "Arm's Length Standard," under which transactions between related entities can be adjusted by the IRS if it finds that the taxpayer's accounting does not produce transfer prices that are in accord with the prices that would have been selected by parties dealing at arm's length.[157] Adams said:

> At the present time it is possible—and I am afraid the device is being used increasingly—to incorporate a subsidiary and throw the profits one way or the other. If that subsidiary is a foreign corporation you can throw the profits to it: in other words, by selling products to it at artificially high prices.[158]

Adams responded to both of these concerns by proposing to lift the residence backstop of the foreign tax credit from a particular class of taxpayers, which he dubbed "foreign traders" and "foreign trade corporations."[159] These taxpayers would be "taxed substantially as foreign corporations and foreign nonresidents"—in other words, taxed only on their U.S.-source income.[160] In order to qualify for this exemption of foreign source income, a taxpayer would need to show that its income was derived primarily from the active conduct of business abroad: at least 80 percent of the taxpayer's income over the past three years had to come from foreign sources, and at least 50 percent from the active conduct of business.[161]

Recognizing a distinction between active business income and passive income, which permeates international taxation today, Adams expressly excluded passive investment abroad from the foreign trader provision.[162] The restrictions requiring active business income were "put in there to prevent, for instance, persons living over here investing in French or Danish or Swiss bonds and getting a large percentage of income from that and claiming exemption . . . The thing would be open to abuse if some such condition[s] were not imposed."[163] Adams intended to lift the residence backstop only in those cases in which he thought it was unhelpful because it was easily evaded and perhaps detrimental to U.S. economic interests.[164]

The House and the Senate Finance Committee agreed to Adams' proposal.[165] The Senate Report argued:

> Under existing law an American citizen or domestic corporation is taxed upon his or its entire income, even though all of it is derived from business transacted without the United States. This results in double taxation, places American business concerns at a serious disadvantage in the competitive struggle for foreign trade, encourages American corporations doing business in foreign countries to surrender their American charters and incorporate under the laws of foreign countries, results in serious administrative difficulties with respect to the collection of taxes due from individuals resident in foreign countries, and encourages American citizens to expatriate themselves. In order to remedy this situation foreign traders and foreign trade corporations . . . will be taxed under this act substantially as

nonresidents . . .[166]

On the Senate floor, however, the Progressive Senator LaFollette led a successful attack on the provision, arguing that it represented an inequitable tax break for the wealthy and would encourage the flight of capital and jobs abroad.[167] As the debate progressed, two facts emerged: 1) few nations at that time exempted the foreign-source income of residents, suggesting that Americans were in fact not routinely handicapped by U.S. residence-based taxation in competition with companies from abroad;[168] and 2) as a practical matter, the problems associated with the residence backstop then were of great economic import only in the Philippines.[169] In the end, Congress adopted a compromise measure: the "foreign trader" provision was transformed into a special exemption for businesses operating in U.S. possessions. Only taxpayers who obtained at least 80 percent of their income from U.S. possessions (including the Philippines), and at least 50 percent from the active conduct of business, were eligible for an exemption of income.[170]

Economists today regard a system that exempts foreign source income from tax in the residence country as furthering "capital import neutrality."[171] The typical example to make this point is an investment by a U.S. company in a low-tax jurisdiction. A foreign tax credit system is designed to tax the U.S. resident on its foreign source income at a rate equal to the excess of the U.S. rate over the foreign rate. This is all the relief necessary to eliminate double taxation (and, it is said today, to make the U.S. investor indifferent about investing here or abroad). This, however, could create a disadvantage for U.S. multinationals in competition with investors who reside in countries that exempt foreign-source income of their residents. These investors will only owe the low-rate tax imposed by the source country. France, Germany, the Netherlands and Canada are among the countries who are regarded as having such exemption or "territorial" systems.[172] This concern with international competitiveness motivated the 1921 "foreign trader" proposal, as today it spurs calls for moving to an exemption for foreign source income.[173] Policymakers' attitudes toward these arguments often depend on whether they are focusing on a choice by a U.S. resident to invest here or abroad, in which case they worry about favoring foreign investment, or, on the other hand, are focusing on whether an investment abroad will be made by a U.S. or foreign firm, in which case they worry about the international competitiveness of the U.S. firm.

But the distinction between exemption and foreign tax credit systems tends to be overdrawn. First, many countries that have an exemption system exempt foreign source income only if taxed "comparably" abroad.[174] In addition, many countries—with France being a notable exception—have a so-called exemption with progression, and take the exempt income into account in determining the applicable tax in a progressive rate structure.[175]

Moreover, the U.S. system has important elements of a regime designed to promote capital import neutrality. The averaging across countries inherent in an "overall" limitation on the foreign tax credit often makes it advantageous for a company that already has investments in a jurisdiction with tax rates higher than the U.S. to invest in foreign jurisdiction with a lower tax rate. In addition, if an investment abroad is made by a foreign subsidiary of a U.S. parent, no U.S. tax is imposed until the earnings of the subsidiary are repatriated as dividends to the parent. When that happens, the U.S. allows a credit for the taxes paid to the foreign government. [176] If the tax rate of the foreign country is low or the deferral of U.S. tax is sufficiently lengthy, the present value of the U.S. tax can be very close to zero—an exemption. In addition, by timing the payment of dividends from foreign subsidiaries, U.S. parents can minimize the impact of the FTC limitation.[177] Thus, a recent survey of countries' different systems concluded: "While the exemption technique is often contrasted with the credit approach, in actual operation the two methods of relieving double taxation often yield quite similar results."[178]

Adams' attempt to effect a significant departure from a credit system in favor of an exemption system had only limited success. His 1921 foreign trader proposal does, however, offer further evidence of the primacy Adams accorded source-based taxation of business income. Indeed, Adams felt that jurisdiction over business taxation was by nature source-based, while jurisdiction over personal income could be residence-based: "The personal income tax is laid upon the individual in his capacity of consumer, and is paid where he resides; whereas the business income tax is paid by men in their productive or commercial capacity at the place where the income is earned."[179] After 1921, Adams remained committed to the foreign tax credit mechanism as a residence backstop, particularly for capturing tax from U.S. residents on foreign-source income not taxed abroad. Adams apparently never revived his "foreign trader" proposal. Indeed, the 1921 Act was Adams' last as chief spokesperson for the Treasury Department and with passage of the 1921 Act, Adams' work on international taxation shifted from domestic legislation to international agreements.[180]

IV. The League of Nations Model Income Tax Treaty

A. The Beginning of the Tax Treaty Process: The International Chamber of Commerce

Many present-day scholars have noticed that the modern OECD model tax treaty is a direct descendant of the League of Nations model treaty developed in the mid–1920s, and some have recognized the roots of the League effort in earlier work by the International Chamber of Commerce.[181] Newly organized in 1920, the International Chamber—an umbrella organization with ties to national chambers of commerce in many nations, including the United States—placed double taxation on the international diplomatic agenda and formulated an influential early approach to the problem. T.S. Adams, a member of the International Chamber's Double Taxation Committee, played an important role in the Chamber's effort. This prologue to the League's 1928 model treaty advanced resolution of many issues the League would grapple with and also sheds light on the priorities and assumptions subsequently carried by Adams to his position as U.S. representative to the League.[182]

The International Chamber adopted a resolution at its organizational meeting in Paris in 1920, calling for "prompt agreement between the Governments of the Allied countries in order to prevent individuals or companies from being compelled to pay a tax on the same income in more than one country."[183] Given the key American presence, the 1920 resolution, to no one's surprise, envisioned an American-style solution to the double tax problem: taxation by both residence and source with residence deferring to source, while retaining a "right to claim the difference between the [source country] tax paid and the home tax."[184]

A year later, the International Chamber took up more detailed resolutions concerning double taxation.[185] Contrary to the American position, these resolutions distinguished the progressive and non-progressive elements of an income tax (or "super" and "normal" taxes), suggesting that the former should be levied based solely on citizenship, while the latter should be levied based on the place where income was "earned and collected."[186] Nations levying normal taxes were to exempt foreign-source income, or at least provide a credit for normal taxes paid abroad. Under this approach, taxing jurisdiction would turn on the nature of the tax in question—as we will see, an idea that reappears in the League effort.[187]

The 1921 resolutions also required nondiscrimination among residents, citizens, and foreigners. This nondiscrimination requirement has become a fundamental principle of tax treaties.[188] It is essentially a requirement that a country where income is sourced must not tax such income in a manner that discriminates against foreigners.[189]

After the International Chamber adopted the 1921 resolutions, the scheme was referred to the national chambers of commerce for suggestions for implementation. The U.S. Chamber asked Adams to head a special subcommittee on the subject.[190] Adams urged the International Chamber to endorse unilateral domestic legislation along the lines of the American FTC, to canvass the double taxation committees of the various national chambers of commerce for concrete examples of international double taxation, and to develop proposals for specific source rules to overcome the problems.[191] In 1922, Adams convened a meeting of the U.S. Committee to discuss specific reform proposals.[192] The Americans decided not to adhere to the normal/super tax distinction of the 1921 resolutions. Rather, Adams' committee endorsed the following suggestions: 1) an American-style foreign tax credit; 2) income of shipping companies should be sourced to the nation of registry of the ship or to the nation in which "effective control" of the company was exercised; and 3) income from sales of manufactured goods abroad should be apportioned "by some fair and reasonable method" between the nation of manufacture and the nation of sale.[193] This was vintage Adams: the U.S. Committee rejected carving out a particular type of tax (here, the super tax) for exclusive citizenship or residence-based jurisdiction, preferring to rely on a foreign tax credit as a means of collecting residual residence-based taxation. The Committee regarded source-based taxation as primary, and it focused most of its efforts on incremental improvements to source rules.

The International Chamber synthesized the responses of the various national committees, and sent a resulting set of fifteen resolutions back to the national committees for comment.[194] These resolutions, slated for discussion and voting at the International Chamber 's 1923 Congress in Rome, were to become the blueprint in many respects for all subsequent model treaty proposals (though the resolutions themselves were not in the form of a model treaty and, in fact, were not ultimately adopted by the Rome Congress principally due to opposition from the British). In particular, the Rome Resolutions incorporated a classification and assignment system for various categories of income (e.g., income from real estate to the nation where located, income from business divided among source nations according to the relative contributions of each).[195] The Rome Resolutions further foreshadowed the core principles of later model treaties by crystallizing the competing theories of taxation at residence and source (discarding the notion of citizenship), reaffirming the ideal of nondiscrimination between foreigners and residents, and proposing the allocation of business profits between source nations by some objective mechanism.[196] A witness to the later League of Nations meetings on double taxation observed that the Rome Resolutions set forth for the first time "a clear statement of the problem" and that it was with the terminology of the Rome Resolutions "that the battles of the [League] experts were waged in 1927 and 1928."[197] He added that while "no group of experts has accepted all these principles [of the Rome Resolutions] as sound…they have been used as the firm basis on which draft conventions have been built or actual treaties adopted."[198]

The 1923 Rome Resolutions by the International Chamber hedged on the allocation rules for interest and dividends, stating that these categories of income could be taxed by the nations of either payor or payee.[199] This, too, was an omen of things to come; a few years later, interest and dividend income would become the most contentious items in negotiations over the League's model treaty.

Adams and the U.S. Committee generally approved the substance of the Rome Resolutions, but objected somewhat to the form. Specifically, the Americans opposed the systematic, *ex ante* allocation of all types of income to one jurisdiction or another; the Americans preferred more limited reforms tailored to address specific, concrete instances of double taxation.[200] Adams sensed that the Rome Resolutions would generate much controversy over the relative claims of countries of residence and source, and felt that the International Chamber should focus on generating consensus behind allocation rules that everyone could agree on.[201] If forced to take a position on the interest/dividend issue, however, the Americans came down on the side of the claim of the payor's country, i.e., taxation by source rather than residence.[202] Otherwise, the U.S. Committee generally approved the resolutions.[203]

In contrast, the British Committee vociferously opposed these resolutions. Its overriding objection was to the resolutions' emphasis on source-based taxation. The British argued that all taxation should be residence-based, mirroring the British system. The British, for example, opposed the Americans on interest and dividends, calling for taxation exclusively by the recipient nation.[204]

The British also made concrete their preference for residence-based taxation by writing their preference into a 1926 bilateral tax treaty with the new Irish Free State, which exempted nonresidents from taxation.[205] With the exception of this treaty, consummated with a dependant partner with little room to maneuver, the United Kingdom did not sign any comprehensive tax treaty until its 1945 treaty with the United States. It took that long for Britain to compromise its preference for residence-based taxation. That year Britain also first introduced a foreign tax credit applicable to nations outside the Common wealth.[206]

In addition to its apparently principled view that taxation should be imposed by the country of residence, residence-based taxation was beneficial to the British fisc as a net exporter of capital. The fact that the United States, also a net capital exporter at that time, took a contrary position may be explained by a variety of factors: Adams' preference for source-based taxation as an appropriate means of implementing the benefit principle of taxation and administrative advantages; Adams' desire to avoid antagonizing debtor nations, who comprised the bulk of International Chamber members and whose support would be necessary to forge a successful international agreement; and the international balance of payments, which was overwhelmingly in the United States' favor and which permitted (perhaps even, in the interests of providing dollars for the purchase of U.S. exports and for the payment of U.S.-held debts, required) generosity in source rules to capital importers. Source-based taxation also represented a less significant departure from prevailing practices under the United States' tax law than in Great Britain—thanks, in substantial part, to Adams' work.

Thus, the battle lines were drawn, with the capital-exporting British rejecting any semblance of source-based taxation, and the capital-importing debtor nations of continental Europe, principally France and Italy, defending source-based taxation, along with the United States which, however, was expressing skepticism about the general direction of the International Chamber's project and certain specific provisions. Caught in this crossfire, the Resolutions failed to be accepted at the Rome Congress, and were referred back to the International Double Taxation Committee for further development.[207]

In response to the issues raised by the American and British national committees, the International Committee proposed a compromise in November, 1923: the International Chamber would endorse the principle that, in the long run, all taxation should be residence-based, but, in the short run, nations should work toward developing bilateral treaties implementing the American-style foreign tax credit.[208] However, the Americans and other national committees (notably the Italians) maintained their opposition to even this formulation of residence-based taxation.[209] The Americans continued their call for a more incremental, less theory-oriented approach to reform. The U.S. Committee argued that no progress would be made so long as the International Committee was in the business of trying to decide between residence and source-based taxation. The Americans asserted that the theoretical claims of both sides were valid and that, in any event, few nations could afford to give up entirely one of the two classes of taxes.

Prior to the 1923 Rome Congress, and arguably until 1925, the International Chamber exercised primary leadership in the movement against international double taxation. As we discuss in detail in the next section, in 1923, a committee of economists appointed by the League of Nations issued a major study of double taxation.[210] This report established a foothold in the international tax field for the League, but the Economists' 1923 Report did not exert a discernible influence on the International Chamber effort. The following two years continued the impasse in the Chamber's work. The body could not reconcile the varying agendas of the British, the Americans, and the Continental allies.

During that time, the League of Nations appointed a committee of "technical experts," who were representatives of seven European governments, to study the double taxation problem.[211] In 1925, these experts produced a new report, less theoretical and more favorable to source-based taxation than the 1923 Report.[212] Given the impasse in its own effort, the Chamber —with Adams' support—endorsed the 1925 Report.[213] After this endorsement, the League assumed a clear leader ship position. The Chamber remained active, primarily through its representatives to the League's Committee of Technical Experts, but from then on, the resolutions of its annual congresses largely functioned as endorsements of the League's work, rather than exercises of innovation and influence.[214]

B. *The Torch Passes to the League of Nations*

As we noted, the League of Nations fired its opening salvo on double taxation with the widely noted 1923 Report by the "four economists": Professor Edwin R.A. Seligman of the United States, Sir Josiah Stamp of Great Britain, Professor G.W.J. Bruins of the Netherlands, and Professor Luigi Einaudi of Italy.[215] Seligman, the primary architect of the 1923 Report, was one of the few living Americans who could claim authority equal to Adams' on taxation.[216] Though similarly renowned as a tax authority, Seligman, a professor of political economy at Columbia, possessed a very different intellectual style than Adams. Adams—a man who held both academic and governmental posts throughout his life—was pragmatic, instinctual, sensitive to political and administrative constraints, and usually oriented toward the technical aspects of a problem. In sharp contrast, Seligman—a lifelong academic—was a grand, systematic thinker. Seligman did not ignore political and administrative constraints, but he preferred to focus on the big picture and avoid problems for which theory seemed inadequate.[217]

Three great principles—all characteristically Seligman's—shaped the 1923 Report: 1) The classification and assignment of specific categories of income to source or residence should be determined by an objective test, "economic allegiance," whose purpose was to weigh the various contributions made by different states to the production and enjoyment of income;[218] 2) Existing tax practices across the globe tended to underestimate the contribution of residence and to reflect a misguided belief in the naturalness and rightness of source-based taxation;[219] and 3) Progressive taxes on global income were fundamentally different than other taxes and ought to be the unique province of residence-based taxation.[220]

The 1923 Report recommended a scheme that rested on a distinction between taxes on global income and all other taxes. The former were to be levied based solely on residence, while the latter were to be divided between residence- and source-based on the principle of economic allegiance, a principle that turned out to be quite generous to residence. Of most practical importance, the 1923 Report allocated taxes on interest and dividend income to the country of residence (that is, of the recipient).[221] Finally, nations of residence were not expected to provide a credit for taxes paid abroad, even if such taxes were legitimately allocated abroad under the economic allegiance principle.

Modern scholars have characterized the 1923 Report as "the intellectual base from which modern treaties developed."[222] The importance of the 1923 Report, however, has been overemphasized, although echoes of both its organizational structure and its rejection of source-based taxation of interest and dividends can be discerned in modern tax treaties. The legislation enacted in the United States in 1919 and 1921 and the work of the International Chamber were undoubtedly more important. One of the principal methods considered in the 1923 Report for the international taxation of income—the exemption of nonresidents from source country tax—has been of virtually no import outside of Great Britain.[223]

While the 1923 Report envisioned the development of a model tax treaty, it was not such a model treaty itself. An entirely different body of individuals was left with the task of drafting model treaties, and this group decided a number of pivotal issues barely addressed by the Report, such as the apportionment of international business income.[224] Moreover, an analysis of the minutes of subsequent meetings of the treaty drafters (the Committee of Technical Experts) suggests that the opinions of the 1923 Report were rarely discussed or consulted. The term "economic allegiance," for instance, appears nowhere in the minutes of the 1927 meeting of the model treaty drafters, although controversy over allocation rules dominated that conference. As the discussion below makes clear, the preference for residence of the 1923 Report was hardly shared by the Technical Experts. Ultimately, Seligman himself came to regret that his chief co-contributors in drafting the 1923 Report had also come from creditor nations (Great Britain and the Nether lands), and feared that the Report had reflected the interests and assumptions of creditor nations overmuch.[225] Finally, although the classification and assignment structure of the Report has been termed "[p]erhaps [its] most significant aspect,"[226] this structure in fact merely reflected the structure of the earlier Rome Resolutions of the International Chamber of Commerce.

In sum, to characterize the 1923 Report as the fountainhead of tax treaties is to miss much of the story. The conventional account of the 1920s under states the precedent s of the prior U.S. tax legislation, the work of the International Chamber of Commerce, and the subsequent role played by the League's Committee of Technical Experts. It also overlooks the influence of tax treaties concluded prior to the League's first model treaty, many of which also antedate the 1923 Report.[227] The first important multilateral tax treaty, signed at Rome in 1921 by Austria, Hungary, Italy, Poland, Yugoslavia, and Romania, as well as several contemporary bilateral treaties, employed the same type of classification and assignment scheme offered by the 1923 Report.[228]

Even before completion of the 1923 Report, the Fiscal Committee of the League of Nations had appointed a Committee of Technical Experts, comprised of representatives from seven European nations, to develop more practical suggestions for mitigating international double taxation.[229] In 1925, the Technical Experts presented a preliminary report, which, as noted above, was endorsed by the International Chamber of Commerce.[230] In essence, the 1925 Report was an effort to transform the pro-residence

1923 Report into a more balanced product. The underlying politics were obvious: while the 1923 Report was the product of creditor nations, a majority of the drafters of the 1925 Report came from debtor nations.[231] The compromise reached by these Technical Experts appropriated the 1923 Report's distinction between taxes on global income and other taxes (now denominated "personal" and "impersonal" taxes), but significantly changed the consequences of this distinction.[232] While Seligman and his colleagues had allocated personal taxes to residence and divvied up impersonal taxes between source and residence, the Technical Experts allocated personal taxes to residence and impersonal taxes exclusively to source.[233] This was an attempt to allow both creditor and debtor nations their special jurisdiction.[234] The Technical Experts made no pretension of theoretical coherence: "The division which we have established…has been made for purely practical purposes and no inference in regard to economic theory or doctrine should be drawn from this fact."[235]

Adams, still active as chairman of the American Section of the International Chamber's Double Taxation Committee, plainly felt that the 1925 Report represented a significant step forward from the 1923 Report. He wrote that the Technical Experts' 1925 Report

> is based upon the frank recognition of the fact that the income-tax serves two purposes; it must satisfy the claims both of the country of origin and the country in which the taxpayer resides; income will inevitably be taxed where it is earned and where the taxpayer resides. This is the first time perhaps that full recognition has been given to the valid claims of the country of origin and the country of residence.[236]

Seligman was less favorably disposed, although he tried to put a positive spin on the 1925 Report, contending that the Economists and the Technical Experts reached "virtually identical" conclusions in that both groups agreed to the "adoption of domicile [residence] as the primary and general criterion applicable to pure income taxes, and its modification by considerations of origin [source] in the case of" impersonal taxes.[237]

The 1925 Report also called for the League of Nations to consult representatives from additional governments and requested authorization to draft a model bilateral agreement.[238] As a result, the Committee of

Technical Experts was expanded from seven to thirteen members by the time of its London conference in 1927.[239] The United States, among the nations sending a delegate for the first time in 1927, chose to be represented by T.S. Adams, who would play an important leader ship role in the League proceedings of 1927 and 1928.[240]

A number of interests motivated the decision of the American government to become involved in the League effort. First, with only two creditor nations—Great Britain and the Netherlands—represented on the Committee, the American government feared that its interests as a creditor might be prejudiced by the ultimate structure of the model treaty. Second, the personal/impersonal distinction, while well suited to the tax systems of various European nations, was ambiguous in the context of the American system. For instance, the French employed a set of schedular taxes on eight categories of income plus a graduated general income tax—the former fit the definition of impersonal taxes and the latter, personal. But the American income tax was a far more unified affair; if the United States levied its entire tax based on residence, without obligation to grant credits for foreign source-based taxes—as apparently envisioned by the 1925 Report—the model treaty would actually contradict the spirit of the established FTC mechanism. Third, certain existing bilateral treaties were more favorable to foreign businesses than was the American FTC. In nations participating in such treaties, American businesses were sometimes disadvantaged. The League model treaty was viewed as a mechanism by which American businesses could obtain access to a more advantageous competitive position.[241] Fourth, the growth of American foreign trade and investment gave the United States an interest in uniform, favorable international tax rules. Fifth, the United States Chamber of Commerce and other authorities wished to see the League push toward a multilateral treaty, rather than a model bilateral treaty.[242] Finally, and perhaps most importantly, tax concessions obtained from trading partner s might reduce the revenue cost of the FTC.[243]

The Technical Experts met in 1926, 1927, and 1928 to draft model tax treaties, with the 1928 treaties becoming the definitive League model.[244] Through day after day of long and contentious negotiations, the Technical Experts generally tried to retain the essential compromise of the 1925

Report: personal taxation by residence and impersonal taxation by source. The most serious intellectual difficulty confronting the Technical Experts was the problem of translating this binary scheme into a workable treaty that could be employed by nations with vastly disparate fiscal systems. As we have said, the compromise worked well enough with a nation like France, which had two important, structurally distinct income taxes, but did not fit well with the American or British models of income taxation.[245] The American income tax, for instance, was comprised of a relatively flat normal tax levied on residents, citizens, and non-resident aliens (though, of course, foreign-source income of the latter group was exempt), a significantly graduated surtax on the same individuals, and a flat normal tax for corporations. Which were the impersonal taxes?[246]

For nations with "unified"[247] tax systems, the personal/impersonal distinction raised a specter of uncertainty in the model treaty. From the American perspective, the distinction presented a substantive risk: if all or substantially all of the American tax system were classified as personal, then the United States would lose the right to tax based on source, and the U.S. income of non-resident aliens would be free of U.S. tax liability.[248] The distinction placed similar, though not identical, pressures on the British system, but given the British commitment to residence-based taxation, the British representatives were less concerned about losing jurisdiction over British-source income of nonresidents. From the British perspective, the problem was that the personal/impersonal distinction threatened the international competitiveness of British business. British residents doing business abroad would be subject to the full brunt of British income taxes, which were strictly residence-based, plus the source-based portion of foreign income taxes. Competitors from other nations, however, while subject to the same foreign source-based foreign levies, would either be exempt from home country taxes on their foreign source income or, in countries that allowed a credit for foreign taxes, would face at most a portion of their home income taxes. Such a situation would have put pressure on Great Britain to grant a foreign tax credit.[249] Indeed, prior to the beginning of American involvement in 1927, the British representative and the other Experts had discussed a number of compromise measures.[250]

International competitiveness was of less immediate concern to the

United States because the U.S. already protected its businesses with an FTC. However, the loss of much jurisdiction over domestic-source income of nonresidents would have exerted fiscal pressure on the FTC. Moreover, if U.S. tax treaties stated that the U.S. income taxes should be residence-based, the political viability of the FTC, which effectively surrendered much residence-based taxation, might have been threatened.

When Adams arrived on the scene, his primary goal was to emphasize the uncertainty surrounding the personal/impersonal distinction so as to protect the ability of the United States to tax nonresidents on U.S. source income. He argued that "[t]he recent discussions of the Committee of Experts make it plain that the items 'personal tax' and 'impersonal tax' are ambiguous."[251] Accordingly, he proposed to do away with the personal/impersonal distinction, replacing it instead with the tautological categories "origin taxes" and "residence taxes."[252] Origin taxes were defined as those levied on non-residents based on source, while residence taxes were those levied on residents based on worldwide income.[253] Under Adams' plan, nations would be permitted both forms of taxation—thereby protecting the right of the United States to levy both its normal and surtaxes on nonresidents—and double taxation would be avoided by virtue of credits against residence taxes for origin taxes paid abroad.[254] In essence, Adams' plan simply would have written the American international tax system into a model treaty. Even the source rules of Adams' plan were substantially the same as those of existing U.S. legislation.[255]

Adams introduced his proposal mid-way through the 1927 meeting. Given the late date, Adams did not press for a formal vote on the proposal, but succeeded in keeping it before the Committee for future consideration.[256] By the time it met again, in Geneva in 1928, the Committee had accepted the idea that disparities in fiscal systems would require the Experts to draft more than one model treaty.[257] Accordingly, the Geneva conference, which marked the conclusion of the work of the Technical Experts, adopted three different treaties: one for use by pairs of nations with mixed income taxes (Draft I–a—a slightly modified version of the 1927 draft), one for pairs with unitary systems (I–b), and one for pairs with dissimilar systems (I–c).

Adams and the British representative drafted I–b, which ultimately reflected a combination of the American and British positions.[258] The treaty made no mention of the terms "personal" and "impersonal," instead articulating a general preference for residence-based taxation (the British position).[259] But Model I–b also permitted source-based taxation on certain classes of income, most notably business income.[260] The treaty also called for nations to grant credits to residents for foreign-source taxes paid abroad—the Adams trademark.[261] In sum, the treaty substantially addressed Adams' primary concerns, protecting U.S. taxation of most categories of U.S.-source income. Models I–b and I–c also pointed toward the future direction of the international treaty movement, in their rejection of the personal/impersonal distinction and in the move toward residence-based taxation of interest and dividends.[262]

If the great intellectual task of the 1927 and 1928 meetings was the adjustment of the 1925 Report to the realities of the world's fiscal systems, the great political difficulty was mediating the continuing tension between creditor and debtor nations. The most visible sign of this tension was agitation, primarily from the British representative, for allocation of more income to residence countries.[263] The British desired most to eliminate source-based taxation of interest and dividends, a position that sparked the most bitter exchanges during the conferences.[264] Although not successful in changing the source rules of I-a, the British arguments prevailed in I–b and influenced I–c.[265]

Although the United States, like Great Britain, was also a creditor nation, the U.S. was less concerned with interest and dividend rules than with business income. On the latter issue, the American preference for source-based taxation did not conflict with its interest in reducing taxes levied by other nations on American businesses. While Adams wanted both to improve the competitiveness of American businesses and to reduce the revenue cost of the FTC, his primary concern was to rationalize source-based taxation to preclude taxation by all conceivable sources.[266] Aside from elimination of the personal/impersonal distinction, this seemed to be the chief goal of the American delegation. Mitchell Carroll, Adams' assistant in 1927 and 1928, recalled the growing problem facing American businesses abroad:

> After World War I when governments were in dire need of revenue to rebuild their economies, they began to try to tax

> the earnings of the visiting businessman and the profits of the foreign company on goods sold through him. Canada even tried to tax a United States firm on profits from advertising its wares and receiving mail orders from customers in its territory.
>
> In the early 1920s, the British Board of Inland Revenue sought to impose liability...[on] sales through a local commission agent....[e]ven if the nonresident and his British intermediary took pains to conclude the contract abroad[267]

In the face of this concern with expanding jurisdiction over business income, the Committee of Technical Experts adopted the "permanent establishment" safeguard: only the nation in which the permanent establishment of a business enterprise was located could legitimately levy source-based taxes on the enterprise's income.[268] If the enterprise possessed permanent establishments in the territories of both treaty partners (say a head office in one nation and a branch office in the other), then both partners were entitled to tax the enterprise's income, using some method of apportionment agreed to beforehand.[269] The 1928 treaties expressly excluded independent sales agents from the definition of "permanent establishment."[270] The United States, a major net exporter of goods in the 1920s, thus relieved its businesses of much foreign taxation with the permanent establishment rule, while preserving the spirit of source-based taxation. Adams later declared that the permanent establishment rule was "the most important field of agreement" among the Technical Experts.[271] Indeed, the "permanent establishment" threshold for business taxation has proven remarkably durable, remaining a central component of both the OECD (Article 7) and U.S. (Article 5) Model Treaties. By contrast, under U.S. statutory law, a foreign resident is subject to U.S. taxation on income that is "effectively connected" with a U.S. trade or business, regardless of whether a permanent establishment is involved.[272] Under the 1921 Act, a nonresident alien could become liable for U.S. taxes merely for conducting a sale in the United States.[273]

Although the League did not at this time take up the apportionment of business income in a serious way, it did introduce the principle of arm's-length allocation in the context of its permanent establishment clause.[274] With the notable exception of the United States, which had endorsed such a method in the 1921 Act, this method was until then unknown.[275]

V. Lessons About International Tax Policy From Adams' "Original Intent"

The common attribution of the foundations of U.S. international tax policy to the 1923 Economists' Report—Seligman's work—has exaggerated Seligman's importance and downplayed Adams' central role. It also has offered comfort to today's analysts who quest for discovery or refinement of a unifying theory of international taxation as the fountainhead of answers to current questions of international tax policy, and in some instances has provoked mistaken claims of an unbroken lineage of a U.S. policy emphasis on residence-based over source-based taxation, which we have shown here to be false. In sharp contrast, T.S. Adams regarded the claims of the country of source as primary to the claims of the country of residence, particularly in business taxation, and explicitly rejected the potential usefulness of any grand theory, of what he called "broad dogmatic generalization" in making international tax law.

A. Theory vs. Practical Wisdom

In studying Adams' work on international taxation, one labors in vain to find a clear First Principle from which his tax proposals flowed. He regarded "[i]dealism as a striving after perfect truth or justice," as "mostly a nuisance," which "does more harm than good, if injected into practical affairs."[276] He regarded John Stuart Mills' observation that "[t]he ends of government are as comprehensive as those of the social union" as the "deepest truth applicable to taxation and taxmaking."[277] Adams was also clear in his view that "[d]ouble taxation cannot be brought within reasonable limits by constitutional restraints or by theories of jurisdiction resting on the essential nature of particular taxes."[278] Instead, he viewed the economic self-interest of nations and private actors as the controlling political force. Adams generally avoided reasoning deductively from simple starting assumptions to concrete policy prescriptions. His work reflected a subtle balancing act involving a large number of interrelated imperatives and instincts.

Adams strove to achieve fair, nondiscriminatory taxation; greater exports of American goods and capital; protection of U.S. taxation of U.S.–source income; maximally administrable taxes (which to him generally implied source-based taxation); some protection of progressive rate structures; elimination of inefficient tax avoidance devices; maintenance and export of the American FTC mechanism; and clarity and international uniformity in international rules for determining the source of various categories of income. Adams' work was an amalgam of principled idealism, national self-interest, and political and administrative practicality. Adams may fairly be criticized for a lack of theoretical coherence and for his inattention to the kinds of economic principles that dominate debate today, such as worldwide wealth maximization, capital export neutrality, and capital import neutrality.[279] Yet Adams' lack of theoretical pronoun cements was no accident; he was not ignorant of the theory of his day. Thomas Sewall Adams expressly rejected the utility of theory in his fight against international double taxation, regarding theory as endlessly malleable.[280] He considered it child's play to manipulate theory to advance parochial interests and private agendas. He insisted, "[p]rove to Jurisdiction A that a given tax, X, logically belongs to Jurisdiction B, and—if self-interest so dictates—A, in the long run, will develop some subtle modification of tax X which the accepted theory of jurisdiction assigns to A."[281] In particular, Adams criticized Seligman's theory of economic allegiance:

> As a theoretical guide through the tax maze which we are discussing, economic authorities whom both the business and the scientific worlds properly respect, have sponsored a theory of "economic allegiance." I find this theory, I regret to say, little more than a generalized label covering a number of separate judgments which the authors of the theory have reached about the expedient place to tax certain persons or transactions, conclusions based upon diverse considerations which unfortunately vary with the business habits and stage of development of the various countries of the world. With most of the judgments under this theory I happen to agree. But their justifications are practical not "scientific," and "economic allegiance" is distinctly different in different states. The theory leads many of its advocates to endorse exaggerated claims concerning the rights of the jurisdiction of domicile. These exaggerated claims rest partly on the fact that their advocates are citizens of creditor states. In part also, they reflect an unconscious rationalization of the democratic urge towards

> progressive taxation. People come to believe that the rich ought to pay higher rates of taxation than the poor. And then they build up ambitious theories of taxation or tax jurisdiction whose only inner logic is that they serve the will to tax progressively.[282]

The dispute between Adams and Seligman over economic allegiance was but one of a series of similar disagreements between the two scholars over the proper role of theory in tax lawmaking. For instance, Seligman, though subsequently a drafter of New York's state income tax, initially disapproved of state income taxes because of the difficulty of apportioning business income among different states involved in a transaction.[283] Adams, however, argued that states should not be deterred for that reason. He insisted that reasonably fair—if not theoretically sound—apportionment formulas could in fact be worked out by the states.[284] In a similar vein, Adams responded to Seligman's criticism of the Wisconsin apportionment scheme: "[It] can never be 'absolutely' correct because there is nothing absolute about it, but it can be 'fair and reasonable.'"[285]

It is no surprise that Adams rejected all *a priori* jurisdictional claims and regarded theory as generally inconclusive:

> As regards the proper place or jurisdiction in which income or property should be taxed, there are, not one, but many principles or bases of taxation which are theoretically valid. Under the income tax, for illustration, some tax may properly be collected in the country where the taxpayer resides, some in the country of which he is a citizen, some where the income is realized or received, some where the income is earned—and the process of earning frequently extends over two or more countries. All of these places or jurisdictions may be different and in all of them, theoretically, a valid tax may be imposed.[286]

Adams was clear that taxation based solely on residence was neither practical nor politically realistic. He regarded residence as a particularly impractical guide to the taxation of business income:

> Here is a corporation whose owners live in jurisdiction A, whose factory is in jurisdiction B, whose main offices are in jurisdiction C, and whose principal sales department is in jurisdiction D. It needs no discussion to prove that each of these jurisdictions will

> demand and in the long run will succeed in collecting some tax, although the personal income tax would ordinarily be collected in only two of these jurisdictions, and many advocates of the income tax would confine the collection to jurisdiction A, in which the individual owners reside.[287]

Adams regarded the problem of the taxation of international shipping profits as presenting an important instance of the general difficulty:

> The taxation of a foreign shipping company under a national income-tax law is a particularly difficult thing, as will appear if you stop to think of the problem presented. A tramp steamer comes from abroad and stopping, perhaps only a few days, takes a lucrative cargo from New York, and moves off, perhaps not touching again at the port for eighteen months or more. The allocation of shipping profits to particular ports is intrinsically difficult.[288]

Under these circumstances, shipping companies face a significant threat of multiple taxation. With no natural means of allocation, many nations could potentially overreach and tax a disproportionately large share of the company's profits. In fact, however, in the early 1920s little—though not zero—double taxation of shipping companies actually occurred. Notwithstanding the legal authority to tax foreign ships, in most countries "[t]he prevailing custom is to tax only in the country of registry . . ."[289] Thus, shipping profits represented a problem for theorists, but not for businesses or governments. Adams moved to translate custom into law, and by so doing to prevent the potential double taxation from becoming actual. He refused to be distracted by the theoretical difficulties of the problem:

> To prevent this injustice [double taxation] the easiest course would seem to lie in formally adopting...the principle now for the most part followed by the leading maritime nations of the world. It is more important to secure the adoption of one uniform rule than to insist that an exactly correct theoretical rule be developed.[290]

Adams pushed both the International Chamber of Commerce and the League of Nations to encourage nations only to tax shipping companies based on registry or on the company's real center of management, and also to extend this allocational rule to the fledgling air transportation industry.[291] The 1928 League drafts reflected Adams' position,[292] and, so popular was the proposal, virtually all maritime nations incorporated the shipping rule in their own domestic legislation.[293]

In assessing the lessons of the shipping rule, Adams observed:

> This substantial achievement in the movement . . . does not represent an application or result of any fundamental theory of "economic allegiance" or natural law of jurisdiction. On the contrary, it is in conflict with the principle of allocation recognized by a large majority of the leading tax experts of the world: the principle that in allocating the profits of a business enterprise doing business in more than one country, an appropriate share of the profits shall be assigned to each country in which the enterprise has a "permanent establishment" . . .important shipping companies usually have permanent establishments in each country from which they regularly derive a substantial volume of traffic . . .
>
> The immunity from double (income) taxation which the maritime shipping industry enjoys is a direct result of . . . the International Chamber of Commerce, working along lines of administrative "least resistance."[294]

Indeed, "working along lines of administrative least resistance" seems a nice description of Adams' typical *modus operandi*, and distinguishes him from theory purists of his day and ours. Adams' skepticism of theory did not, however, translate into unrestrained cynicism. He did see an important role for "ideals and idealism in taxation."[295] For Adams, the key to good tax law and good tax treaties was the principle of "enlightened self-interest"—finding the places where ideals and practical politics coalesced. He insisted that "we shall eliminate, in the long run, only that measure and degree of multiple taxation which the competing jurisdictions believe harmful to themselves."[296] Of the prospects for treaties restraining double taxation, Adams wrote: "The surprising and optimistic phenomenon, however, is the number of agreement s which an enlightened self-interest makes possible, when the matter is approached on practical grounds."[297]

Given the necessary constraints of self-interest, Adams envisioned limited treaties representing incremental reforms. During the Chamber of Commerce effort, Adams argued:

> [a]ctual progress in the elimination of double taxation can best be secured at the present time by endeavoring to agree upon, and after such agreement, to secure the adoption by the principal commercial nations, of a few definite proposals of a comparatively restricted scope, which have been found in practice or which, after careful consideration, promise to reduce or eliminate important cases of double taxation.[298]

Again, the treatment of international shipping profits was a paradigm—a modest reform advancing the ideal of reducing double taxation, but consistent with national self-interest and administrative constraints. Later, after the League process generated substantial consensus on allocation rules except for those governing interest and dividends, Adams urged the nations of the world to sign a multilateral agreement institutionalizing all of the consensus rules, but leaving interest and dividends for another day.[299] Adams saw little sense in pushing his ideals beyond what the international community perceived as its own interests.[300] In a different context, he wrote, "The dominating factor of economic interest in taxation determines to a large extent the role or place of idealism in taxation....[A]las for the idealist whose convictions call for a forthright and conscious sacrifice of the obvious economic interest of the majority."[301]

B. Adams' Emphasis on Collectibility, Certainty and Simplicity

Given his emphasis on practicality over theory, it is not surprising that Adams' policy judgments were often driven by concerns for the enforcement and collection of taxes. While in Wisconsin, Adams had witnessed firsthand the inequities that resulted from a tax system that was not successfully enforced. In particular the old personal property taxes in Wisconsin and across the country were notorious for failing to capture intangible wealth, such as stocks and bonds.[302] As a result of evasion by urban business classes, the weight of taxation fell disproportionately on the owners of real property, which, in Wisconsin at the turn of the century, primarily meant cash-strapped farmers. The Wisconsin farmers fought back, demanding and eventually winning a state income tax.[303] To Adams, the lesson must have been clear: widespread evasion resulted in unfairness and the delegitimization of a tax system. Thus, Adams was profoundly concerned about the administrability of any tax proposal.[304]

Adams' sense of the moral wrongness of tax systems that lend themselves to evasion is particularly evident in his writings on the tax system imposed on Puerto Rico by Spain.[305] He wrote, "[T]he direct taxes were largely evaded through the complexity of the law and the venality of the officials, while the greater burden of the indirect taxes was shifted from those who owned property and were able to protest effectively, upon a sodden, inarticulate peon class...."[306]

To understand the centrality of collection and enforcement in Adams' work, it is important to realize that, to Adams, tax avoidance implicated concerns that went well beyond simple losses of revenue to the Treasury. Adams felt that the very legitimacy of the income tax was threatened by widespread avoidance and evasion. Moreover, tax avoidance might result in the diversion of capital to unproductive purposes, which is a concern that was evident in Adams' resistance to the spread of tax-exempt securities in international markets.[307]

Adams was particularly sensitive to the potential for tax avoidance in the international arena. Adams argued, "The modern habit of living or incorporating in one jurisdiction and holding property or doing business in another has led to much unjust double taxation, but it has also led to a large volume of tax evasion."[308] In Adams' mind, the causes of, and the solutions to, tax evasion and double taxation were intimately connected.[309] An international tax system that carefully constrained double taxation would both lessen the incentives for tax evasion and imply a degree of international cooperation and administrative competence that would lessen the opportunities for avoidance. Thus, Adams could conclude that "[m]easures to prevent double taxation, if properly devised, will result in almost as much gain as loss to the fiscal authorities cooperating."[310]

In the domestic arena, Adams was an outspoken advocate for simplicity in taxation.[311] Not surprisingly, he brought the same concerns with him to the problems of international tax. Adams declared himself more interested in developing simple, administrable rules for the allocation of income to countries of source than in getting the allocations themselves "correct."[312] Adams presented the 1921 source rules to Congress as "altogether in the interests of simplicity and clarity."[313] Later, in discussing the "primary conditions" that should shape the drafting of a model treaty, Adams wrote: "There is a final condition of momentous importance—that of simplicity. There will be great administrative difficulties in enforcing even the simplest of Bilateral Conventions. The execution of an ambiguous and complicated convention will prove virtually impossible."[314] Adams thus opened the 1927 conference of the Technical Experts with a call for greater clarity in drafting,[315] and continued to raise the issue throughout the meetings of the Technical Experts, most notably in his efforts to have the committee dispense with the confusing personal/impersonal distinction.[316]

Concerns for collectibility, enforcement and administrability also shaped Adams' preferences regarding source rules for specific categories of income. He insisted: "[I]n agreement s allocating tax sources for the purpose of preventing double taxation, the tax should not be assigned to a jurisdiction which cannot effectively administer and collect the tax."[317] Adams felt that this principle motivated many of the source rules that were already widely accepted internationally, such as the allocation of real estate to the state where it was located for purposes of property, income, and death taxes:

> There is probably no very recondite economic or juristic theory behind this approximate agreement to allocate taxes in respect of real estate to the jurisdiction of situs. It certainly interferes with progressive rating upon the entire income, estate or inheritance, and conflicts with the theories usually advanced by defendants of progressive income and inheritance taxes to explain or justify them. The explanation probably lies in a mixture of considerations arising chiefly in custom, administrative practicability, and the will to avoid double taxation....For a good many generations wisdom will lie in giving the tax to the jurisdiction that can successfully administer it.[318]

Adams approved of the real estate rule for its ease of enforcement.

Adams also expressed concerns over source rules that were open to taxpayer manipulation, such as the U.S. Attorney General's rule that sourced business income to point of sale.[319] Such opportunities for manipulation raised all of the concerns about tax avoidance that led Adams to place so much emphasis on administrability.

Adams had an additional reason for stressing enforceability in source rules: rules based on administrative practicability stood the best chance of gaining widespread international acceptance. Adams believed that nations would surrender tax jurisdiction only so long as they could do so without incurring significant financial harm: "[W]e shall eliminate, in the long run, only that measure and degree of multiple taxation which the competing jurisdictions believe harmful to themselves."[320] Adams was sure that nations would most easily be swayed to surrender jurisdiction over income that they could not tax effectively anyway: "[A]greements to abolish or restrain double taxation must be based on a variety of practicable grounds, among which the possibility of successful administration is the most important."[321]

Adams, so committed to the ends of reducing double taxation, kept political salability and stability very much in mind while designing the means. In his work on tax policy, Adams was an economist in the service of politics. He would be more than a little disappointed at the monumental complexity which is the hallmark of this nation's international tax rules today.

C. Source vs. Residence

Normative analysis of international tax policy by economists today emphasizes the goal of worldwide economic efficiency with a policy of capital export neutrality as its instrument. This, in turn, has led for calls for residence-based taxation of income earned worldwide.[322] But regardless of the modern economists' analysis, Thomas Sewall Adams' view that countries where income is earned will insist on taxing business income earned within their borders remains as true now as in his time. Thus, Adams' view that the only *unilateral* action available to eliminate potential double taxation of such income is for countries of residence to defer to countries of source either by exempting such income or allowing a foreign tax credit is as valid at the end of this century as it was at the beginning.

Vigorous policy debate is now taking place over proposals to replace the U.S. foreign tax credit system with an exemption for foreign source income.[323] Again, Adams' views of the reasons to choose between a foreign tax credit and an exemption system are instructive. In general, Adams' reasons for preferring the foreign tax credit mechanism—particularly his appreciation of its role in counteracting a "race to the bottom" in taxation by source countries—have lost none of their persuasiveness. Indeed, current calls for replacing the U.S. income tax altogether with some form of consumption tax can be viewed potentially as a major development in such a race. Such a change would transform the United States into the world's major tax haven for income from capital.[324] Improving the "international competitiveness" of American investors and businesses is a rallying cry of proponents of such a change.[325] Ironically, this kind of massive change in the U.S. tax system would probably inspire many countries, which have, so far, exempted foreign source income from tax, to embrace a foreign tax credit system of the sort first put into place in the United States more than seventy-five years ago.

On the other hand, the complexities of the existing foreign tax credit law, which have developed principally to prevent averaging of foreign taxes across different kinds of income and to protect the U.S. tax base on U.S. source income, are extremely costly for taxpayers to comply with and for the IRS to administer. Other countries—Australia and Canada, for example—have effectively combined foreign exemption and tax credit methods to reduce some of the complexities, without shifting to a "territorial" policy that limits taxation to income earned within their borders or abandoning their claims to residual taxation of foreign source income. Some European countries, including, for example, Germany and the Netherlands, have gone even further in providing an exemption for foreign source business income.

The potential advantages of introducing exemption elements for business taxation surely merit reexamination in the United States today. Thomas Adams identified the principal concerns. In his proposals for an exemption for foreign traders, Adams would have restricted an exemption system to active business income. He refused to consider extending such relief to passive investment income, which, even then, he knew to be much more mobile and manipulable. Second, Adams knew that exemptions should be limited to foreign source income which is subject to taxation abroad comparable to that which would be imposed by the United States. This probably is best evinced by his concerns with the international issuance of tax exempt bonds. Some such "comparability" test is now used by most countries that have exemption systems. Third, Adams' emphasis on clear, explicit and, to the extent possible, uniform source rules would be even more critical if the United States were to exempt foreign source business income. Likewise, Adams' concerns with related party transactions, such as payments of interest and royalties, makes clear that an exemption system would not be free of many of the issues that have for so long plagued implementation of a foreign tax credit system. In sum, Adams' insights are valuable in informing our own analysis of the issues raised in substituting for the foreign tax credit an exemption of limited categories of foreign source income. Even on somewhat narrower issues of international tax policy, asking how Thomas Sewall Adams would have approached the question often is enlightening. For example, in 1989, the United States added section 163(j) to the Internal Revenue Code to limit deductions for interest paid on debt to related parties.[326] This provision was intended to limit the ability of foreign-owned businesses to avoid payment of U.S. tax on U.S. source income by paying deductible interest rather than dividends.[327] The 1993 Act extended these limitations to additional forms of debt between related parties and to certain third-party debt guaranteed by related entities. These limitations have been frequently criticized by commentators (apart from their complexities which are substantial) principally on the ground that, in addition to attacking tax-avoidance transactions designed to shift income from the United States to a tax-haven country that imposes low or no taxes on such income, this provision also denies interest deductions for payments from the United States to another country with equivalent or even higher tax rates. In so doing, it overrides the ability of U.S. treat y negotiators to concede U.S. tax jurisdiction over such amount s to other countries. If, however, following T.S. Adams, one takes as a prime goal of U.S. international tax policy the collection of U.S. tax on U.S. source income, the provision looks sensible and important, the rate of tax in the foreign country becomes irrelevant, and the major question for the United States becomes whether the provision is appropriately broad and effective. Adams would also be clear that it is the responsibility of the country of residence to alleviate any double taxation that might result.

D. Multilateral vs. Bilateral Treaties

Thomas Adams recognized early that a multilateral, rather than bilateral, approach to tax treaties was desirable. He pressed for a multilateral solution to the problem of international taxation, despairing of the complexity, administrability, and manipulatibility of taxation under a large number of bilateral tax treaties. He was optimistic about the prospect. "[I]t is entirely practicable for the great nations of the world to get together and adopt a uniform multilateral treat y by which double taxation could be eliminated, except for these items of bond interest and dividends."[328] But Adams was unsuccessful in getting the League of Nations to shift its approach to double taxation from a model bilateral treaty to a multilateral agreement. He claimed that the League's approach "would result in a tangle of conflicting solutions applicable to the nationals of different countries, which [would] be highly complicated and highly mysterious, and about as bad as the situation now exists."[329] However, no action was taken on Adams' proposal for a multilateral treaty during the 1928 League conference.[330]

Modern attempts at multilateral tax treaties, even on a regional basis, have also enjoyed limited success at best. There was a brief Andean effort in 1971 and a similarly unsuccessful Caribbean tax agreement.[331] Probably the most successful example is the Nordic tax treaty, but one thoughtful observer has remarked that it serves principally to confirm that cultural regional cohesion has advantages in taxation as elsewhere.[332]

The European community has abandoned the idea of a multilateral tax treaty in favor of an effort to harmonize the domestic tax laws of the member states.[333] To date, there has been relatively little progress toward harmonization in the income tax arena. Probably the most notable effort has been the Ruding Committee's attempt to chart a path for greater uniformity in cross-border transactions involving countries with integrated corporate tax systems.[334]

If anything, the need for multilateral cooperation has increased since Adams' time, but the likelihood of such action seems no brighter today. Ironically, the enormous success of the network of bilateral treaties, which began with the League of Nations Model in 1928 and has remained remarkably stable through the most recent OECD model in 1992, itself serves to inhibit multilateral action.[335] The habit and flexibility of dealing bilaterally, along with the entrenchment of the principles of the League of Nations model, make it extremely difficult to move in the tax area toward the kind of multilateral negotiating practice that, for example, occurs through the General Agreement on Trades and Tariffs (GATT) in the international trade arena. Professor Richard Vann of Australia has best described the difficulty:

> Although it is possible to refine the actual terms of the OECD Model and to elaborate the commentary so as to cover new cases as they arise, the time has passed for radical revision within the current bilateral framework. In a sense the opportunity to go in another direction was lost before the 1963 draft appeared. The failure to adopt any new approach to international tax after the Second World War (compared to trade law and the international monetary system) meant that effectively the solution adopted after the First World War continued by default. In other words the OECD Model is the culmination of 50 years of development, rather than a new departure.[336]

This status quo will continue to be difficult to displace.

Conclusion

While the structure for international taxation put in place in the 1920s has been remarkably stable, modern theories have emerged to explain and evaluate that system and its alternatives. As we have discussed in this Article, the current theories contending for supremacy in this area are capital export neutrality, capital import neutrality and the misnamed national neutrality.[337] It has by now become well-known in the tax policy literature that it is simply not possible to implement both capital import and capital export neutrality simultaneously.[338] Our favorite way of making this point is in terms of an irreconcilable conflict among the following three simple principles:

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

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

Principle 3: Sovereign countries should be free to set their own tax rates and to vary them as their domestic economic situations demand.[339]

The essential difficulty is that the first two principles can hold simultaneously only when capital income is taxed at the same rate in all countries. This requires identical tax systems, including identical tax rates, an identical tax base, and identical choices between source and residence based taxation. That has never happened, and it never will. Even if it ever did, there would be no way to keep such a system in place without violating Principle 3. Moreover, bilateral treaties in which the United States gives benefits to certain foreign investors or foreign-owned businesses, in exchange for their countries giving reciprocal benefits to U.S. persons, will also defeat the ability to satisfy simultaneously both Principles 1 and 2. This difficulty makes compromises between these principles inevitable. Such compromises, in turn, have made the tax law governing international transactions subject to routine complaints of competitive disadvantage by U.S. companies depending on where they are competing and against whom. As a result, in practical political terms, the modern theories have proved little more useful than the ancient theories, such as "economic allegiance," which they have replaced.

In the meanwhile, as we wait for improvements in theory and knowledge, we could do much worse than to follow the basic principles and priorities established for international tax rules by T.S. Adams. We should remember that it was not economic theory, but first, concerns for the essential unfairness of both double taxation and zero taxation, and second, a preference for source-based taxation of business income, based on the view that the nations where such income is earned both are entitled to a share of that income and will claim such a share, that most shaped his policy recommendations and, in turn, U.S. tax policy. In addition, T.S. Adams' approach emphasized the enlightened selfishness of nations;

certainty, administrability and enforceability of international tax rules; and nondiscrimination against foreigners. Finally, given T.S. Adams' role in helping to fashion a stable and generally successful international income tax regime for the United States and his influence in the League of Nations tax treaty effort, we probably should take with a grain of salt Adams' general admonition that anyone "who trusts wholly to economics, reason and justice, will in the end retire beaten and disillusioned," in that "hard game" of tax lawmaking.[340]

Chapter 2

Historical Perspective on Subpart F

Introduction

Despite various suggestions in the tax literature to the contrary, the United States has never enacted an international tax regime that makes capital export neutrality its principal goal with respect to the taxation of business income.[1] Indeed, during the period 1918–1928, the formative era for U.S. tax policy regarding international business income, the United States ceded primary taxing jurisdiction over active business income to the country of source.[2] Rules were formulated to protect the ability of the United States to collect tax on U.S.-source income, and the foreign tax credit was introduced allowing U.S. income tax to be imposed whenever the foreign country where the income was sourced failed to tax the income. The dominant purpose of the U.S. international tax system put in place then—a system that still governs U.S. taxation of international income—was to eliminate the double taxation of business income earned abroad by U.S. taxpayers, which had been imposed under the taxing regime enacted at the inception of the income tax.[3]

When the foreign tax credit was first enacted in 1918, the United States taxed income earned abroad by foreign corporations only when that income was repatriated to the United States. In addition to implementing the basic policy decision to grant source countries the principal claim to the taxation of business income, this "deferral of income"[4] reflected concerns both about whether the United States had the legal power to tax income of foreign corporations (even if owned by U.S. persons) and about the practical ability of the United States to measure and collect tax on income earned abroad by a foreign corporation. Deferral of tax on active business income remained essentially unchanged for the next 44 years—until 1962. The only exception to this rule was the result of "foreign personal holding company" legislation enacted in 1937 to curb the use of foreign corporations to hold income-producing assets and to sell assets with unrealized (and untaxed) appreciation. The foreign personal holding company rules tax currently certain kinds of "passive" income of a narrow class of corporations in the hands of their owners.[5]

However, President Kennedy, in his State of the Union Address of January 11, 1962, urged a reversal of this longstanding U.S. tax policy. In a section of his address regarding the U.S. balance of payments, President Kennedy told Congress that he would "seek tax laws which do not favor investment in other industrialized nations or tax havens."[6] The change in policy proposed by President Kennedy and his reasons for the change were detailed in the President's tax message transmitted to Congress on April 20, 1961, in which the President called for the "elimination of tax deferral privileges in developed countries and 'tax haven' privileges in all countries."[7] Despite the breadth of this proposal, the legislation that eventually passed Congress as the Revenue Act of 1962 provided for much narrower constraints on deferral. Congress aimed to curb tax haven abuses rather than to end the deferral of U.S. income tax on active business income in developed countries. This historical chapter explains how the Administration's proposal for a broad anti-deferral regime was transformed into the narrower anti-abuse provisions of the Revenue Act of 1962.

The Situation before 1962

During the Depression, Congress had revised the U.S. international tax provisions to raise revenue, principally by tightening limitations on the foreign tax credit. However, during the period following the end of World War II, until the 1962 legislation, U.S. tax policy had been hospitable to foreign investment. In 1954, for example, both the foreign tax credit limitation and the ability to use foreign losses had been liberalized. In 1958, a carryover of foreign tax credits was added to the I.R.C. In 1960, the foreign tax credit limitation was again liberalized.

When Congress had examined the deferral of U.S. income tax on foreign-source income before 1961, the question had not been whether to eliminate or curb deferral, but whether to extend it. In 1959, for example, the Ways and Means Committee held detailed hearings on the Foreign Investment Incentive Act, introduced by Representative Hale Boggs (and eponymously termed the "Boggs Bill"), which would have extended to domestic corporations the deferral privileges enjoyed by foreign U.S. controlled corporations.[8] Ultimately this bill died a quiet death. Nevertheless, the arguments for and against the bill provide a good starting point for analyzing the debate over subpart F that would take place in 1961 and 1962.[9]

The Boggs Bill proposed that U.S. corporations that derived 90 percent or more of their income from active business activities and from foreign sources might elect not to have their foreign income taxed until that income was distributed as a dividend.[10] The bill therefore sought to equalize the tax treatment of U.S. corporations with substantial foreign-source income and the tax treatment of controlled foreign corporations by extending the tax privileges of the latter to the former.

Beginning on July 7, 1959, the House Ways and Means Committee, chaired by Wilbur Mills, began hearings on the Boggs Bill.[11] Not surprisingly, business favored the foreign income provisions of the bill, while organized labor, particularly the AFL-CIO, opposed them.[12]

The Eisenhower Administration failed to present a unified view. Henry Kearnes, Assistant Secretary of the Department of Commerce, echoed the arguments of U.S. businesses. He contended that encouraging private investment abroad served the interests of U.S. foreign policy; noted that the bill would assist small businesses by granting them equivalent tax treatment to large businesses that were able to set up controlled foreign corporations; and emphasized that the bill would ameliorate already existing discrimination against U.S.-based exporters by extending favorable tax treatment to domestic corporations. Mr. Kearnes discounted arguments against deferral grounded in balance of payments concerns by arguing that receipts from foreign investments had been greater than capital outflows during the prior six years.[13]

In contrast to the Commerce Department's enthusiasm, both the State Department (represented at the hearings by Douglas Dillon, then Under Secretary of State) and the Treasury Department (represented mainly by David A. Lindsay, Assistant Secretary) objected to the Boggs Bill. Treasury argued that the revenue cost of the bill was too great, the balance of payments situation too precarious, and the need for investment incentives in developed countries too slight to justify extending deferral privileges. Lindsay observed: "[s]etting aside our fiscal situation, the problem of revenue, and the question of encouraging investment abroad, there is substantial merit to [the deferral provisions] of H.R. 5."[14] Lindsay suggested that a more limited bill that extended deferral privileges only to foreign-source income from less developed countries would be acceptable.

The State Department's position, as expressed by Dillon, was the same as the Treasury's. Dillon stressed that "no new incentives [were] needed to encourage private investment in the more advanced countries."[15]

Significantly, neither the Treasury nor the State Department objected to the Boggs Bill on the ground that it offended capital export neutrality—that is, equalization of the tax treatment of foreign and domestic income so as to make taxpayers indifferent to the tax consequences of a decision to invest in the United States or abroad. When pressed by Hale Boggs to clarify the basis for the State Department's objections to the bill, Mr. Dillon responded that his Department's stance was "primarily a question of revenue."[16]

Mr. Dillon made clear his lack of any principled opposition to deferral by remarking: "[w]hen we have deferral, the income is eventually still subject to U.S. tax. Therefore, there cannot be any feeling that there is inequitable treatment of American investment outside as against investment inside the United States."[17]

The Treasury Department also rejected the position that it would advance two years later. Lindsay acknowledged that one way to equalize the treatment of foreign and domestic corporations would be to tax foreign corporations as if they were managed and controlled domestically. However, he stated that the Treasury was "not prepared to make any such recommendation…and we may have a constitutional question in taxing foreign corporations on that basis."[18]

Chairman Wilbur Mills, expressing considerable skepticism about the bill, asked to "be sold on the idea that there is some overwhelming, compelling reason" for enacting the bill's "preferences."[19] Other representatives, such as Howard Baker and Thomas B. Curtis (both Republicans), expressed concerns about the use of tax havens by U.S. corporations.[20] When asked to comment on the tax haven situation by Representative Curtis, Assistant Secretary Lindsay replied that the Treasury preferred to work within the existing framework, but would support facilitating the taxation of foreign earnings and profits through tinkering with distribution rules.[21]

In sum, the Treasury's opposition to the bill, shared by the State

Department, was grounded in concerns about revenue loss and the deteriorating balance of payments situation. This was a pragmatic rather than a principled opposition to extending deferral. Second, the Treasury regarded current taxation as a method of controlling deferral to be both unpalatable and of questionable constitutional validity. Third, Wilbur Mills and other members of the Ways and Means Committee were reluctant to extend additional tax privileges to U.S. business, and were uneasy with the increasing practice of U.S. companies using tax havens, such as Switzerland and Panama, to avoid taxation.

The Kennedy Administration's Proposal to End Deferral

President Kennedy's 1961 State of the Union Address, elaborated on in his tax message of April 20, 1961, prompted Congressional consideration during 1961 and 1962 of changes in the U.S. taxation of controlled foreign corporations. As indicated earlier,[22] in addressing broad balance of payments concerns, Kennedy announced in his State of the Union Address that his administration would ask Congress to reassess the tax provisions that favored investment in foreign countries over investment in the United States. The President, in his April tax message, urged five goals for revising U.S. tax policy: (1) to alleviate the U.S. balance of payments deficit; (2) to help modernize U.S. industry; (3) to stimulate growth of the economy; (4) to eliminate to the extent possible economic injustice; and (5) to maintain the level of revenues requested by President Eisenhower in his last budget.

In addition to changes in foreign income tax provisions, President Kennedy, in both his State of the Union Address and tax message, called for the introduction of an 8 percent investment tax credit on purchases of machinery and equipment to "spur our modernization, our growth and our ability to compete abroad."[23] Kennedy urged that this credit be limited to expenditures on new machinery and equipment "located in the United States."[24]

Specifically, with regard to the taxation of foreign income, the President stated that "changing conditions" made continuation of the "deferral privilege undesirable," and proposed the elimination of tax deferral in developed countries and in tax havens everywhere. The President stated:

> "To the extent that these tax havens and other tax deferral privileges result in U.S. firms investing or locating abroad largely for tax reasons, the efficient allocation of international resources is upset, the initial drain on our already adverse balance of payments is never fully compensated, and profits are retained and reinvested abroad which would otherwise be invested in the United States. Certainly since the post-war reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries."[25]

The President called for three changes to U.S. international tax laws, which would be phased in over a two-year period. First, he recommended that U.S. owners of foreign firms be taxed each year on their current share of the undistributed profits realized by controlled foreign corporations in economically advanced countries. Second, the President proposed that tax deferral be continued in developing countries to attract private investment. Third, the President argued for the "elimination of the tax haven device anywhere in the world, even in the underdeveloped countries, through the elimination of tax deferral privileges for those forms of activities, such as trading, licensing, insurance, and others, that typically seek out tax haven methods of operation."[26] Though the President noted that "the rate of expansion of some American business operations may be reduced," he observed that "such reduction would be consistent with the efficient distribution of capital resources in the world, our balance of payments needs, and fairness to competing firms located in our own country."[27]

Thus, from its inception, the Kennedy Administration's foreign income tax proposals had three aims: (1) the creation of a U.S. tax regime based on a policy of capital export neutrality (except where U.S. foreign policy favored incentives to private investment); (2) the elimination of tax haven abuses; and (3) the amelioration of the U.S. balance of payments position. President Kennedy's 1961 proposals reversed Treasury's previous reluctance to endorse current taxation of foreign income and explicitly embraced capital export neutrality, due, in substantial part, to concerns with the U.S. balance of payments situation at the time. When combined with his investment tax credit proposals, however, the Kennedy Administration's recommendations were not neutral toward the location of capital. They favored investment in machinery and equipment to be used in the United States.

Consideration of the President's Proposals by the House Committee on Ways and Means

On May 3, 1961, the House Ways and Means Committee began to consider President Kennedy's tax proposals (which had not yet been reduced to legislative language or given form in an introduced bill). The Committee's membership was substantially the same as it had been two years earlier when it had considered the Boggs Bill. Wilbur Mills was still the Chairman, and Democrats still held a comfortable majority.

Treasury Secretary Dillon's Statement

The Committee heard first from Douglas Dillon, who had been promoted by President Kennedy from the State Department to Secretary of the Treasury. In sharp contrast to his earlier statements about deferral in the Boggs Bill hearings, Mr. Dillon's statement revealed that he now regarded promoting capital export neutrality as a key factor militating against the continuance of deferral of foreign-source income. In the portion of his testimony devoted to foreign investment income, Secretary Dillon reiterated the three justifications for the proposal to eliminate tax deferral for foreign income: fostering the efficient allocation of U.S. investment capital; eliminating tax haven abuse; and alleviating the U.S. balance of payments deficit. Essentially, Dillon did not give primacy to any one of these reasons for changing course.

When he introduced the Treasury's specific suggestions for ending deferral, Secretary Dillon framed his suggestions largely in terms of capital export neutrality: "To avoid the artificial encouragement to investment in other advanced countries as compared with investment in the United States, we propose that American corporations be fully taxed each year on their current share in the undistributed profits realized by subsidiary corporations organized in economically advanced countries."[28] Current taxation was not to be imposed immediately, but instead phased in over two years.

Current taxation also would not be imposed on corporations in less developed countries unless the corporations were engaged in specified "tax haven" operations: "For this purpose a tax haven company would be defined generally as one receiving more than 20 percent of its gross profit from sources outside the country in which it is created."[29] The importance of capital export neutrality as a motivation for the proposal emerged most clearly in Secretary Dillon's preemptive strike against those who he predicted would argue that the end of deferral would undermine the competitive position of U.S. firms operating abroad:

> "Either we tax the foreign income of U.S. companies at U.S. tax rates and credit income taxes paid abroad, thereby eliminating the tax factor in the U.S. investor's choice between domestic and foreign investment; or we permit foreign income to be taxed at the rates applicable abroad, thereby removing the impact, if any, which tax rate differences may have on the competitive position of the American investor abroad. Both types of neutrality cannot be achieved at once. I believe that reasons of tax equity as well as reasons of economic policy clearly dictate that in the case of investment in other industrialized countries we should give priority to tax neutrality in the choice between investment here and investment abroad."[30]

Secretary Dillon's most detailed defense of these proposals was in terms of alleviating the U.S. balance of payments deficit. He admitted that it was difficult to estimate the extent to which tax deferral contributed to that deficit, but concluded that deferral was a significant contributing factor. Its elimination, he calculated, would improve the U.S. balance of payments deficit by $390 million per year.[31] Dillon argued that although deferral of income earned abroad tended to increase the growth of U.S. capital returns from foreign investments—eventually resulting in the repatriation of higher dividends—the time frame in which this occurred was too long and adversely affected the short and medium-term balance of payments situation.

Secretary Dillon's statement also attempted to respond to the main counter-arguments he expected the proposal would confront. He anticipated the argument that the measures would hurt—rather than help—the U.S. balance of payments by observing that the finance ministers of the European Common Market unanimously believed that the United States would be justified in ending deferral to relieve its balance of payments situation. Some individuals, who later testified against the proposals, ridiculed this argument, contending that these ministers would, of course, support such a U.S. position because it would severely hinder the competitive position of U.S. firms.

Secretary Dillon also attempted to counter the argument that it would be unfair to change the rules on which U.S. firms had relied while making prior investment decisions, asserting that since the need to stimulate investment in advanced countries no longer existed, there could be no proper claim that preferential treatment should be continued to perpetuate a private gain.[32] Moreover, the change would not hurt companies operating abroad, Dillon asserted, because changing "the timing of income tax liability will not normally turn a profit into a loss. At most, it may slow the growth of companies abroad by making the financing of growth somewhat more expensive."[33] This reasoning also prompted derision from those who presented opposing statements to the Committee, who argued that any hindrance to the competitive position of U.S. firms placed the United States at a disadvantage in the cut-throat world of foreign trade.

The Reaction from Industry and Business Interests

Trade and business interests reacted swiftly and negatively to the Kennedy foreign income proposals. In Ways and Means Committee hearings in June 1961, statement after statement from business organizations and by representatives of prominent corporations attacked the Administration's proposals. Many of the United States' most significant firms and organizations, including the NFTC, the United States Chamber of Commerce, the National Association of Manufacturers, Proctor and Gamble, Boroughs Corp., and Abbott Laboratories, presented oral or written statements. These witnesses strongly defended deferral as a legitimate and non-abusive practice, repeatedly stating that they did not condone the abusive avoidance of U.S. tax. To abolish deferral, they argued, would erode the competitive position of U.S. firms operating abroad.

Neil McElroy, Chairman of Proctor and Gamble, for example, pointed out that his firm's main competitor, Unilever, was owned and based abroad (in the United Kingdom and the Netherlands) and was able to enjoy the substantial advantages of the deferral that those nations granted. He stated that "[w]e could not compete if our net cost of doing business is much greater than theirs. The result of an imposition of the U.S. tax rate on our oversea [sic] corporate earnings would be that it, and other competitive companies similarly situated, would be in an excessively competitive position." He added that "such advantages to foreign competitors could not help but impair our ability to compete in the world market."[34] Mr. McElroy defended Proctor and Gamble's use of Swiss subsidiaries as motivated not only by tax considerations but also by the geographical convenience to European markets and the excellent business infrastructure and climate in that alpine federation.[35]

Opponents of the Administration's proposals also contended that growth of U.S. investments abroad would ameliorate the nation's balance of payments position through the eventual remittance of increased dividends back to the United States. Many statements attacked the Treasury's analysis of the balance of payments problem, echoing arguments made in earlier hearings on the Boggs Bill that increasing foreign investment would eventually ameliorate the balance of payments situation as income earned abroad was repatriated. These witnesses also argued that the current U.S. balance of payments situation did not justify a wholesale reversal of U.S. tax policy with regard to foreign-source income.[36]

The arguments on behalf of U.S. businesses advanced a view of the proper standard of taxpayer equity in fundamental conflict with the Kennedy Administration's conception. The opponents of the Kennedy proposals considered the proper measure of tax equity to be whether firms conducting business in the same jurisdiction were subject to the same rate of tax (capital import neutrality), not whether firms with the same nationality were taxed at the same rate (capital export neutrality). The repetition of similar arguments by firm after firm, organization after organization, made it abundantly clear to the members of the Committee that important U.S. businesses with significant financial interests abroad strenuously opposed the attempt to abolish deferral.

Testimony from Labor and Academics

The only support that the Kennedy proposals received during the Ways and Means Committee hearings was from organized labor. As Stanley Ruttenberg, Director of Research for the AFL-CIO made clear, his organization supported the Administration's proposals because deferral "distorted U.S. investment decisions."[37] The AFL-CIO believed that deferral encouraged the export of capital and jobs that otherwise would remain in the United States. Organized labor, however, felt most strongly about the use of tax havens, calling for their elimination in both industrialized and less developed nations. Ruttenberg reserved his most graphic language for urging the abolition of the use of tax havens, calling them a "legal monstrosity."[38]

The proposal to eliminate deferral received a lukewarm reception among the academics who presented their views to the Ways and Means Committee. Professor Albert Anthoine of Columbia Law School flatly opposed the Administration's proposals. Dan Throop Smith, of Harvard Business School, remarked to the committee that "though there seems to be need for some change, the specific proposals appear to go too far."[39] Roy Blough of Columbia University argued that although the Treasury had identified areas for concern, significantly more research was needed before the Administration's proposals should be enacted.

Executive Sessions of the House Committee on Ways and Means

Following its public hearings, the Committee on Ways and Means considered the Administration's proposals in executive sessions closed to the public. The fierce opposition to ending all deferral that had become clear in the public hearings had swayed the Committee, and by July 1961, the Treasury had retreated from its insistence on a general anti-deferral regime. Treasury then offered a more modest proposal that aimed to address only the use of tax havens. Treasury's new position marked its abandonment of a policy of capital export neutrality in U.S. international tax law and also was the beginning of the transformation of the Kennedy proposals into "anti-abuse" provisions.

On July 20, 1961, the Treasury presented a substantially scaled back proposal, which incorporated some suggestions of Committee members in light of the testimony they had heard. This Treasury proposal suggested taxing currently the income of controlled foreign corporations from certain kinds of income, including income from purchases and sales between related persons, commissions, licensing, holding company income, service income,and the insurance of U.S. risks abroad. Current taxation would be imposed if the income arose from transactions with related parties outside the country in which the controlled corporation was organized, where five or fewer U.S. shareholders owned more than 50 percent of the stock of the foreign corporation, but only to those shareholders that owned 10 percent or more of the stock of the corporation.[40]

From the summer of 1961 through early 1962, the Treasury Department and the Ways and Means Committee worked to agree on a concrete legislative approach to restrict deferral. By March 1962, the Ways and Means Committee had prepared legislation and reported it to the House.[41] The Committee explicitly announced that the legislation did not go as far as the President's initial proposal. Instead, the Committee's March 1962 proposal had four objectives: (1) to prevent U.S. taxpayers from taking advantage of foreign tax systems to avoid taxation by the United States "on what could ordinarily be expected to be U.S. income;"[42] (2) to reach income retained abroad that was not used in the taxpayer's trade or business and not invested in an under-developed nation; (3) to prevent the repatriation of income to the United States in such ways that it would not be subject to U.S. taxation; and (4) to prevent taxpayers from using foreign tax systems to "siphon off sales profits from goods manufactured by related parties either in the United States or abroad."[43] Specifically, the legislation proposed taxation of income from the insurance abroad of U.S. risks; income from patents, copyrights, and exclusive processes developed in the United States and transferred to foreign subsidiaries; and dividends, rents, royalties, and income from sales of goods for use outside the country where the controlled subsidiary was organized. In addition to containing provisions directed at tax havens, the bill also limited deferral in developed countries by taxing currently foreign-source business income unless that income was reinvested in the same trade or business or in a less developed country.

The reasons enunciated by the Ways and Means Committee for the changes it proposed reflected continuity with—not a departure from—

longstanding U.S. international tax policies. In particular, the Committee voiced concerns with protecting the U.S. tax base on U.S.-source income and limiting deferral to active foreign-source business income. The major shift, recommended by the Kennedy Administration, to a general policy of capital export neutrality had been rejected.

The legislation adopted by the Ways and Means Committee also contained an investment tax credit along the lines proposed by President Kennedy, a substantial incentive for new investment in the United States. The Committee's legislation allowed an investment tax credit equal to 8 percent of the cost of investment in new plant and equipment used in the United States.[44]

On March 28, 1962, the House of Representatives passed the Revenue Act of 1962, including the foreign income provisions, substantially as they had been reported by the Committee on Ways and Means, and an investment tax credit, although the credit amount was reduced from 8 to 7 percent.[45] The burden of shaping the foreign income proposals then moved to the Senate.

"Tax Haven" Legislation in the Senate

Senate Finance Committee Hearings

From April 2, 1962 to July 3, 1962, the Senate Finance Committee held hearings on the 1962 Revenue Act. Many of those who had presented their views to the Committee on Ways and Means repeated them before the Senate. The debate over the policy implications of the foreign income proposals was not significantly advanced.

Opponents attacked the House bill, emphasizing that it would erode the competitive position of U.S. businesses operating abroad. They also complained about the complexity of the foreign income provisions, the inconsistency of the proposals with other legislation intended to foster foreign trade, and the discretion that the requirement that earnings be reinvested in the same trade or business would grant to the Treasury.

The Treasury, for its part, presented the Finance Committee with two contradictory options for taxing foreign income, both of which differed from the House's approach. Although, Secretary Dillon stated that the House bill was effective in addressing the use of tax havens to divert income earned in one foreign jurisdiction to another foreign country, he renewed the Kennedy Administration's call for a policy of capital export neutrality, urging elimination of deferral for foreign income in all developed countries and in tax haven jurisdictions, whether or not in developed countries. Secretary Dillon stated:

"The privilege of deferring U.S. taxes until income is repatriated as dividends should simply be eliminated for our subsidiaries in advanced industrial countries… The deferral privilege should be retained, for income earned in less-developed countries, in line with our general foreign policy objectives."[46]

Some policymakers in the Treasury had held out hope when the Department initially retracted from urging the elimination of deferral in general in July 1961, that the Senate Finance Committee might prove more receptive to the idea of capital export neutrality.

Secretary Dillon's primary objection to the deferral left in place under the House bill was that it provided a tax incentive to invest abroad. He said a "drain is imposed on our already adverse balance of payments and the reduced domestic investment limits employment opportunities and retards our economic growth."[47] Dillon contended that each dollar invested abroad in developed countries provided only a comparatively small impetus to U.S. employment. On the other hand, he claimed that each dollar invested abroad had a relatively large effect on the U.S. balance of payments position. He said the effects of eliminating deferral would be twofold: it would create smaller net capital outflows and would eliminate the "tax inducement" to leave earnings abroad, thus presumably encouraging capital invested abroad for tax-related reasons to return to the United States.[48]

Treasury, however, also offered a second option, urging elimination of deferral only for tax havens and not for any manufacturing operations abroad. One member of the Treasury staff, who worked on the legislation, said the Treasury placed this narrower option before the Finance Committee because it was concerned that the Senators might accept taxpayer arguments that even the House bill was too harsh.[49]

Secretary Dillon described the problem of tax havens as follows: low tax rates in certain jurisdictions, combined with the U.S. policy of not taxing currently retained earnings from foreign subsidiaries, invited the use of foreign subsidiaries to channel profits from overseas operations to tax haven corporations, which were subject to tax rates significantly lower than U.S. rates. He singled out corporations acting as middlemen in largely "paper transactions."[50] Dillon regarded these tax haven activities as "a most serious breach in our principle of tax neutrality."[51]

Dillon claimed that the problem of tax havens "is growing in quantitative terms by leaps and bounds every year. We are dealing here with a tax differential on retained income, not of 5 or 10 percentage points, but of 40 or 50 percentage points."[52] In answering a question by Senator Frank Carlson of Kansas, Secretary Dillon emphasized his discomfort with the increased use of tax havens by U.S. corporations operating abroad. Dillon noted that "the abuse of these foreign tax havens . . . has become a scandalous thing. It is not that everyone who uses them should be stigmatized that way, but they have been very seriously abused, and that is the second major reason they should be prohibited."[53] Secretary Dillon suggested only one change to the bill as it affected tax havens: that the exemption for tax haven profits invested in less developed countries be restricted to earnings generated in less developed countries, so as to avoid presenting an "artificial stimulus to investment in advanced industrial countries."[54]

The Secretary summed up his recommendations in the area of deferral as follows: "Tax fairness, revenue requirements, and our balance of payments position all demand that the tax deferral privilege now enjoyed by controlled foreign corporations in industrialized countries should be eliminated."[55] But Dillon's response to a question by Senator Carlson about whether the "ultimate effect of these provisions would be to reduce the revenues to the United States rather than increase it" made it clear that the Treasury regarded capital export neutrality and balance of payments concerns as paramount. Dillon answered as follows:

"I do not think they would reduce the revenue. I do not think we would get all the revenue back that might be expected on a gross basis, and our figures or our estimates take that into account.

"That is why we have estimated a relatively low figure of income for the tax haven provisions, because one of the things that this may do is simply make tax havens less attractive in Europe. Companies may operate more normally in the country in which they are manufacturing, in which their manufacturing concern is located, and pay taxes there, so we will not get the actual tax.

"But the tax inducement to go abroad and to make new investments because of these very low taxes will be removed, and we will gain in our balance of payments from this."[56]

Senate Finance Committee Action

The Senate Finance Committee ultimately adopted the general approach of the House bill, but further diluted the anti-deferral measures. The Senate eliminated the "same trade or business" requirements of the House legislation and also added two "safety valves" or relief provisions. First, the bill exempted U.S. shareholders from current taxation if their foreign corporations paid substantial current dividend distributions (as specified by a minimum distribution schedule) or otherwise paid high foreign taxes. Second, the bill permitted deferral in cases of specifically sanctioned export trade where the government was actively seeking to promote and expand U.S. exports.

The foreign income provisions of the legislation provoked considerable disagreement among the Senators on the Finance Committee. Senators Paul Douglas, Albert Gore, Sr., Frank Carlson, Wallace Bennett, John M. Butler, Carl Curtis, Thurston Morton, and Eugene McCarthy all attached additional or dissenting views to the Finance Committee's Report on the legislation.[57] Unsurprisingly, they did not agree about how or why the legislative approach of the Committee was defective. For Senator McCarthy, the bill was too far-reaching and its effects were too uncertain. Acknowledging the existence of tax haven abuses, he argued that "[w]e should not throw the baby out with the bath water but should reconsider the means by which we undertake to correct abuses."[58] Senators Carlson, Bennett, Butler, Curtis, and Morton argued that none of the objectives that the Kennedy Administration had advanced for the legislation had stood up in the hearings, that the tax provisions were of dubious constitutionality, too complex, and would have unintended adverse economic effects. Consequently, they argued that action on the legislation should be postponed.

Significantly, these Senators also expressed concern about ambiguity as to what constituted the tax haven abuse to be curbed by the legislation. In the Senate hearings, pressed by Senator Curtis, Secretary Dillon had defined a tax haven transaction as "one where a company incorporated in country A purchases from country B and resells in country C." Senator Curtis asked if "all such operations . . . [were] tax haven transactions?" Dillon responded that "[n]ot all such operations are necessarily tax haven transactions, and that is the specific reason why I requested . . . that the Secretary of the Treasury be given authority to exempt specific transactions, specific operations that are not entered into for the purpose of tax avoidance."[59]

Not all the Senators felt that the bill as referred by the Finance Committee was too far-reaching. Senators Douglas and Gore, Sr. complained that too little had been done to curb the tax subsidy for moving U.S. capital abroad and then advocated replacement of the House and Senate anti-deferral provisions by "the complete removal of the deferral privilege."[60]

Final Passage of the Revenue Act of 1962

Despite the reservations of some members of the Committee, the Finance Committee's revisions were sent to the Senate floor where they passed and were forwarded to a conference committee. In conference, the House acceded to the Senate's changes, and the foreign income provisions, as modified by the Senate, were passed by Congress in the first days of October 1962. The 7 percent credit and the geographical restrictions of eligibility to U.S. property were retained by the Senate and conference committee, and were enacted into law in the final version of the bill.[61]

"Tax Havens" and the Definition of Abuse

It is clear that neither the House nor the Senate embraced the Kennedy Administration's call to shift U.S. international tax law to a policy of capital export neutrality. Instead, the 1962 legislation, as ultimately enacted, was targeted at eliminating certain "abuses" permitted under prior law. The historical record, however, is far from clear about exactly what the "abuses" were that Congress intended to curb.

The abuses that the Revenue Act of 1962 sought to rectify changed substantially as the legislation made its way through the legislative process. Under President Kennedy's original proposal contained in his tax message of April 1961, and urged throughout the Congressional process by Treasury Secretary Dillon, any deferral of U.S. taxation constituted an abuse. An exception to current taxation would have been provided for (and limited to) investments in less developed countries, but this exception was explicitly grounded in foreign policy, not tax policy, considerations.

Treasury's proposal of July 20, 1961, implicitly treated as abusive the deferral of tax on income from transactions between a foreign corporation and a related party outside the country in which the foreign corporation was organized.[62] In the legislation sent to the House by the Committee on Ways and Means and adopted by the House, the abuse appeared to be the avoidance of "taxation by the United States on what could ordinarily be expected to be U.S. source income."[63] As stated above, this concern was consistent with U.S. tax policy dating back to the formative period of 1918–1928, and can be viewed, not as a change in policy, but rather as an application of longstanding policies to new circumstances.

In the Senate Finance Committee hearings, Secretary Dillon singled out as abusive the use of foreign corporations that market their goods or services in third countries with the subjective intent of "reducing taxes."[64] It is clear, however, that Congress did not intend to reverse the policy of generally permitting deferral of active business income earned abroad. Ultimately, no clear Congressional understanding of exactly what constituted an abuse can be determined from the history of the 1962 Revenue Act. Indeed, the Act left determinations of abuse—at least to some extent—up to the Treasury on a case-by-case basis.

The lack of clarity in the historical record of the 1962 Act about what constituted an abuse of tax deferral in international transactions has resulted in ongoing debates about the proper scope of subpart F that continue to this day. As subsequent chapters show, legislation since 1962 has changed the rules for when current taxation is required, but has not resolved the basic debate that raged in 1962. Moreover, interpretations of the 1962 Act subsequent to its enactment have sometimes described as abusive any transaction where a foreign government imposes lower tax than would be imposed by the United States on the same transaction or income.[65] This cannot be right. In 1962, Congress clearly rejected making capital export neutrality the linchpin of U.S. international tax policy. Attempting to force a strained interpretation of the legislation it did enact into an endorsement of capital export neutrality by defining anything that departs from capital export neutrality as an abuse flagrantly disregards the historical record.

Conclusions

The anti-abuse approach adopted by Congress in 1962 has often been described as a political compromise, one that sought to achieve a balance between inconsistent goals. On the one hand, Congress clearly concluded that ensuring the competitiveness of U.S.-based companies required the retention of deferral for most active business operations; thus, a company's tax-influenced decision to move "bricks and mortar" activities into a low-tax jurisdiction, although a clear violation of strict capital export neutrality principles, remained well outside the scope of the statute, because Congress decided that U.S.-based companies needed to be able to compete in world markets by engaging in such activities on the same terms as their foreign competitors. On the other hand, concerns about the protection of the U.S. tax base moved Congress to end deferral for certain categories of income that were deemed to be most susceptible of being moved out of the United States for tax reasons.

Although the historical record does not support the conclusion that this anti-abuse notion was grounded in capital export neutrality, proponents of that principle have steadily argued that it was. Thus, subpart F has often been described as a "balancing" between competitiveness and capital export neutrality concerns. While the history contains no evidence of such a balancing by Congress, the concept of such a balance may nevertheless be a useful analytical tool, not least because Treasury has recently described subpart F as requiring a balance among rival goals that include competitiveness, capital export neutrality, and fairness. Accordingly, the remainder of this part of the NFTC Foreign Income Project will examine the ways in which the policy balances within subpart F have shifted over time, and compare those shifts with comparable policies in other countries and with changes in the macroeconomic context in which subpart F operates.

Part 2
Business Income

Chapter 3

Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies

I. Introduction

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

Our nation's system for taxing international income today is largely a creature of the period 1918-1928, a time when the income tax was itself in childhood.[2] From the inception of the income tax (1913 for individuals, 1909 for corporations) until 1918, foreign taxes were deducted like any other business expense.[3] In 1918, the foreign tax credit (FTC) was enacted.[4] This unilateral decision by the United States to allow taxes paid abroad to reduce U.S. tax liability dollar for dollar-taken principally to redress the unfairness of "double taxation" of foreign source income-was extraordinarily generous to those nations where U.S. companies earned income. In contrast, Britain, also a large capital exporter, until the 1940's credited only foreign taxes paid within the British Empire and limited its credit to a maximum of one-half the British taxes on the foreign income.[5]

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

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

Nothing comparable to the thoroughgoing multilateral restructurings of international monetary and trade relationships that followed the Second World War (which themselves have been substantially revised and refined since) has affected the system of international income taxation.[11] It is remarkable that not only the fundamental structure of the system for taxing international income today, but also many of the core concepts used to implement that structure—concepts such as permanent establishment, corporate residence, and arm's length pricing-date from a time when airplanes were first becoming a regular means of travel, and when the "wireless" was a relatively new instrument of communication, and when Dorothy Parker, Robert Benchley, and Haywood Broun were holding court in the lobby of the Algonquin Hotel, a mile away.

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

Likewise, the method for determining the limitation on foreign tax credits has taken a variety of forms over the years, having been computed based on a taxpayer's overall foreign source income when first enacted in 1921,[17] limited to the lesser of an overall or per-country amount in the 1930's, 1940's, and early 1950's,[18] and computed country by country in the latter half of the 1950's.[19] Beginning in 1960, taxpayers were given the option of an overall or per country limitation[20] until 1976 when the per country limitation[21] was repealed and the law returned to its 1921 shape.[22] There it rested until 1986 when today's system, which categorizes various types of income into so called baskets for purposes of calculating the foreign tax limitation, came into effect.[23] Whenever the limitation has changed, has expressed concern with protecting the U.S. tax on U.S. source income from erosion.[24]

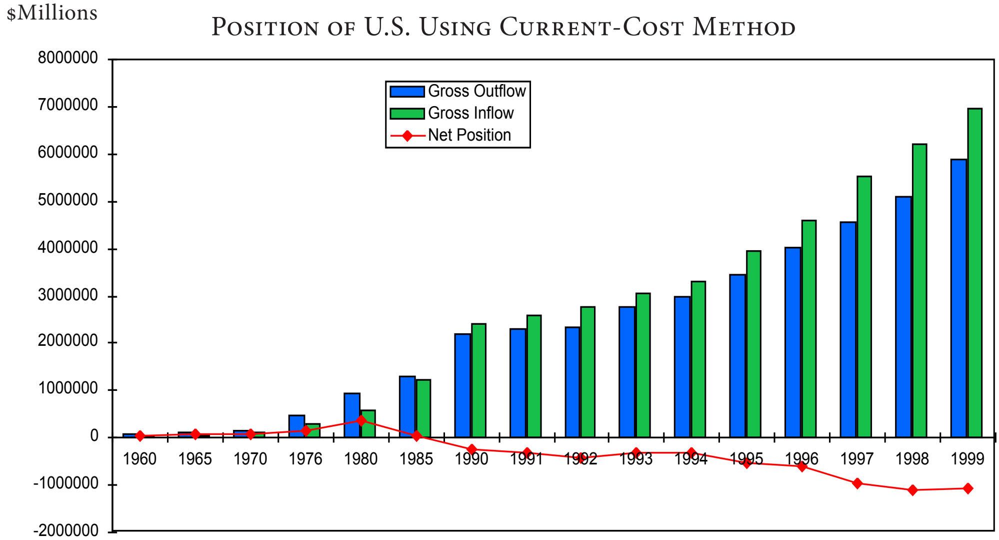
Each time the law has changed, it has introduced new challenges for tax compliance and administration. Thus, although the fundamental structure of international income taxation devised in the 1920's remains in force, the legal rules detailing the implementation of that structure today comprise a cumbersome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

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

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

Figure 1

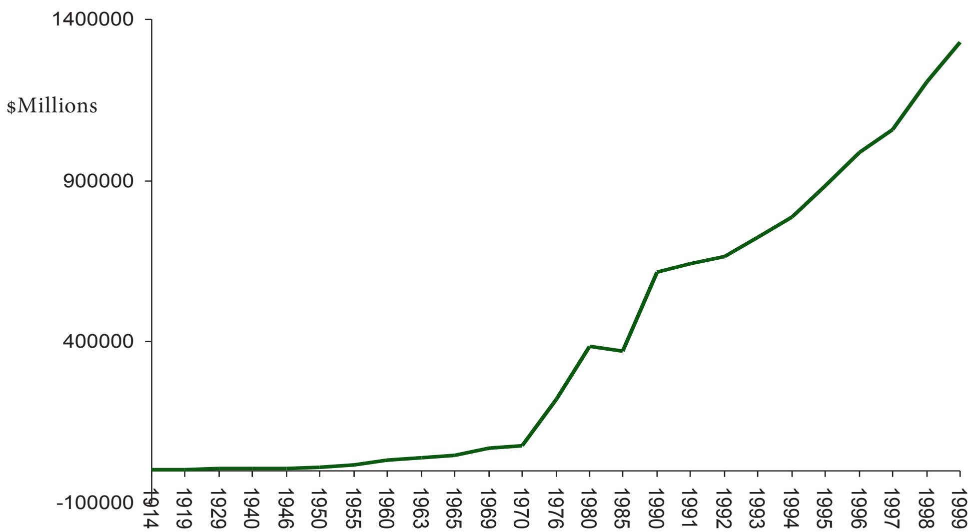
U.S.-Owned Assets Abroad, Foreign-Owned Assets, and Net Position of U.S. Using Current-Cost Method



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

Figure 2

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

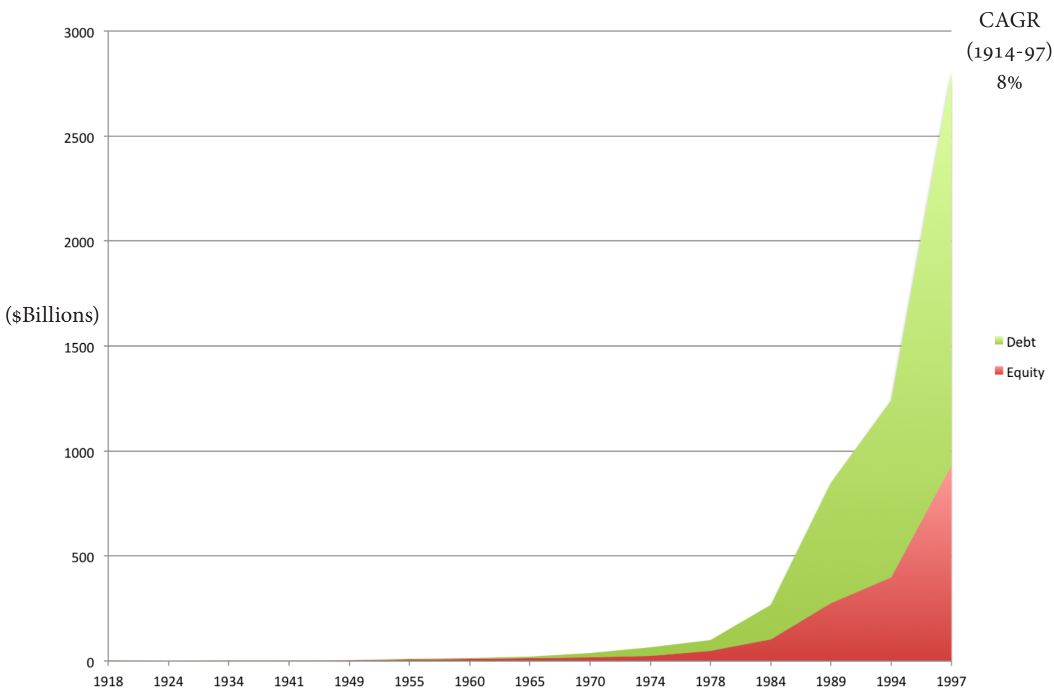


Source: Mira Wilkins, The Maturing of Multinational Enterprise: American Business Abroad From 1914 to 1970 (1974); Russell B. Scholl, *The International Investment Position of the United States at Yearend 1999*, 80 Survey of Current Business (July 2000).

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

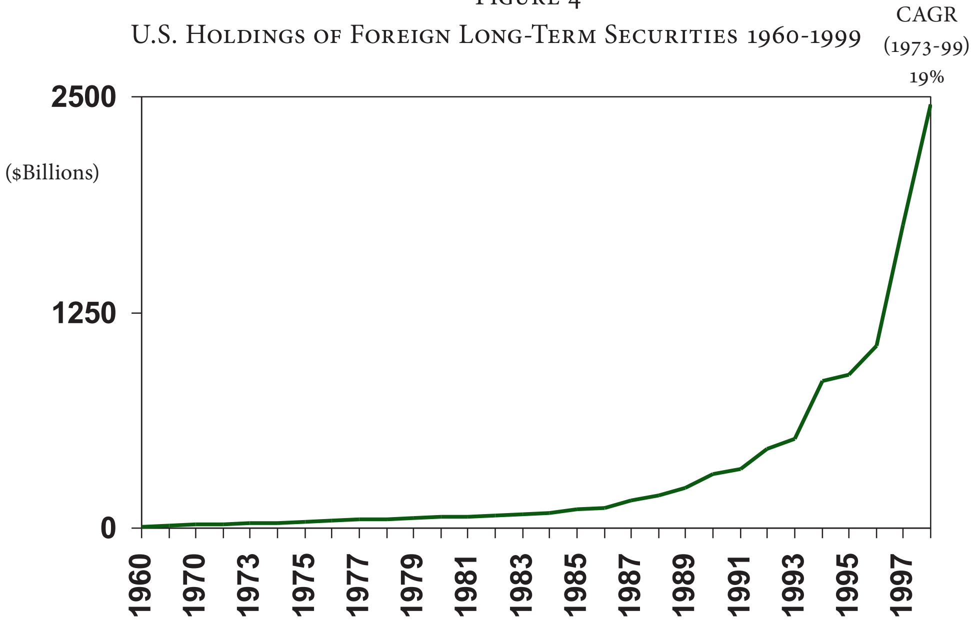
Figure 3

Foreign Holdings of U.S. Long-Term Securities



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

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

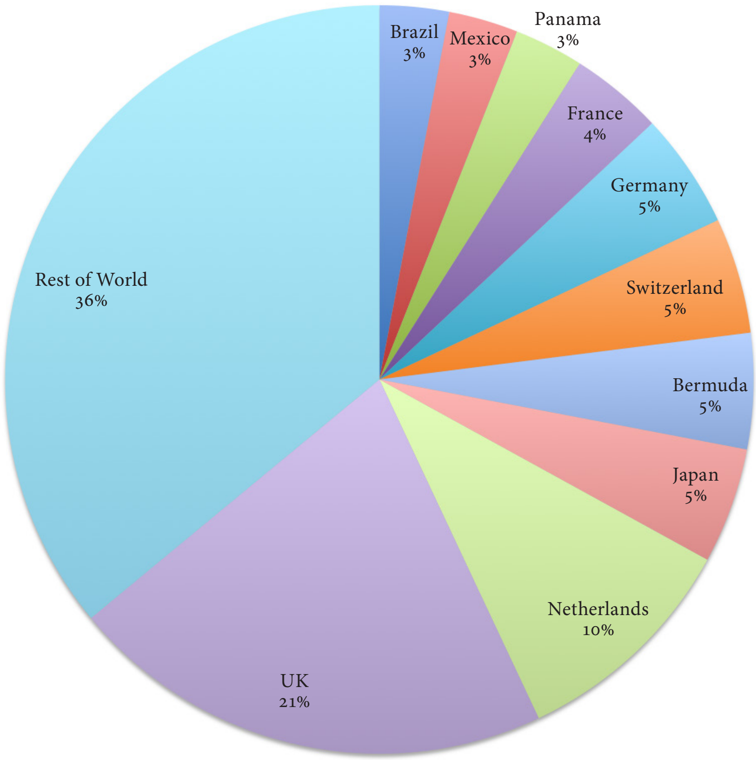


Source: Russell B. Scholl, *The International Investment Position of the United States in 1988*, 69 Survey of Current Business (June 1989); Christopher L. Bach, *International Transactions, Revised Estimates for 1974-1996*, 77 Survey of Current Business (July 1997); U.S. Treasury Dep't, Report on U.S.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

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

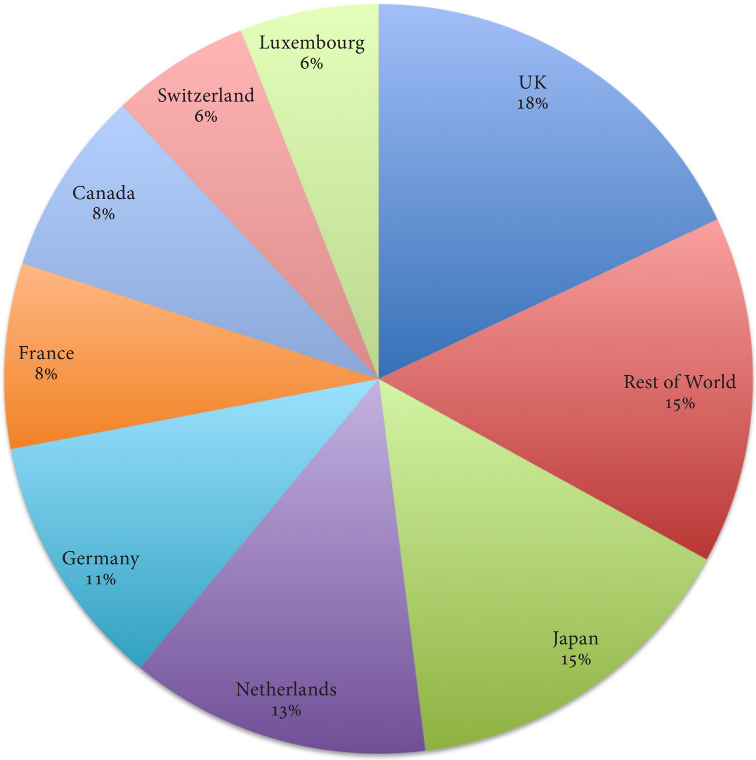
Thus, although the founders of the system for taxing international income confronted only one important issue, the taxation of foreign direct investments by U.S. multinationals, policymakers today must address the taxation of large inbound and outbound flows of both direct and portfolio investment. Moreover, just looking at the incoming and outgoing flows of direct investment in the figures below, it is clear that, for corporations at least, tax considerations play a significant role. Luxemborg, for example, supplies almost as much direct investment to the United States as France and Canada, and the size of direct investment from the United States to Bermuda and Panama surely is not justified by economic considerations alone. The important role played by tax considerations in business activities is not surprising, and is confirmed by more sophisticated empirical analyses.[27]

FIGURE 5
U.S. DIRECT INVESTMENT DESTINATIONS, BY SELECTED NATIONS, 1999



Source: Sylvia E. Bargas, *Direct Investment Positions for 1999*, 80 SURVEY OF CURRENT BUSINESS 57 (July 2000).

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

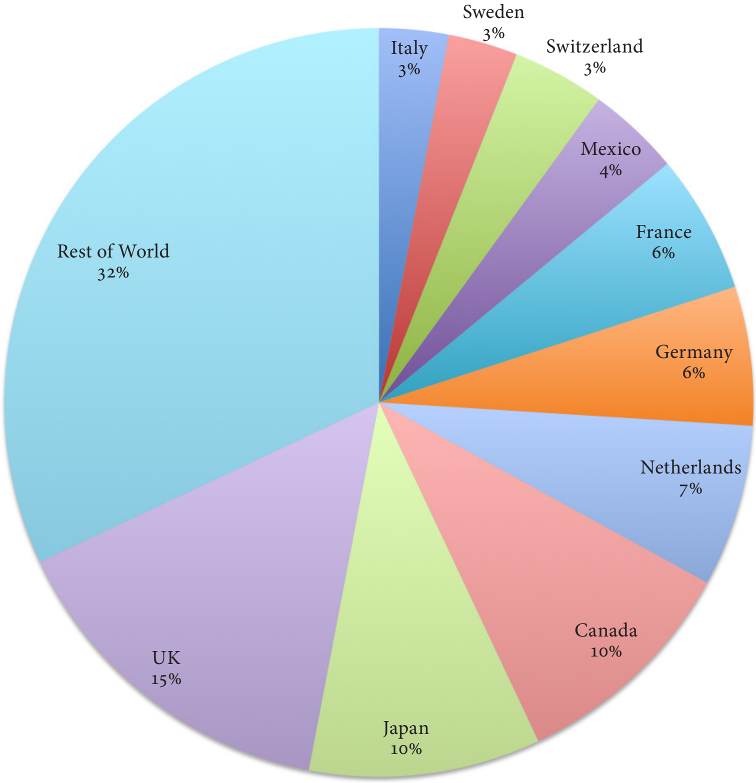


Source: Sylvia E. Bargas, *Direct Investment Positions for 1999*, 80 Survey of Current Business (July 2000).

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

Figure 7

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



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

Despite the age of the international income tax regime and the dramatic economic changes since it was put in place, Congress has shown little interest in ideas for fundamental restructuring or even review of the basic international income tax arrangements. Instead, the international income tax system lurches from one perceived threat to another: transfer pricing abuses yesterday, "harmful" tax competition and under-reporting of portfolio capital income today, and who knows what tomorrow. Despite the obvious strain, the wheels do not seem to be coming off, at least not yet. In fact, the international income tax system has served reasonably well;

it has not proven a significant barrier to the international flows of goods, services, labor, or capital, and may even have facilitated such flows. This no doubt is why it has survived intact for so long.

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

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

II. Inadequate Principles

Discussions of the principles and goals motivating international income tax policy are perplexing to the nonspecialist. Often description of foundational principles is omitted altogether; many authors simply assume that the normative basis for international income tax rules is widely understood and enjoys universal agreement. One common shorthand, especially prevalent in the legal literature, is to begin by announcing acceptance of the "1920's international tax compromise" and then proceeding to describe how a modern transaction or problem might be shoehorned into that regime.[29]

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

Sometimes a second kind of neutrality, capital import neutrality (CIN), is supported. CIN requires that all investments in a given country pay the same marginal rate of income taxation regardless of the residence of the investor. CIN thus subjects all business activity within a specific country to the same overall level of taxation, whether the activity is conducted by a resident or a foreigner. If CIN holds, all savers, regardless of their residence, receive the same after-tax returns. They therefore face the same prices for future versus present consumption and the allocation of savings is efficient.[32]

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

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

It is by now known that it is impossible to achieve CEN and CIN simultaneously in the absence of either a worldwide government or identical income tax bases and rates in all nations.[36] This means that the analyst either must choose between these conflicting norms or—since both residence and source countries exercise their rights to tax income—urge some "compromise" between them. CEN enjoys the greatest normative support both in government analyses and in the academy.[37] This is because distortions in the location of investments are thought to be more costly than distortions in the allocation of savings. Many economists regard the choice between CEN and CIN as essentially empirical, turning on the relative elasticities of savings and investment.[38] Since investment is thought to be more responsive to changes in levels of taxation, a policy of CEN predominates. But the British economist Michael Keen emphasizes that "we currently know almost nothing about the quantitative welfare implications of alternative tax treatments of cross-national direct investment."[39]

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

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

The idea that CEN should be the lynchpin of U.S. international tax policy was first voiced by the Kennedy administration in connection with its 1962 international tax proposals, proposals that led to the adoption of Subpart F.[44] Treasury since that time often has expressed the view that CEN should guide policy. A few important examples include Blueprints for Tax Reform, issued in 1976, President Reagan's tax reform proposals of 1985, the 1996 Treasury White Paper on the International Taxation of Electronic Commerce, and Treasury's Study of Subpart F, issued in December 2000.[45]

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

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

Occasionally, international tax policy analysts give a brief nod to the misnamed norm of "national neutrality," which takes a national rather than worldwide point of view. This norm seeks neutrality between the pretax return on domestic investments and the return on foreign investments after the payment of foreign taxes (which is said to represent the return on foreign investments to the capital exporting country.) In essence, this norm regards domestic investment as preferable to foreign investment because the U.S. Treasury gets to keep the revenue from taxing the income from domestic production.[49] National neutrality would treat foreign taxes the same as domestic costs of doing business and allow only a deduction for foreign income taxes. The AFL-CIO urged replacing the foreign tax credit with a deduction for foreign taxes in the 1970's,[50] and such legislation, the Burke-Hartke Bill, was introduced and debated, but Congress rejected the proposal.[51] Today, while the national neutrality idea often is mentioned as a potential norm, national neutrality's policy of allowing only a deduction for foreign taxes generally is discussed only in passing; it is routinely dismissed as unwise and unrealistic.[52]

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

But, even though President Kennedy and Douglas Dillon, his Treasury Secretary, talked about the virtue of equalizing the treatment of income from foreign and domestic investments, it is not accurate to characterize the Kennedy Administration in 1962 as endorsing a policy of CEN—as Treasury has as recently as December 2000.[55] President Kennedy's proposals were not neutral between investments in developed and developing countries, offering a tax advantage to the latter.[56] Moreover, at the same time President Kennedy was urging neutrality between foreign and domestic investment as the guiding light for international tax policy, he also pressed Congress to enact a generous tax credit limited to business investment within the United States.[57] In1962, both in the White House and Congress, encouraging domestic investment and promoting economic growth within the United States took political and economic precedence over advancing worldwide economic efficiency.

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

The dominant normative perspective of international tax policy debates-limited to a choice or a compromise between CEN and CIN—both inhibits an adequate understanding of the normative underpinnings of international income tax policy and improperly limits serious consideration of alternative policies. There are three major problems with relying on worldwide economic efficiency (and thus CEN) as the foundation for international income tax policy. First, it seeks to improve worldwide rather than national well-being. Second, the idea of economic efficiency is too limited. Third, focusing on economic efficiency as the guiding light excludes other important values.

A. Rejecting a Worldwide Perspective

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

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

Since World War II, international law has become more protective of fundamental human rights of people throughout the world, even when it limits a nation's internal sovereignty. But I have found no one who argues for grounding U.S. international income tax policy on worldwide economic efficiency (or CEN) who also proposes assessing the fairness of U.S. income tax policy on a worldwide basis. More importantly, no nation has ever made a genuine commitment to worldwide equity.[59] We often take quite seriously our obligations to foreigners and show respect for their rights, but we regard our obligation for the well-being of our fellow citizens as more pressing than for people in need elsewhere in the world.[60]

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

When we are talking, as now, about making policy, we cannot ignore history or culture. The freedom and independence, as well as the economic welfare, of people varies from nation to nation. This simply is fact. In the absence of a world government, this is how it must be. Moreover, although I cannot develop the argument here, I believe this is how it should be. Notwithstanding the utopian philosophical ambitions for worldwide harmony implied by those who urge taking a "one-world view," I agree with those political philosophers who insist that a world government—a political entity exercising the powers now held by national governments—would likely live in a constant state of civil unrest, as various populations and regions contest for freedom, autonomy, and self-government. A "world government" would likely become a dictatorship.[62]

National boundaries often may be arbitrary and no doubt they will continue to shift as they have over time, but they demarcate the political organizations responsible for the well-being of the people within their territory. The people of a nation often share a common language and common political antecedents. In democratic societies, national boundaries determine the jurisdiction of the people's representatives and thereby define the scope of political (and often social) operation.

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

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

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

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

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

Unfortunately, international income tax policy does not enjoy a harmony between national and worldwide interests similar to international trade. The consensus of economists insists that a policy of free trade not only improves worldwide efficiency but also improves the economic efficiency of each nation that reduces trade barriers unilaterally.[64] But many economists claim that the benefits of free trade are not replicated by free flows of capital, and no such confluence between national and worldwide gains has been claimed for international tax policy.[65]

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

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

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

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

In some circumstances, domestic investment may be more beneficial to Americans' well-being than foreign investment.[67] At other times, at least for some categories of investment, the converse may be true.[68] And pursuing a policy of capital export neutrality sometimes may best serve the interests of U.S. citizens and residents.[69] But which of these claims is true is an empirical question from a national perspective, a question that may depend on a host of economic, political, and social conditions that vary from time to time. Such empirical claims are very different from the contention that pursuing worldwide economic efficiency is the appropriate principle for formulating U.S. international income tax policy. Making tax policy choices, including international tax policy decisions, routinely requires policymakers to select among competing and controversial empirical claims. Needless to say, the empirical claims about the consequences of alternative international tax policies are often controversial.

B. Too Narrow a View of Economic Efficiency

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

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

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

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

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

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

The seminal analyses of the efficiency aspects of foreign investments by U.S. persons were published in 1963 and 1969 by Peggy Musgrave.[76] The economics literature since has been greatly influenced by her work.[77] Musgrave examined only outbound investment from both a theoretical and empirical perspective and concluded that following a policy of capital export neutrality would maximize worldwide welfare.[78] She also concluded that a policy of allowing only a deduction for foreign income taxes, which she labeled "national neutrality," would maximize the national welfare of the capital-exporting nation.[79] Importantly, although there have been numerous applications and extensions of Musgrave's work, there has been no comprehensive reexamination of these issues—for example, to assess whether Musgrave's proposed policy of national neutrality would have well-served or would now well-serve the interests of the United States-in the 30 years since her work was first published.[80]

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

Subsequent empirical work has tended to support Musgrave's conclusions in this regard, although at least one important analysis suggests that a combination of CEN and CIN will maximize worldwide efficiency.[84] Likewise, recent empirical work has confirmed that locational decisions are sensitive to tax rates, although much of this work considers choices among foreign locations once the decision to invest abroad has been taken.[85]

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

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

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

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

Second, Musgrave assumes a first-best world, one where markets are perfectly competitive and governments are well-behaved.[91] This means, for example, that there are no economies of scale or scope to be achieved by U.S. corporations through investments abroad, an assumption that eliminates one of the major reasons identified by international business analysts for foreign investments of multinational corporations.[92] To take but one example, economies of scale commonly occur when the benefits of successful research and development, patents, and business processes can be exploited worldwide rather than just domestically. Licensing or sharing such knowledge with unrelated foreign third parties may not be a realistic alternative. Some observers have also suggested that the firms principally engaged in foreign direct investment may be operating in an "oligopolistic environment."[93] Likewise, there are no externalities in Musgrave's analysis, such as those that have been widely urged for research and development expenditures undertaken by multinational corporations and by some observers for headquarters operations generally.[94] Musgrave also fails to take into account any potential political benefits to the United States that have resulted (especially in the years following World War II) and may result from some foreign direct investments. Musgrave also ignores the fact that the tax policies of government may not be optimal. For example, when she was writing (and at certain other times), the United States provided a generous tax credit available only for investment in equipment used in the United States.[95] Depreciation allowances also often contain advantages for domestic investments.[96] Elsewhere in the world, the rules for dividend relief in schemes for integration of corporate and shareholder income taxes have tended to favor domestic investments.[97]

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

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

Third, Musgrave assumes that a dollar of foreign investment is a dollar of domestic investment lost; in other words, that foreign investment substitutes for domestic investment dollar for dollar.[100] The function of tax policy under such circumstances is simply to affect the allocation of a fixed supply of capital between domestic and foreign investments. This treatment may be reasonable for portfolio investment, which is far more volatile than direct investment and which, because of its liquidity, can readily move in response to changes in rates of return (although the supply of portfolio investment may beaffected by international tax policy.)[101] But there is considerable evidence that much foreign direct investment by U.S. multinationals is complementary to domestic investment rather than a substitute for it.[102] John Dunning, for example, insists that "increasingly, outward and inward investment are not in competition with one another."[103] Musgrave, in contrast, assumes that exports are perfect substitutes for foreign investments.[104]

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

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

Fourth, Musgrave entirely ignores individual-level taxes on both foreign and domestic investments, probably on the assumption that they will have an equal impact on both. But the international tax economist James Hines, has found that, for U.S. multinationals, one dollar of reported foreign profitability is associated with the same level of dividend payments to common shareholders as three of reported domestic profitability.[107] This means that the U.S. classical system of taxing corporate profits is more burdensome for firms with foreign income than for those with domestic income only. In fact, the U.S. Treasury receives greater tax revenues from the foreign operations of U.S. companies by taxing individual income than by taxing the income of the corporations themselves.[108] Hines speculates that "[f]irms reporting foreign profits may have greater need than do others to signal their profitability in the form of dividend payments to common shareholders, because market participants are particularly skeptical of reported earnings that may be denominated in foreign currencies, are subject to exchange rate risk, capital controls, subvention by foreign managers, and various forms of interference by foreign governments."[109]

Hines concludes that this additional cost of capital associated with foreign investment may be a reason for beneficial treatment of foreign investment at the corporate level.[110]

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

Despite the favorable tax treatment it receives, the stock of foreign direct investment abroad from the United States is considerably smaller both as a percentage of U.S. GDP and as a percentage of U.S. gross capital formation than the comparable ratios for the stock of foreign direct investment of other industrialized nations.[114] For example, the ratio of the U.S. stock of foreign direct investment abroad to GDP is less than one-half the ratio of the United Kingdom or the Netherlands, and the increase in that ratio since 1980 has been relatively small for the United States, compared to the rest of the world.[115] U.S. multinationals have been exceptional in their tendency to concentrate activities, particularly research and development, and resources at home, that is, in the United States.[116]

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

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

It is not clear to me exactly how the benefits of inbound investment would be taken into account in the formula used by Musgrave and other economists to measure the national welfare effects of foreign investments.[120] Typically economists treat rates of return of foreign investment as accruing to the suppliers of capital. But the benefits of inbound direct investment to the host country are surely substantial. Otherwise nations and states would not compete as they do to attract such capital. Ignoring the benefits of inbound investments seems a major shortcoming of Musgrave's analysis as a basis for policymaking.

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

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

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

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

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

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

In recent years, this multilateral income tax regime also has facilitated foreign investments into the United States, as I discussed earlier. I find it difficult to believe that our national well-being—Americans' standards of living—would have been improved with the isolationist policy toward foreign investment implied by allowing only a deduction for foreign taxes.[128] Put simply, while I recognize the difficulties of measuring the effects of international tax policy, indeed of tax policy generally, on national welfare, I reject the simple formula of "national neutrality" that suggests allowing only a deduction for foreign taxes is the best policy if the goal is to enhance national, rather than worldwide, welfare.

C. Economic Efficiency as the Sole Value

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

There has long been heated dispute over what constitutes a fair system of taxation. The most vigorous policy debate during the past 25 years has been over the choice between income and consumption taxation, with the question whether it would be fair to replace the income tax with a tax on consumption the most contentious issue. Indeed, the decision to impose an income tax in the first instance was grounded in considerations of equity.[130] Put somewhat crudely, the fundamental claim is that income is a better measure of ability to pay than the alternatives, notably consumption or wages.

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

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

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

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

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

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

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

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

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

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

D. Inter-nation Equity

The unlimited FTC, which was in place from 1918 until 1921, also offended Adams' sense of fairness. In this case, however, he was concerned about fairness among nations rather than taxpayers. He complained of a violation of what (due to Peggy Musgrave[148]) is now described as inter-nation equity: "[The unlimited FTC] is subject to this...rather grave abuse: If foreign taxes are higher than our rate of taxes, that credit may wipe out taxes which *fairly* belong to this country."[149]

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

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

In the consumption tax context, the widely-accepted general practice is to impose such taxes on a destination basis, in other words to allocate the tax to the nation where the consumption occurs. Although credit-method value-added taxes are the common form of consumption taxes, consumption taxes may be imposed in a manner quite similar to income taxes.[154] The deep connections between consumption and income taxes render the longstanding GATI distinction between indirect and direct taxes archaic, if it was ever meaningful.[155] Moreover, recognizing the links between income and consumption taxes may suggest claims of inter-nation equity heretofore largely unanalyzed, in particular claims to share in income taxes by nations that supply a market for goods and services produced elsewhere from capital supplied from other nations. In other words, countries that supply only a market for goods and services may have a claim to income tax revenues in competition with those of both residence and source countries.[156]

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

E. Nondiscrimination and Reciprocity as Fairness-Based Norms

Taking the demands of fairness seriously in the formation and implementation of tax policy is always a daunting challenge, filled with controversy and inevitably subject to compromise. Difficulties multiply in the international context where new issues must be confronted. As I have indicated, the foreign tax credit was a response to concerns about unfair "double taxation" or unfairly burdensome taxation of income earned internationally.[158] The income tax treaty requirement of nondiscrimination against foreigners was developed virtually simultaneously to guarantee fair treatment by the source country for foreigners and foreign businesses.[159] The fundamental idea that everyone, including foreigners (once they are in the country legally), is entitled to equal treatment before the law (including the income tax law and tax treaties) is grounded in concern for fairness and mutual respect. Whether the nondiscrimination requirement of existing tax treaties also furthers worldwide economic efficiency is, at most, a secondary consideration.[160]

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

F. Redistribution Among People of Different Nations

Achieving fairness in international income taxation is complicated further by the question whether the use of the tax law to redistribute income should stop at the nation's borders. Interrogation of this question, so far, has been largely absent from the international income tax literature, having generally been left to political philosophers.[163] At a minimum, questions of international redistribution introduce two concerns: first, the issue of a worldwide entitlement to a minimal level of resources at least to prevent starvation, and perhaps malnutrition; second, the question of whether rich nations have any obligation to reduce misery to an "acceptable" level worldwide. The responsibility of rich nations to ensure any baseline of resources for all humanity is a controversial idea. And few observers contend that our obligations to people abroad are similar to those within our borders. As with efficiency, a national rather than worldwide perspective seems appropriate. Concerns for the economic opportunities of foreigners, indeed for their liberty, do not correspond to the commitment to equal opportunity we aspire to at home. But accepting that the international obligations required by justice, or by simple humanity, are less than those domestically does not render them nonexistent.

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

G. Fairness for Corporations?

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

We know that all taxes ultimately are borne by individuals, so that a requirement for fairness in taxation is properly regarded fundamentally as a requirement of fairness among individuals. The traditional tax fairness concepts of horizontal and vertical equity have their primary salience when analyzing tax burdens on individuals. Clearly vertical equity, distinguishing among individuals based upon ability to pay, does not demand distinctions among corporations similar to those among individuals. The income of a single corporation may be owned by or attributable to individuals with markedly different levels of income and different abilities to pay taxes.

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

When income is taxed only when realized, as it is everywhere, and the undistributed profits of corporations are not attributed and taxed currently to shareholders, vertical equity does, however, demand separate taxation of corporate income. Otherwise, corporations will serve as tax shelters, a place for people with capital to come together and avoid the individual income tax. This is why a corporate tax is a necessary adjunct to an individual income tax, and why many nations, including ours, impose income taxes directly on corporations, although with some uncertainty about just how this tax burden is transferred to individuals.[170] Most economists believe a corporate income tax principally burdens owners of capital, and if this is true, the corporate tax plays an important role in the allocation of tax burdens between labor and capital income.[171] In my view, in a classical corporate tax system, vertical equity also suggests that the corporate income tax rate be reasonably close to the top individual marginal rate, although others disagree.[172]

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

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

While the issues are not nearly as straightforward as with vertical equity, I also believe that horizontal equity-the requirement of similar treatment of taxpayers similarly situated-has a role to play in the taxation of corporate income. The metaphor here, frequently advanced by both business representatives and members of Congress, is the "level playing field." To be sure, the idea of a "level playing field" (like the idea of "double taxation") and exactly what it means for tax policy are far from self-evident. We should be wary not to personify corporations simply because we treat them as "legal persons," or, in the language of the Code, "taxpayers." Nor, on the other hand, should we ignore the importance to justice of equal treatment before the law.

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

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

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

A few years back, the topic du jour of international tax policy was the allegedly low level of taxes paid to the United States by foreign owned businesses doing business in the United States. President Clinton ran for office in 1992 claiming he could raise $45 billion by equalizing the taxes of foreign- and U.S.-owned businesses, although after he was elected President the number had dwindled to less than 10% of that amount,[181] but the public had been stirred. About the same time, Sam Donaldson devoted a segment of his prime-time TV show to the low level of taxes being paid to our Treasury by Japanese owned companies.[182] Neither Clinton nor Donaldson expressed concern with the potential misallocation of capital caused by a low level of tax on foreign companies doing business in the United States. Even if they uttered the phrase "competitive advantage," they were beating the drums of fairness.

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

H. Summary of Discussion of Fairness

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

In the international context, we must also pay attention to questions of fairness among nations. Each nation's claims of entitlement to share in the income of its residents as well as income produced within its borders—and the circumstances under which nations are willing to forgo their share—must be taken into account. Reciprocity has both substantive and procedural dimensions. Unilateral actions by sovereign nations often must be given force and responded to, but some level of international coordination and cooperation is essential.

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

I. Foreign Policy and International Taxation

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

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

Foreign policy concerns have long played an important role in U.S. international tax policy. In 1921 Congress enacted a special exemption for businesses operating in U.S. possessions to encourage economic development there.[185] That law became the model for the special tax advantages enacted in 1942 for Western Hemisphere Trade Corporations.[186] In1922 Congress passed the China Trade Act, which adopted a complicated structure providing benefits to "China Trade Corporations" to stimulate investments in China by U.S. corporations.[187] In 1950 the U.S. permitted oil-exporting countries to base their income tax on posted prices, a move intended both to encourage foreign investments by U.S. oil companies and to transfer U.S. revenues to oil-producing nations.[188]

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

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

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

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

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

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

In assessing the role of international tax policy as an instrument of U.S. foreign policy, we should keep in mind the relative inadequacy and costliness of other foreign policy options, including economic sanctions, military blockades, and war. In many instances cutting off (or increasing) foreign aid might serve as well or better than changes in international tax rules, but such tinkering may not be a viable policy option, given the relatively small size of current U.S. foreign aid.[195] Moreover, using direct foreign aid as a stimulus to change the domestic policies of another nation might be regarded by third-party nations as more intrusive on their sovereignty than limiting (or enhancing) tax advantages for private investments. One need not believe that what is good for U.S.-based multinationals is necessarily good for the United States, nor that U.S.-based multinationals will always act consistently with U.S. foreign policy, to accept a role for international tax policy as an instrument of U.S. foreign policy.

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

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

J. Compliance Costs and Administrability

Even when treated as a separate goal, rather than just a facet of economic efficiency, simplicity always seems to be the forgotten stepchild of income tax policy. Routinely lip service is offered to the idea that the tax law ought to be as simple to comply with and administer as possible; then, after a nod and a wink, vaulting complexity overleaps itself. Analyzing international tax policy solely through the competing lenses of CEN and CIN relegates simplicity to a footnote. But wasting valuable resources through unnecessary costs of complying with a complex tax law is economically inefficient. And the Service cannot fairly administer a law its personnel cannot comprehend. Only cursory contact with the details of U.S. international income tax rules confirms their overwhelming complexity. The economists Marsha Blumenthal and Joel Slemrod have estimated that nearly 40% of the income tax compliance costs of U.S. multinationals is attributable to the taxation of foreign source income, even though foreign operations account for only about 20% of these companies' economic activity.[196]

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

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

K. International Cooperation and Conformity

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

Often our national interests can be enhanced through international cooperation, cooperation that also may produce gains for other nations.

And when a cooperative solution proves impossible or impractical, our national interests may best be promoted by bringing our rules into closer conformity with those of foreign countries. The flexibility that companies enjoy in determining the source of income and their country of residence may mean that the international tax policies and rules of other nations may constrain our ability to depart dramatically from international practice and still achieve our policy goals. This constraint may be especially important as a practical matter in taxing income from direct investments by corporations.

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

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

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

L. Enforceability

Collectability is an essential attribute of any tax. Enacting rules that cannot be enforced is pointless. In the international tax arena, considerations of enforceability have always shaped the law and always will. Source-based taxation of income, for example, has long been justified, at least in part, on the ground that the country of source is in the best position to collect income tax.[203]

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

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

The Treasury surveys of foreign portfolio holdings by U.S. citizens and residents were part of an internationally coordinated effort of 29 countries under the auspices of the International Monetary Fund, undertaken because reported worldwide liabilities held by foreigners greatly exceeded reported foreign assets.[208] Most industrialized nations participated in the surveys.[209]

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

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

The agreement by the countries of the European Union to expand information reporting of cross-border income flows is an encouraging development.[210] It demonstrates the willingness of countries to collaborate to limit tax evasion, even when they are unwilling to impose low-rate withholding taxes, as had been long urged by E.U. officials.[211] And, despite the gaps in coverage, it shows both the potential benefits and necessity of international cooperation in improving tax enforcement. Although U.S. portfolio investments are widespread throughout the world, two-thirds of such investment is in 10 countries, with five countries (the United Kingdom, Canada, Japan, the Netherlands, and Germany) attracting more than $100 billion each of such investments.[212]

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

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

III. Outdated Concepts

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

A. Rules for Determining the Source of Income

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

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

If the source rules are to serve as a way of allocating income equitably among nations and enhancing national economic well-being and/or fairness among taxpayers, they should be overhauled to be better linked to the location of real economic activity, the location of customers, workers, or assets.[220] Moving in this direction demands that greater attention be given to the economic role of intangible assets. Valuing such assets is, of course, not practical and their allocation to various locations tends to be illusory. Sales may reflect the value of many customer-based intangibles and labor costs may reflect workforce-in-place intangibles, but the location of research and development also must be taken into account for such rules to reflect reasonably the real economic activity underlying the production of income. The need to redesign source rules to connect better to real economic activity is linked to recent efforts to shore up the rules designed to protect against the manipulation of the source of income through transfer prices among related companies.

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

The major alternative to the arm's-length pricing fiction is apportionment of income among related companies based on a formula turning on sales, labor costs, or assets, or some combination of those three plus perhaps a fourth factor relating to research and development expenditures. Despite the genuine economic importance to the production of income of assets, sales, and labor, experience with formulary apportionment in U.S. state income taxes is not encouraging.[223] Because different states' formulas weigh the factors differently, typically to the advantage of the local treasury, some income income is taxed more than once by multiple jurisdictions, although some income may escape taxation altogether.

Formulary apportionment was considered and rejected by the League of Nations in 1927 and 1928, principally because tinkering with the variety of methods of apportionment then in place throughout the world would have upset the fragile compromise that permitted the League to issue the model income tax treaties of 1928.[224] In 1976 formulary apportionment passed the U.S. Senate but was not accepted by the conference committee.

Formulary apportionment remains a potential solution to transfer pricing difficulties. I am not aware. however, of any serious attempt to develop a formulary system for international income taxation on a revenue neutral basis for the United States and its major trading partners, nor am I aware of a formulary recommendation that gives appropriate weight to the role of intangible assets in producing income. While not easy, such an effort should now be made in conjunction with exploring the potential use of such formulas (or other profit-spliting techniques) as a basis for determining the source of business income more generally.[225]

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

B. Corporate Residence

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

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

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

The separate legal status and taxation of corporations has long been a feature of U.S. law.[229] The 20th century corporate income tax predates the modern individual income tax. The Code treats corporations organized in the United States under federal or state law as U.S. persons.[230] This allows companies considerable flexibility whether to subject their business operations abroad to residence-based taxation in the United States. Other nations sometimes look to more than the simple act of incorporation-for example, to the place of actual management[231]-in determining residence of corporations, but flexibility in establishing a corporation's residence is a universal phenomenon.

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

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

Additional flexibility in determining corporate status and residence was ushered in a few years ago with the "check-the-box" regulations.[236] As the furor over Notice 98-11[237] and its progeny dramatically illustrated, the check-the-box development has produced much debate over the extent to which and when the United States should be concerned with techniques for reduction of foreign income taxes by U.S.-owned foreign entities.

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

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

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

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

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

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

IV. Unsatisfactory Policy

Adherents of CEN have clear policy priorities: They would eliminate "deferral"-taxation by the United States of active business in come of foreign corporations controlled by U.S. corporations or persons when repatriated to the United States rather than when earned. As I have indicated, elimination of deferral was proposed to Congress in 1962 by President Kennedy, suggested again in December 2000 by Treasury (along with reliance on CEN as a basis for U.S. international tax policy), and frequently endorsed by other CEN proponents.[245] On the other hand, support for the other two policy changes implied by CEN—elimination of cross-crediting of foreign taxes and repeal of the foreign tax credit limitation—is scarce. The former is regarded as impractical (although the 1986 Tax Reform Act's basket system might be regarded as a move in the direction of CEN); the latter unwise. No one urges an unlimited foreign tax credit, because it would both undermine the ability of the United States to collect taxes on U.S. source income and invite other nations to impose high taxes on U.S. companies as a way to shift revenues from our treasury to theirs. Although CEN advocates insist that their policy is "worldwide" taxation of residents,[246] a "pure" CEN policy is not in the cards.

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

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

Instead, we can now ask the straightforward, but difficult to answer, question: What international tax policy is in the best interests of the people of the United States, taking into account political as well as economic considerations, and the demands of fairness as well as of efficiency, recognizing that nations believe that they have rights (or at a minimum, fair claims) to the tax revenues attributable to the economic activities that take place within their borders, and keeping in mind that the United States is now a large importer, as well as ex porter, of capital? We should minimize the costs of compliance and administration and acknowledge that an unenforceable tax can be neither efficient nor fair.

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

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

From the perspective of CEN, which abhors tax-induced distortions in the location of investments, any tax-induced shift in the allocation of resources is bad, whether the culprit is U.S. or foreign taxes. In contrast, from the perspective of national welfare, we may be indifferent about the avoidance of foreign taxes due to a shift in resources from one foreign country to another. Indeed, paper transactions to reduce foreign taxes, as opposed to shifts in real economic resources, should increase our national welfare, at least until techniques for foreign tax avoidance stimulate owners of capital to locate assets abroad rather than in the United States. Thus, for example, when foreign taxes can be reduced simply by "checking the box," the United States may benefit so long as this ability does not cause U.S. resources to move offshore. In contrast, if one views CEN as the fundamental ground for policymaking (either for reasons of economic efficiency or fairness), any ability to reduce foreign taxes is problematic.

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

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

Moreover, the reasons for investing abroad tend to be different in the two cases. Portfolio investors seek diversification and higher rates of return. Portfolio capital is considerably more mobile than direct investment and its liquidity often makes it quite volatile, as it was during the Asian, Latin American, and Mexican economic crises in the 1990's.[251] Direct investments, in contrast, typically are made by corporations when the company's ownership-specific advantages, such as proprietary know-how or technologies, compensate for the additional costs of establishing facilities in a foreign country and for any disadvantages of the firm vis-a-vis local competitors, and when the company enjoys greater benefits from exploiting such ownership advantages internally rather than contracting with unrelated third parties.[252] Foreign direct investment typically involves a long-term commitment to a business endeavor in a foreign country.[253]

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

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

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

A. Inbound Investment

As I mentioned earlier, the principal determinants of how attractive the United States is to direct investments from abroad relate to non tax economic conditions, such as our flexible labor markets.[256] In terms of tax policy, foreign corporations are treated similarly to domestic corporations so the U.S. corporate income tax also plays an important role. I have detailed elsewhere my own ideas for U.S. tax reform, which would lower the U.S. corporate tax rate to 25%.[257] The changes I recommend—enacting a 10-15% value-added tax to finance a $100,000 per family exemption from the individual income tax and reduction of both the top individual and corporate tax rates to 25%—would enhance the attractiveness of the United States as a location for foreign investments. I have also long supported integration of the corporate and individual income taxes, which many industrial nations have embraced but from which some now seem to be retreating.[258]

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

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

B. Foreign Direct Investment

As I noted earlier, CEN enthusiasts from time to time have endeavored to tax currently the income of foreign corporations controlled by U.S. persons or companies, thereby reversing the longstanding U.S. policy of taxing foreign active business income only when repatriated.[260] In my view, however, none has yet made a convincing case that this would increase the well-being of U.S. citizens and residents. My concern is that the principal effect of such a shift in U.S. policy to a substantially more burdensome policy followed by none of our major trading partners—a significant departure from international practice—would be to encourage incorporation of businesses outside the United States and efforts to move U.S. corporate residents abroad.[261] Malting the United States a less hospitable place for corporate incorporation, headquarters, or management does not seem likely to enhance our national welfare.

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

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

From time to time, analysts have suggested that the U.S. system of international taxation and U.S. economic welfare could be for example, substantially improved by moving to an exemption system.[265] For example, a recent paper co-authored by a leading international economist at Treasury suggests that moving to an exemption system, with appropriate anti-abuse rules, could both increase U.S. revenues and improve economic efficiency.[266] Moreover, there is credible economic evidence that exempting foreign source active business income would not precipitate any substantial outflow of capital from the United States.[267]

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

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

In an exemption system, we would need to retain rules to distinguish foreign and domestic source income and to separate active business income from passive income. Anti-abuse rules along the lines of subpart F and the foreign personal holding company rules also would have to be retained. Look-through rules would be necessary to protect against mischaracterization of income and source. If exemption were limited to active business income from relatively high tax countries, we also would have to maintain a foreign tax credit regime for income not eligible for exemption, although such a foreign tax credit could be considerably simpler than the one we now employ, since companies would have excess foreign tax credit limitations, and there would be no need to provide rules to deal with excess credit situations. We could greatly simplify or eliminate the basket system, for example, and substantially simplify the rules for allocating deductions, such as for taxes, interest, and research and development between foreign and domestic sources. Transitional issues of moving to an exemption system also would have to be addressed.

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

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

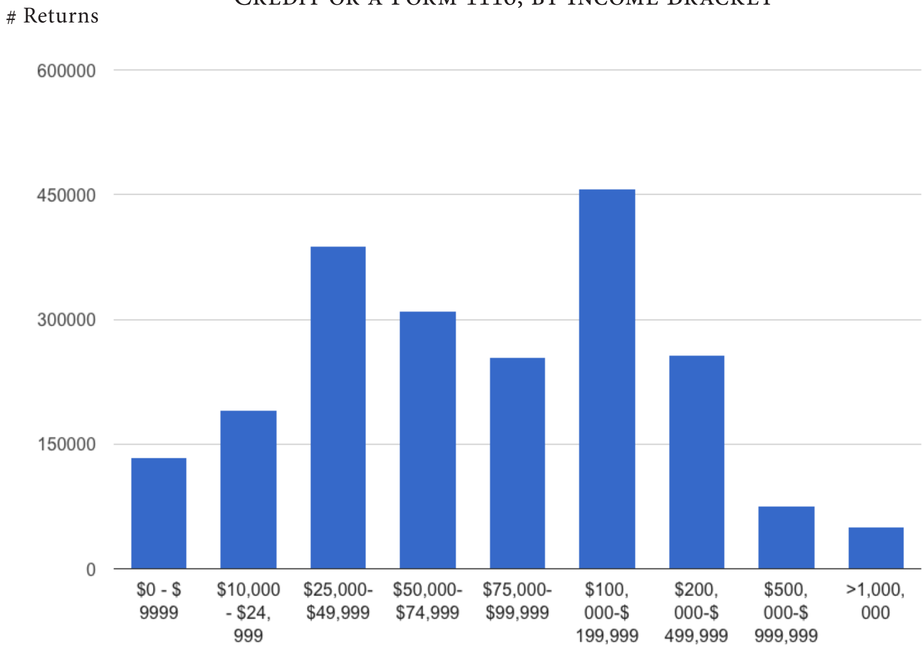
C. Foreign Portfolio Income of Individuals

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

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

Figure 8

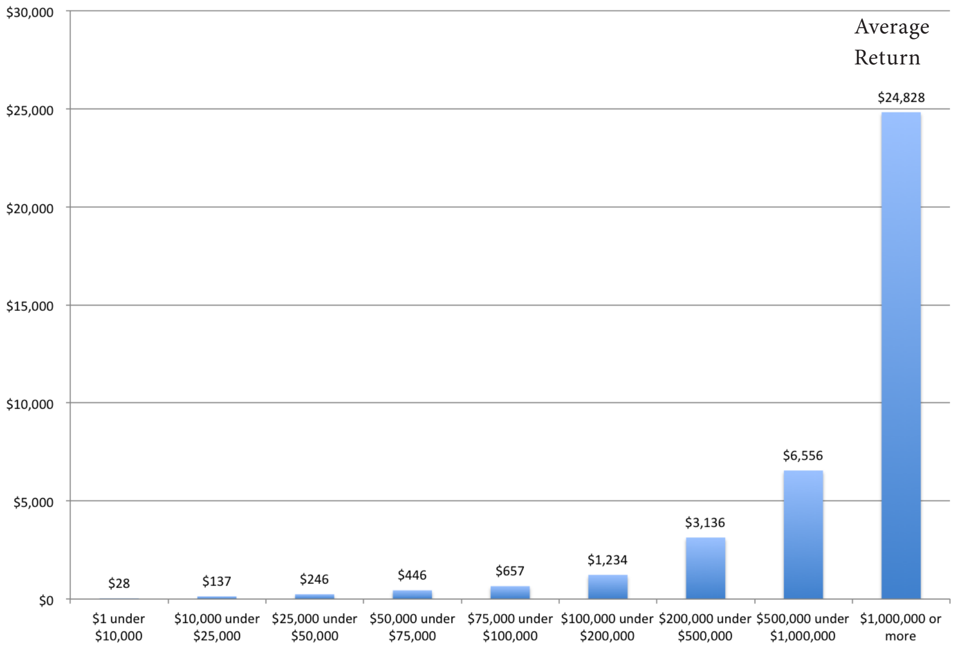
Numbers of Individual Income Tax Returns With a Foreign Tax Credit or a Form 1116, by Income Bracket



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

Figure 9

Average Foreign Tax Credits at Selected Incomes, 1996



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

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

In the case of an individual' s portfolio income, the claim to tax the income by the residence country predominates. Not only does the residence country's claim seem stronger, but taxation by the country of residence is the only way to impose a progressive income tax based on an individual's ability to pay. In the case of portfolio investment by individuals, considerations of fairness are paramount. Lower taxes on foreign portfolio investments than for domestic portfolio investments of individuals violate both vertical and horizontal equity norms. There seems to be no good reason to tax individuals who are diversifying their risks by investing abroad more favorably than individuals who invest domestically. Moreover, individuals' portfolio investments abroad do not seem to produce any significant political or economic advantages to the United States. Although further analysis is necessary to evaluate the effects on national well-being of such a change, we should explore the possibility and consequences of allowing only a deduction for foreign taxes on such portfolio income. A deduction system would be simpler than the credit system, and might well increase our national welfare.[277] Because our treaties commit us to allowing credits for foreign taxes, such a change should not be taken unilaterally, certainly not by Congress overriding current treaty obligations. The potential damage to our standing and relationships in the· international community from proceeding in that manner would almost certainly outweigh any potential gains.

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

In any event, as I have previously discussed, the important problems of enforcement of residence-based taxes on portfolio income demand significantly enhanced information reporting on a multilateral basis.[279]

D. Earned Foreign Source Income of Individuals

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

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

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

V. Conclusion

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

Chapter 4

Technological Innovation, International Competition, and the Challenges of International Income Taxation

Introduction

Two things are clear and essentially uncontested among economists. First is the importance of technological innovations to economic growth. In a 1957 paper, Robert Solow advanced an economic growth model (for which he won a Nobel Prize in 1987) demonstrating that a large majority of economic growth per hour of labor in the United States between 1909 and 1949 could be attributed to technological advances.[1] The importance of technological development to economic growth has been accepted ever since.[2]

Second, research and development ("R&D"), which is crucial to ongoing technological advances, is underproduced in the absence of government support.[3] In the absence of government intervention, firms underinvest in R&D, despite its benefits, because R&D produces positive externalities–knowledge that "spills over" to others, preventing investors from reaping the full benefits of their R&D through profits.[4] In addition to spurring innovation, R&D also creates good jobs and raises standards of living.[5] But when investors cannot reap the full benefits of their R&D, they may not invest in projects that would produce substantial benefits to society. Economic studies have estimated that the public returns from R&D can be two to five times greater than the private returns.[6] So while technological innovation–the development of intellectual property ("IP")–has become the key element in building national wealth, the divergence between private and social returns may limit advancement in the absence of public subsidies for technological development.

It is not surprising, therefore, that substantial government support of technological advances is ubiquitous. Such support comes in many forms: legal protections for IP; government grants, loans, and loan guarantees to both for-profit firms and not-for-profit research institutions; and tax benefits for both R&D itself and the gains from innovation.[7] Designing cost-effective methods of supporting technological innovations, however, has become substantially more difficult as the world economy has become more interconnected. National governments may also underinvest in R&D when they believe that much of the resulting benefit will occur outside their borders. Nations have great difficulty cooperating in such endeavors even when it would be in their interests to do so, and the creativity, mobility, and flexibility of multinational enterprises ("MNEs") multiply the challenges that national governments face.

In a closed economy, a nation's citizens and residents would fully reap the rewards of directing their tax dollars to spur and reward technological innovation. In an open economy, however, this will not be the case: There are too many potential moving pieces. For starters, with cross-border trade in goods and services, whenever R&D leads to new products, such as new drugs or medical diagnostic equipment, customers around the world may benefit from the technological innovation, regardless of where the R&D is performed. As another example, new technologies that enhance cost-competitive energy production with less or no greenhouse gas emissions will have benefits across the globe. But, since the risks are global, it would be foolhardy for any nation to try to confine such benefits within its borders.

Combining labor and capital mobility with cross-border trade complicates matters substantially: It allows the location where R&D is performed and the location where income is earned to change in response to the nature and level of government support. Adding to the mix, the flexibility of MNEs to shift across national borders the locations of production of their IP, ownership of their IP, and income from their IP, along with their ability to establish new corporations resident in tax-favorable jurisdictions, renders designing cost-effective incentives even more difficult. For example, when technological innovation occurs within an MNE, it is quite possible for the firm to shift the location of the income from the innovation and, by doing so, minimize the firm's income taxes and also redirect the revenues from taxing such income to a country different from the one that provided financial support for the endeavor. In some instances, but not always, this may involve shifting the location of the ownership of the IP. MNEs are not indifferent to the scope, strength, location, and ownership of their IP. The deflection of income to a low-tax country often occurs through manipulation of intercompany prices, a practice that national governments have found extremely difficult to control.[8]

If one were concerned only with increasing worldwide welfare through technological advances, these location vagaries might be of little or no importance, but national governments care deeply about them. Typically, there are advantages to the citizens and residents of a particular nation if the R&D leading to such advances occurs within the nation's borders. Nearby geographic spillovers from R&D are significant. National governments also want the resulting IP to be governed by their laws, their citizens to be the principal beneficiaries of the economic growth resulting from technological innovations, their resident MNEs to own the resulting technology, and the tax revenues from such innovations to flow into their own treasury. But in today's global economy, achieving these goals has become a quixotic quest. Fashioning appropriate national policies to further technological innovations become a herculean task for governments that support such advances primarily to increase the wellbeing of their own citizens and residents. It is hardly surprising, therefore, that the variety of public policies that have emerged from contests among nations to capture many or all of these benefits for their citizens and residents sometimes have beggar-thy-neighbor aspects. Devising appropriate tax rules for the costs of developing IP and for IP income, thus, has become a critical challenge for international income taxation.

The difficulties in evaluating such public policies are compounded because any such effort is fraught with empirical uncertainties. As Julian Alworth has observed, "[p]olicy prescription in a world with few empirical benchmarks is difficult."[9] Tax policies have taken center stage in national policy efforts to stimulate and attract R&D and to capture a share of the income from technological innovations, so the inquiry here is limited to examining the three primary tax policies supporting innovation: (1) incentives for R&D, (2) so-called "patent boxes," and (3) proposals for tax benefits for "advanced manufacturing." This Article begins by describing the current smorgasbord of R&D incentives and the economic evidence concerning their efficacy. It then briefly describes common techniques that MNEs use to lower the taxes on income from IP. This Article then assesses the soundness of the various incentives and offers recommendations about how the United States might respond to the international income tax challenges it now faces in promoting technological innovation.

I. U.S. and European Tax Incentives for R&D

Tax incentives to promote research and development are not new.

The United States adopted an R&D credit in 1981,[10] and France's research tax credit has been in place since 1983.[11] Ireland began exempting patent income in the 1970s.[12] Over time, more and more countries have adopted such incentives, and the countries that employ them have tended to make them more generous–despite the absence of clear evidence of their effectiveness.

A. Tax Incentives for R&D

There are two primary approaches to encouraging innovation through tax incentives: directly encouraging R&D by subsidizing it, and indirectly encouraging R&D by giving favorable treatment to income from IP. The United States has, to date, limited its tax benefits to the former, although there are now calls for the latter.[13]

The United States first enacted an R&D credit in 1981.[14] The R&D credit is a 20% nonrefundable income tax credit for qualifying R&D expenditures greater than those incurred in a specified base period, 19841988.[15] Alternatively, taxpayers may elect a simplified credit of 14% of qualified research expenditures in excess of 50% of the qualified expenditures in the preceding three years.[16] The U.S. R&D tax credit has frequently been limited to a duration of one year and thus has expired numerous times. However, with one exception, it has always been extended continuing from the previous expiration date.[17] President Obama has proposed increasing the amount of the credit and making it permanent.[18]

European incentives initially focused on encouraging research and development by offering super deductions for R&D expenses or R&D tax credits: Austria adopted a 125% deduction of R&D expenses in 1988,[19] Hungary adopted a double deduction in 1997,[20] the United Kingdom adopted a 150% deduction for small companies in 2000 and a 125% deduction for large companies in 2002,[21] Denmark adopted a 150% deduction in 2002,[22] Belgium adopted an R&D investment deduction in 2003,[23] and the Czech Republic adopted a double deduction in 2006.[24] France adopted a research tax credit in 1983,[25] Spain adopted an R&D credit in 1995,[26] Hungary adopted an R&D credit in 2003,[27] and Ireland adopted an R&D credit in 2004.[28]

Some EU countries have also adopted various employment tax incentives for R&D workers. The Netherlands, for example, has offered a special payroll tax deduction since 1994.[29] In 2003, Belgium adopted a partial withholding tax exemption for remuneration paid to certain researchers.[30] In 2005, Hungary introduced a tax credit for salary costs related to R&D activities.[31]

Not only have more countries adopted R&D incentives, those that already had such incentives have made them more generous. In 2004, France changed its research tax credit from a purely incremental credit to one that was both incremental and volume-based.[32] In 2008, a new French policy enhanced the previous scheme–a 10% volume-based rate and a 40% incremental rate–by eliminating the requirement that R&D be incremental and increasing the volume-based rate to 30%.[33] In 2008, France also eliminated a cap that had previously limited the amount of expenditures eligible for the credit.[34] In 2006, Belgium introduced an R&D tax credit as an alternative to the investment deduction.[35] The credit offers the same effective tax rate as the previous investment deduction, but it is refundable and also has financial reporting advantages.[36] Hungary started out with a super deduction in 1997,[37] added an R&D credit in 2003,[38] and introduced a 400% deduction of certain R&D expenses in 2004.[39] Ireland initially introduced a 20% R&D credit in 2004,[40] but subsequently increased it to 25%.[41] In 2000, the United Kingdom started with a 150% super deduction for small and medium-sized enterprises ("SMEs"), added a 125% super deduction for large enterprises in 2002,[42] and subsequently increased the rates to 225% and 130%, respectively.[43] European R&D incentives have thus become increasingly generous over time.

B. How Well Do R&D Tax Incentives Work?

Given the ongoing debates over the continuation and possible expansion of the U.S. Research and Experimentation ("R&E") credit, recent suggestions for a U.S. "patent box," and the proliferation of innovation tax incentives in the European Union and elsewhere, the effectiveness of these incentives is a central concern. There is scarce evidence, however, that even the most successful innovation tax incentives are cost-effective in accomplishing the goals of the countries that have adopted them. First, while there is substantial evidence that R&D tax incentives increase the level of R&D, the economics literature provides wide-ranging estimates of how large that increase is. Second, the question of whether R&D tax incentives lead to increased output and more jobs, or whether the incentives simply shift R&D among regions without creating more of it, remains largely unanswered. Third, it may be possible for companies to reclassify expenditures to qualify for R&D incentives and such reclassification will show up in data as an increase in R&D expenditures. A brief summary of the existing literature follows.

A number of economic studies attempt to measure the effectiveness of R&D incentives in spurring additional R&D.[44] Two common measures are the benefit-cost ratio, which compares the increase in R&D spending to the loss in tax revenue from the tax incentive, and the price elasticity of R&D, which measures the percentage change in R&D in response to a 1% change in the user cost of R&D.[45] Because it is difficult to measure precisely the amount of R&D resulting from an incentive, a benefit-cost ratio greater than one still may not indicate that the incentive is cost-effective: Some of the measured "benefit" may consist of R&D that would have happened anyway.[46] Conversely, a small benefit-cost ratio may result in part from the fact that increased spending on R&D does not account for all of the benefits from the incentive.[47]

Studies have found a wide range of benefit-cost ratios for R&D incentives, which is hardly surprising given the use of data from different countries in different time periods as well as the variation among the countries' incentives.[48] Even among studies of a single country in similar time periods, however, estimates of the benefit-cost ratio of a given incentive vary significantly depending on the methodology of the study and the data set used. Studying a sample of roughly 1,000 U.S. manufacturing firms per year from 1980 to 1991, Bronwyn Hall found a benefit- cost ratio of 2.0 for the R&E credit.[49] In sharp contrast, looking only at the effect of the U.S. R&E credit on the pharmaceutical industry from 1982 to 1985, William McCutchen found a benefit-cost ratio of 0.293.[50] While these two studies are not directly comparable, their dramatically different estimates of the benefit-cost ratio of the U.S. R&E credit suggest that these ratios may not reliably assess whether R&D tax incentives are good policy.[51]

Moreover, any individual study may find a wide range for the benefit-cost ratio of a particular incentive, with estimates varying depending on firm size, how recently the incentive was introduced, and other factors. A study of the effectiveness of the WBSO (wage tax credit) program in the Netherlands, for example, found that the WBSO initially produced a benefit-cost ratio of about 6.4 for small firms but only 1.02 for large firms.[52] However, the benefits diminished rapidly over time, moving to a ratio of 1.87 for small firms, 3.5 for medium-sized firms, and 0.37 for the largest firms.[53] The authors concluded that the WBSO stimulates R&D in all but the largest firms. Again, even though they do indicate that R&D tax incentives increase R&D spending, these results do not provide a clear answer to whether R&D tax incentives are cost-effective.

Econometric studies measuring the price elasticity of R&D also suggest that such incentives increase the level of R&D, but, again, the estimated elasticities vary widely. Daniel Wilson found that R&D tax credits offered by U.S. states increase R&D (specifically, he found that a 1% increase in a state's effective R&D credit rate leads to a 3%-4% increase in in-state R&D spending in the long run and a 1.7% increase in the short run).[54] Nicholas Bloom and his coauthors found that, in nine Organisation for Economic Co-operation and Development (OECD) countries (the G7, Australia, and Spain), R&D tax credits affect the level of R&D, with a short-run elasticity of 0.1 and a long-run elasticity of one.[55]

In an earlier survey of the econometric evidence on R&D tax incentives, Bronwyn Hall and John Van Reenen found that U.S. studies on the R&E tax credit suggest a long-term elasticity of around one and a lower elasticity in the early years of the credit.[56] They suggest that non-U.S. data, on average, yields a comparable result. A 1989 GAO study found that between 1981 and 1985 the U.S. R&D credit stimulated additional spending, but the gains in R&D spending were only a fraction of the cost of the credit.[57]

These varying elasticities are hardly surprising, since the studies use different models and data and focus on different countries during different time periods. In an HM Revenue and Customs R&D report, U.K. researchers compiled evidence from numerous studies of price elasticities of R&D in the context of R&D tax incentives.[58] These studies, which examined data from different countries over various time periods, found price elasticities ranging from 0.07 (Canada, 1975-1992)[59] to between 2.68 and 2.78 (France, 1983-1997).[60] This is a large range of estimates. It does appear, nevertheless, that R&D tax incentives increase R&D spending, with an effect that is typically smaller in the short term than in the long term.

We know even less about how, and to what extent, R&D tax incentives affect firms' decisions about where to locate their R&D activities–an important question in today's global economy. Increased R&D spending may result from firms already performing R&D in a given state or country increasing their level of R&D or from firms changing locations to reap the benefits of a tax break. A study by Josh Cantwell and Ram Mudambi examined the effect of government investment incentives on the location of R&D activities by MNEs in the Midlands region of Britain.[61] This analysis suggests that government investment incentives (including tax credits) increase R&D only on the margin, encouraging MNEs to "upgrade somewhat the technological role" delegated to a local affiliate.[62] This study, which used firm-level data, suggests that investment incentives do not affect firms' location decisions. However, because the study was based on U.K. data only, it does not account for the possibility of cross-country choice. Firms may examine different factors when choosing where to locate R&D within a country than they do when choosing the country in which to locate. So, while this study is suggestive, its implications should not be exaggerated.

Most studies of the determinants of where R&D is located are based on surveys of MNE executives or analysis of data from single countries.[63] Thus, econometric evidence concerning whether R&D tax incentives affect location decisions is inconclusive.[64] Though the studies ask how the volume of R&D in one region responds to changes in R&D prices in competitor regions,[65] they lack the firm-level data that would be necessary to estimate the extent to which R&D tax incentives affect decisions whether to locate R&D in a given area in the first place or what amount of R&D to perform at an existing location.[66] In sum, there is currently no satisfactory answer to the question of the extent to which the introduction of R&D tax incentives causes firms to locate R&D in a given country or state.[67]

Although there are not any persuasive cross-border econometric studies that identify whether and how much R&D tax incentives affect location decisions, there are some cross-border studies that attempt to ascertain whether and to what extent domestic and foreign R&D are complements or substitutes. A substitution effect might indicate that firms are relocating to take advantage of R&D incentives. However, even if there is a substitution effect, it remains unclear whether firms are simply adjusting the amount of R&D performed in various locations or are actually opening new labs and closing old ones in response to incentives.[68]

Once again, the picture is hazy. James Hines analyzed aggregate data on the activities of U.S. and foreign MNEs and found that local R&D is a substitute for imported technology.[69] Using firm-level data, he, along with Adam Jaffe, subsequently came to the opposite conclusion–that decreases in domestic R&D directed at foreign markets result in decreases in foreign patenting, suggesting that domestic and foreign R&D are complements.[70] Contrarily, using aggregate data, Nicholas Bloom and Rachel Griffith found that domestic R&D increases as the tax price of doing R&D in competing economies increases, suggesting that domestic and foreign R&D are substitutes.[71] Using state-level U.S. data, David Wilson found that in-state R&D is an increasing function of the out-of-state user cost of R&D in neighboring states, also suggesting that in-state and out-of-state R&D are substitutes.[72]

Taken together, these studies may imply that domestic and foreign innovation are complements at the firm level but substitutes in the aggregate. However, the Hines and Jaffe study is the only one to find complementarity and is the only one that used firm-level data. So, it seems premature to presume this result, especially given the lack of available firm-level analysis. Additional uncertainty arises because the various studies evaluate the effects on local R&D of different measures of "foreign innovative activity." Hines looked at the importation of foreign technology; Hines and Jaffe examined the number of foreign patents; and Bloom and Griffith used the foreign-user cost of R&D,[73] as did Wilson. Thus, the studies are not directly comparable.

Although the extant studies do not indicate whether R&D tax incentives drive firms' decisions of where to locate R&D, studies focusing on the effect of taxes generally on firm location provide some insights. Michael Devereux and Rachel Griffith have found that average tax rates do not affect U.S. firms' decisions whether to locate production in the European Union, but they do affect their decisions where in the European Union to locate (assuming that production will occur somewhere in the European Union).[74] Other studies on general tax rates and firm location suggest that firm affiliates engaged in different functions are affected differently by taxes. Sven Stowhase, for example, concluded that the location of affiliates in the production sector is affected by average tax rates, while the location of affiliates in the service, finance, and R&D sectors is affected more by statutory tax rates.[75] Other studies have confirmed that the characteristics of firms affect how they respond to taxes.[76] Obviously, countries providing incentives believe that they will attract more R&D by doing so, despite the dearth of evidence.[77]

From a policy perspective, in addition to answers concerning whether and by how much R&D tax incentives increase R&D, as well as how they affect location decisions, it is necessary to consider what spillover effects are produced by R&D and the extent to which R&D incentives affect production and employment. Sergey Lychagin and his colleagues have addressed the question of the nature of R&D spillovers, persuasively finding that geographic spillovers are significant to firm productivity, but that such spillovers decay rapidly with distance.[78] This important finding suggests that government incentives aimed at attracting R&D may help produce valuable spillovers in nearby locations, but that the spillover effects are not likely to be felt outside the region or country.

Other studies have addressed the impact of increased R&D on productivity levels and on employment patterns. Rachel Griffith and her colleagues have found that an R&D tax credit increases productivity, though not to an extent great enough to justify its cost in the short term.[79] They concluded, however, that in the long run, the increases in productivity may make an R&D credit cost-effective.[80]

Steven Machin and John Van Reenen found that technological change, measured by increased R&D, increases the demand for skilled workers.[81] On the other hand, Austan Goolsbee found that a significant fraction of the increased R&D spending that results from government incentives goes to increasing the salaries of R&D workers rather than to increasing the volume or quality of R&D performed.[82] Russell Thomson and Paul Jensen estimated that both tax subsidies and direct grants are effective at increasing the number of R&D employees.[83] Kris Aerts has analyzed the effect of public R&D subsidies on R&D investment, employment, and wages in Flanders and found that the subsidies did cause companies receiving them to hire additional personnel and to increase wages, but that the companies did not increase their R&D budgets by the full amount of the funding, suggesting that some part of the subsidy merely substitutes for R&D spending that the companies would have done anyway.[84] In combination, these studies imply that R&D incentives create additional job opportunities, but they also may shift resources toward employment of skilled, rather than unskilled, workers and serve to increase the salaries paid to workers who are already employed.

In sum, the economic literature suggests that R&D tax incentives may increase the amount of R&D and the number of R&D employees but their cost effectiveness is less certain than their advocates claim. There is considerable evidence that such incentives often serve to shift the location where firms perform R&D and that positive spillovers from R&D are often concentrated geographically. The efficacy of R&D incentives often turns on their structure, size, and scope. Whether current incentives are cost effective, as well as what changes are necessary if they are not, remains uncertain. Nevertheless, as discussed in Parts II and III, there is more favorable evidence regarding R&D incentives than there is supporting "patent box" incentives or incentives for manufacturing activities.

II. Patent Boxes in Europe

A substantial number of European countries have recently implemented innovation tax incentives that focus on the income, rather than the development, side of IP by adopting "patent boxes," or "innovation boxes." A patent box offers a preferential tax rate for patent income; an innovation box offers a preferential rate for income from other intangible assets in addition to patents.[85] An important distinction between R&D incentives and patent and innovation boxes (hereafter both referred to as patent boxes) is their timing: R&D incentives are provided when the expenses are incurred; patent boxes, in contrast, reduce taxes when, and if, income is earned. Countries implement preferential patent box rates through any of three mechanisms: a deduction for a portion of the income, a reduced rate for IP income, or an exemption of a portion of such income. Patent boxes vary in terms of what kind of IP is eligible, whether the IP must be self-developed to qualify, and what types of income are benefitted. With the exception of Ireland, which exempted patent income starting in 1973,[86] most EU countries have adopted patent boxes only recently. Hungary, Belgium, France, the Netherlands, Luxembourg, Spain, and the Basque region of Spain all now offer patent boxes, and the United Kingdom will join their ranks in April 2013. A description of each follows.

A. Tax Benefits for IP Income

Hungary offers a deduction of up to 50% of gross royalties received on qualified IP and gains on the sale of qualified IP.[87] The deduction applies to up to 50% of a company's income before tax.[88] The Hungarian corporate tax rate is 10% for income up to HUF 500 million and 19% above that,[89] leading to effective tax rates of 5% and 9.5%. IP may be self-developed or acquired, and qualified IP includes patents, copyrights, know-how, trademarks, business names, and business secrets.[90] The incentive applies to IP developed both before and after its adoption in 2003.[91] Starting in 2012, gains on the sale of qualifying IP may be exempt from corporate tax if the seller has held the property for at least one year.[92]

Belgium offers a patent income deduction ("PID") of 80% of the gross patent income of Belgian companies or Belgian permanent establishments of foreign companies.[93] This reduces the effective tax rate to a maximum of 6.8%.[94] Most expenses, though not license fees, are deductible at the normal corporate rate of 33.99%, which may further lower the effective rate and even make it negative.[95] However, the PID cannot be used to create a net operating loss.[96] The PID only applies to patents granted and extended patent certificates granted or first used commercially after 2007, when the incentive was enacted.[97] The patents do not have to be self-developed, but they must be improved if they are acquired, and the PID applies only to the improvement.[98] In order for patents to qualify, the R&D leading to the patents or improvements must take place in an R&D center that qualifies as a branch of activity, meaning that it is part of an entity that is able to operate autonomously.[99] The R&D center may be located abroad as long as it is owned by a Belgian entity.[100] The PID applies to income from licensing patents or patent certificates, as well as income from the use of patents or patent certificates in producing patented products or in the delivery of services.[101] When the patent is used by the Belgian company or permanent establishment, the PID applies to 80% of the license fee that would have been received had the patent been licensed to an unrelated company.[102] The PID does not apply to capital gains.[103]

France offers a 15% reduced rate on net royalties from licensing of, and net capital gains from transfer of, patents, patentable inventions, improvements on patents and patentable inventions, some manufacturing processes, and certificates for plant-related inventions.[104] IP may be acquired, but it has to be owned by the company for two years to qualify.[105] The reduced rate applies to IP created before and after 2001, when the incentive was first adopted.[106]

The Netherlands' innovation box offers a 5% reduced rate on net qualifying IP income from intangible assets that are patented or that result from R&D activities for which a qualifying R&D certificate has been received.[107] R&D certificates are available for IP such as software-related intangibles and trade secrets that cannot be patented.[108] In order to qualify, the IP must be self-developed or, if acquired, must be further developed.[109] The 5% rate applies to income that is reasonably linked with the intangible asset—applicability is not limited to capital gains or royalties.[110] This means that IP remuneration embedded in the sales price of goods or services is also eligible, so long as certain requirements are met.[111] For patents, more than 30% of the income must be attributable to the patent right.[112] For an R&D certificate, firms must perform 50% of the R&D in the Netherlands or a Dutch entity must have a decisive coordinating role.[113] The certificate requirement is obviously an effort by the Netherlands to ensure that it benefits from the R&D. Losses arising from the intangible assets can be deducted against the regular corporate income tax rate of 25%. The reduced rate applies to IP that has become a business asset since 2007, when the incentive was first adopted.

Luxembourg offers an 80% exemption on net income, including capital gains, derived from the use of and right to use software copyrights, patents, trademarks, brands, design, models, and domain names.[114] This results in an effective tax rate of 5.84%.[115] The exemption applies to IP that was acquired or developed in or after 2008, when the incentive was adopted.[116] IP acquired from a directly related company, defined as a "10 percent direct patent, subsidiary, or sister company," does not qualify.[117]

Spain exempts 50% of gross royalty income from qualifying IP, which includes certain technological IP rights such as patents, secret formulae and processes, designs, models, plans, and rights for information concerning industrial, commercial, or scientific experiments.[118]

This results in a maximum effective tax rate of 15%.[119] Expenses are deductible at the regular corporate tax rate.[120] The patent box applies only to self-developed IP used for business activities,[121] and Spain further requires that the licensee company not be a resident of a listed tax haven or zero-tax jurisdiction.[122] The incentive only applies until the tax year following the tax year in which cumulative IP income exceeds six times its cost of development.[123] It applies to IP developed before or after the incentive was adopted in 2008.[124]

The Basque Country offers its own patent box. It offers a 60% exemption for gross revenue from licensing self-developed IP and a 30% exemption for gross revenue from licensing acquired IP.[125] This results in maximum effective rates of 11.2% and 19.6%, respectively.[126] Capital gains are not eligible.[127] The patent box applies to a wide range of IP including patents, utility models, industrial designs, domain names, plant variety rights, secret formulae and processes, semiconductor product topography, trademarks, trade names, and know-how.[128]

Ireland exempted patent income until 2010.[129] The exemption applied to income–including royalties and capital gains–derived from patents when received by a company that was resident in Ireland and not elsewhere, and was initially limited to patents for which the underlying R&D took place in Ireland.[130] In 2006, the European Commission notified Ireland that the requirement that R&D be carried out in Ireland was incompatible with E.C. Treaty rules regarding freedom of establishment and free movement of services.[131] In response, Ireland extended the exemption to patents for which the underlying R&D was performed anywhere in the European Economic Area and made the exemption subject to a limitation of five million euros.[132] Ireland then abolished the exemption with its National Recovery Plan of 2011-14.[133]

The United Kingdom's new patent box will come into effect April 1, 2013.[134] The U.K. patent box will apply a reduced tax rate of 10% to profits from patents.[135] The United Kingdom noted that "some patent-rich UK businesses face a higher overall effective tax rate than their foreign competitors,"[136] and the patent box appears to be at least partially a response to the plans of some prominent MNEs to move to Ireland.[137] By lowering the rate on patent income, the patent box is explicitly intended to "improve the competitiveness of the UK corporate tax regime."[138] Because of the importance of the United Kingdom and its recent entry into the patent box competition, this section shall describe its structure in some detail.

The U.K. patent box will apply to patents granted by the U.K. Intellectual Property Office, the European Patent Office, and other EU Member States with patent regimes similar to that of the United Kingdom.[139] Companies can qualify if they own or hold exclusive licenses for the IP.[140] The patent box will apply to both acquired and self-developed IP, but if the IP is acquired, it must be further developed in order to qualify.[141] To avoid subsidizing the passive holding of IP, the government has indicated that, in order to qualify, a company must create or significantly contribute to the creation of the IP, or perform a significant amount of activity to develop the IP or any process incorporating the IP.[142]

The U.K. patent box will apply to the following types of income: license and royalty income, income from the sale of products incorporating the qualified IP, income from the sale of IP, infringement income, income from damages and insurance, and notional royalty income for the use of qualifying IP in processes or services.[143] Income received for up to six years between the application for a patent and its grant will qualify.[144]

One major challenge for patent boxes is ensuring that the tax reduction applies only to income from the innovation. Simply making all income eligible while subtracting out a "routine" return will, for example, conflate gains from business risks with those attributable to innovations. In the new U.K. regime, for example, profits attributable to routine activities are deducted from IP income profits before qualifying.[145] Companies with marketing intangibles that contribute 10% or more to their residual profit will have to calculate an arm's length royalty rate for the use of those intangibles in determining income qualifying for the patent box.[146] This arm's length royalty, minus any royalty actually paid, will not be eligible for the patent box.[147] Setting the amount of such royalties necessarily implicates intercompany transfer pricing.[148] All companies claiming the patent box benefits must comply with the United Kingdom's transfer pricing regime in transactions with affiliated companies.[149] Income from existing IP as well as newly commercialized IP will be eligible for the tax reduction.[150]

The proliferation of patent boxes in the European Union raises the question whether the United States will follow suit, and if it does, what form its patent box will take. The next section discusses a prominent recent proposal.

B. A Proposed Patent Box for the United States

As part of a broad corporate income tax reform that would reduce the U.S. corporate income tax rate from 35% to 25% and provide a 95% exemption for overseas profits when they are repatriated to the United States as dividends, House Ways and Means Committee Chairman Dave Camp has proposed a limited patent box for the United States.[151] The patent box, which would apply only to income earned abroad, is one of three alternatives Camp has offered as responses to erosion of the U.S. tax base resulting from the shifting abroad of intangible property and its associated income.[152] The third of these options would effectively create a patent box for sales abroad.[153] Under this proposal, a new category of income taxed currently in the United States (under subpart F of the Internal Revenue Code) would include controlled foreign corporations' ("CFCs'") worldwide income derived from intangibles.[154] The domestic parent corporation would be entitled to a deduction of 40% of its income from the foreign exploitation of intangibles.[155] This would result in an effective tax rate of 15% on such income (60% of the new top corporate tax rate of 25%).[156] Intangible income would consist of income from the sale, use, consumption, or disposition of property outside the United States, as well as income from the provision of services with respect to people or property used in or connected with the transactions or services.[157] Intangible income would qualify for an exemption from subpart F if subject to foreign tax at a rate equal to or greater than 60% of the maximum federal income tax rate.[158] With Chairman Camp's proposed U.S. corporate rate of 25%, this exemption would apply to income taxed at a 15% rate or higher.

Chairman Camp couples this "patent box" proposal for income earned abroad with a proposal for a similar 15% rate on domestic exploitation of patents and certain domestic income from manufacturing. Before turning to the issue of incentives for domestic manufacturing, however, it is necessary to summarize what is known, to date, about the effectiveness of patent boxes.

C. How Well Do Patent Boxes Work?

Because they are a relatively new phenomenon, there is much less economic evidence on the effectiveness of patent boxes than there is for R&D incentives. Nevertheless, it is worth summarizing what is known.

According to its Minister for Finance, Michael Noonan, Ireland decided to abolish its exemption for patent income after the Irish Tax Commission concluded that the exemption did not have the desired impact in stimulating innovation.[159] The Commission concluded that the relief was not well targeted and had not resulted in increased R&D.[160] Instead, according to the Commission, the exemption was being used by some companies simply "as a tax avoidance device to remunerate employees."[161]

Other commentators have echoed Ireland's concern that patent boxes are not well targeted to increasing domestic innovation.[162] The Information Technology and Innovation Foundation (ITIF), for example, has observed, "[t]he lion's share of economic value from innovation to society comes from R&D, a high-skilled workforce, and domestic high-value manufacturing, not simply housing a greater number of patents."[163]

Rachel Griffith, Helen Miller, and Martin O'Connell have recently estimated the effect of patent box regimes on the location of IP and on government revenues. Based on their model of firms' location choices for IP, they find that patent box regimes are likely to significantly affect firms' decisions concerning the location of new IP, but also reduce government revenue.[164] In their simulation of how IP location responded to the introduction of Benelux patent boxes, for example, the authors found an increase in the share of EU patents held by the Benelux countries and a reduction in the share of patents held by other European countries, including the United Kingdom.[165] The authors suggest that when the United Kingdom introduces a patent box regime, the Benelux patent share will decrease (though it will still be greater than the initial share).[166] Therefore, the benefits to a nation of introducing a patent box are diminished as more countries adopt patent boxes. The authors conclude that the introduction of patent box regimes will decrease patent revenue for all affected countries.[167] However, the authors do not seek to measure the nontax benefits of patent boxes, which presumably are the primary motivation for adopting them.[168]

Although reliable data on the extent to which patent boxes can be expected to increase R&D, employment, or sales of patented products, or to lead to new patents is lacking,[169] a recent ITIF report analyzed 2009 Eurostat data in an attempt to assess some of the potential effects of patent boxes.[170] The report found that between 2008 and 2009, R&D among European countries with patent boxes increased at a *slightly* higher rate than R&D among other European countries (4% compared to 3.8%).[171] Patent box countries also had more high-tech exports and experienced greater growth in their numbers of European trademarks from abroad.[172] On the other hand, patent box countries experienced smaller growth in venture capital and employment in knowledge-intensive sectors.[173] The report suggests that patent box countries may have lagged in these two areas prior to their adoption of patent boxes and that their deficiency in those areas may actually have induced them to adopt patent boxes.[174] However, the report does not suggest or assess any causality between the presence of patent boxes and these indicators, leaving it unclear to what extent, if at all, these effects are related to the patent box regimes.

A recent report by the Staff of the Joint Committee on Taxation also bears on the question of the effectiveness of patent boxes, though it does not discuss them directly.[175] Based on case studies of six U.S. MNEs, the committee staff concluded that locating income from intangible property in low-tax jurisdictions is a major way that MNEs lower their tax liability. According to this study, the companies "performed a significant portion of the product development, product specification, manufacturing process development and improvement, marketing, patent application process, regulatory approval, trade name development, development of customer relationship, and the creation of other valuable intangible property in the United States," but transferred or licensed the rights to exploit the IP to an affiliate in a low-tax jurisdiction as a way to shift income and thereby lower their income tax.[176] In such circumstances, providing a low tax rate on IP may attract IP income without producing any shift in the location of the underlying R&D or other inputs.

As Ireland's experience demonstrates, under the European treaties, EU countries cannot limit patent boxes to IP for which the underlying R&D takes place in the country.[177] And, as discussed below, IP ownership is quite mobile.[178] This makes it difficult to ensure that patent boxes actually promote domestic R&D, manufacturing, or other productive activities. Nevertheless, as described, patent and innovation boxes are very popular with EU countries.

D. Summary of the Evidence on R&D and Patent Boxes

In sum, despite the popularity of innovation tax incentives and the numerous studies that have sought to evaluate them, the effectiveness of such incentives remains unclear. R&D tax incentives do appear to stimulate additional R&D, and patent boxes apparently do attract additional IP income. There is some evidence that R&D tax incentives increase employment and production. And there is also considerable evidence that, at least to some degree, the additional R&D and IP income resulting from innovation tax incentives is moved from other jurisdictions. On balance, such incentives may or may not result in a net increase in innovative activity.

All in all, the extant data is too limited to adequately assess the effectiveness of patent boxes. For some of the nations that have adopted tax reductions for IP income through patent boxes, the goal seems to be to increase the likelihood that the R&D attendant to technological innovation will occur within their borders. However, some other nations seem to be simply endeavoring to capture at least a small slice of the tax revenue from such innovation–tax revenue that is exceptionally mobile in today's economy, given some tax planning. The Netherlands and the United Kingdom offer examples of the former, Luxembourg of the latter.[179] For countries in the former category, there are reasons to doubt the efficacy of patent boxes; it appears that they affect the location of IP ownership and income, but that the IP may not be accompanied by any significant increase in underlying R&D. Given the mobility of IP income, one cannot help but conclude that firms are more likely to shift income eligible for patent box treatment to low-tax jurisdictions than to increase local R&D in response to patent box tax breaks.[180]

Our description of the current state of econometric research on the effectiveness of tax incentives for R&D and patent boxes illustrates the difficulty of assessing their efficacy and the uncertainties about the cost-effectiveness of these incentives. Nevertheless, the absence of convincing evidence of cost-effectiveness has proven no bar to the proliferation of such incentives, nor to their expansion and enhancement. Nor has the lack of convincing evidence about the effectiveness of these incentives diminished calls for additional incentives, for example, to promote "advanced manufacturing." Discussion of these proposals follows.

III. Incentives for "Advanced Manufacturing"

As stated earlier, nations choose to subsidize technological innovation because, in the absence of such subsidies, crucial research and development would be underproduced. However, it is difficult to design cost-effective subsidies. To complicate matters further, a number of important countries seem now to also be endeavoring to attract manufacturing, especially "advanced technology manufacturing," within their borders.

A. U.S. Manufacturing Incentives

U.S. manufacturers benefit from various tax provisions, some general and some aimed specifically at manufacturing.[181] First, taxpayers are entitled to annual depreciation deductions to account for the deterioration of property used in their trade or business or for the production of income.[182] Accelerating such depreciation deductions is a time-honored response to fiscal downturns, one that has been repeated during the past decade.[183] The Job Creation and Worker Assistance Act of 2002 instituted a first-year bonus depreciation deduction for 30% of the adjusted basis of qualified property in the year the property was placed in service.[184] Most depreciable property qualified for this benefit. In 2003, Congress substituted a 50% first-year bonus depreciation deduction for the 30% deduction, with slightly modified rules.[185] Responding to the Great Recession, Congress extended the 50% bonus depreciation deduction for a year in 2009,[186] and again in 2010.[187] In 2010, Congress increased the additional first-year depreciation deduction to 100% for qualified property acquired and placed in service after September 8, 2010, and before January 1, 2012.[188]

The American Jobs Creation Act of 2004 enacted a new deduction to benefit "domestic production activities."[189] This provision allows taxpayers to deduct from taxable income 9% of the lesser of their taxable income and their "qualified production activities income."[190] Qualified income includes income derived from property manufactured, produced, grown, or extracted in the United States, and also includes income from the production of electricity, natural gas, potable water, and film, and income from domestic construction projects and associated engineering and architectural activities.[191] At the current corporate rate of 35%, this provision essentially provides a reduction of three percentage points in the tax rate applicable to qualified manufacturing and other activities.

Congress enacted this tax break in the aftermath of a WTO decision striking down a U.S. tax incentive for exports and described it as supporting domestic manufacturing, but the incentive applies quite broadly to a variety of corporate activities.[192] One-third of domestic corporate activities qualify for the deduction.[193] Only two-thirds of this provision's revenue costs are attributable to manufacturing; 12% are from the information sector, and 7% from mining.[194] Its many beneficiaries include such companies as Starbucks and Time Warner Cable, not generally thought to be engaged in manufacturing.[195] In the case of Starbucks, for example, its food processing qualifies for the deduction, but its retail activities do not. So, companies like Starbucks can treat a portion of their gross receipts from the sale of brewed coffee as qualified receipts to the extent that the income is attributable to the roasting of the coffee beans used to brew the coffee. This tax reduction is also available for a variety of other activities that do not fit our notions of manufacturing, including mining, fishing, cultivating soil,[196] and oil extraction, though oil-related income receives only a 6% deduction (or a two percentage point reduction in the current corporate tax rate).[197]

For a time, certain alternative energy manufacturers also benefitted from an Advanced Manufacturing Tax Credit ("MTC"), adopted in the

American Recovery and Reinvestment Act of 2009.[198] The MTC provided a 30% credit for investments in clean energy manufacturing facilities built in the United States, but reached its cap of $2.3 billion in 2010.[199]

In 2012, the Obama Administration released its *Framework for Business Tax Reform*, recommending further changes intended to boost domestic manufacturing.[200] In addition to making the R&E credit permanent, the Administration would increase the domestic production activities deduction from 9% to 10.7% for regular manufacturing activities and allow a larger deduction for unspecified "advanced manufacturing activities."[201] Under the Administration's proposal, income from the production of oil, gas, coal, and other hard mineral fossil fuels, as well as income from other activities not considered to be manufacturing activities, would no longer qualify for the deduction.[202] In July 2012, the House Ways and Means Committee held hearings on tax reform and the manufacturing sector. In his opening statement, Chairman Camp emphasized the importance of the manufacturing sector to the U.S. economy and asked how tax reform might make U.S. manufacturers more competitive in today's global economy,[203] thereby showing that political support for manufacturers is bipartisan. And support for manufacturing is not limited to the United States; some European nations also offer manufacturing incentives.

B. European Manufacturing Incentives

A few European countries offer or have offered manufacturing tax incentives. In 1981, Ireland enacted a special 10% corporate tax rate that applied to manufacturing activities carried out in the country.[204] That incentive was eliminated in December 2002, but manufacturing companies that had benefitted from it before July 1998 continued to receive the special rate until December 31, 2010.[205] As the incentive was eliminated, Ireland lowered its regular corporate tax rate from 32% to 12.5% between 1998 and 2003.[206] The Irish manufacturing incentive, like the one in the United States, had applied quite broadly, including activities such as fish farming, certain shipping activities, film production, and meat processing.[207]

The Czech Republic offers incentives for investors who introduce new production or expand existing production in the country.[208] Newly established companies may qualify for full tax relief for up to ten years, while expanding companies may qualify for partial tax relief for up to ten years.[209] These incentives apply until the ceiling on "state aid" permissible under the European treaties has been reached.[210] Manufacturing operations in areas with significant unemployment may also qualify for job-creation grants and grants for training and retraining employees.[211]

Hungary provides several incentives for manufacturing.[212] The government awards individually determined cash subsidies, and a development tax allowance provides an exemption for 80% of corporate tax for up to ten years for investments of certain amounts that create jobs.[213] Hungary also offers a subsidy for training new employees and a job creation subsidy.[214]

Before 1999, Albania provided a four-year tax holiday to domestic and foreign-owned enterprises that engaged in manufacturing activities, followed by an exemption of 60% of profits after the four-year period.[215] The manufacturing activities had to continue for an additional six years after the holiday or they would be subject to tax retroactively.[216]

So, it is clear that incentives for manufacturing are extensive; the question is whether they are sound.

C. The Justifications for Manufacturing Incentives

President Obama's proposals for advanced manufacturing are partially a response to well-founded criticisms that the current U.S. domestic production deduction is not well targeted to actual manufacturing activities.[217] The idea that roasting coffee constitutes manufacturing is laughable, although line-drawing problems between manufacturing and other activities loom large.[218] The more important question, of course, is whether a tax incentive for domestic manufacturing is sound policy. President Obama's February 2012 *Framework for Business Tax Reform* offers the affirmative argument:

> The manufacturing sector plays an outsized role in the U.S. economy with significant spillovers to other sectors that make it particularly important to future job creation, innovation, and economic growth. Furthermore, the United States is in a global competition for manufacturing investment, and both existing

> and emerging manufacturing industries are subject to more intense international competition than other sectors.
>
> Encouraging manufacturing investment and production supports higher wage jobs. Manufacturing contributes disproportionately to U.S. innovation; manufacturing firms conduct more than two-thirds of the private sector research and development (R&D) in the United States and employ the majority of scientists and engineers in the private sector. Investment in new production capacity and proximity to the manufacturing process create spillovers across firms and industries, leading to the ideas, capabilities, and technologies that enable innovation. In this way, investments in manufacturing increase innovation and economy-wide productivity growth.[219]

The *Framework* thus offers three primary justifications for encouraging manufacturing investment: (1) job creation, (2) the link between manufacturing and R&D, and (3) spillovers from manufacturing. Other proponents of special tax benefits for manufacturing offer the same justifications.[220] On inspection, however, these justifications are not persuasive.[221]

1. *The Link Between R&D and Manufacturing.*—Detail is absent concerning what would qualify as "activities involving the manufacture of certain advanced technology property,"[222] but President Obama's Framework makes clear that this tax benefit is being proposed largely because of the linkage between manufacturing and R&D. The Framework notes, "R&D is especially important for manufacturing, which is a technology-intensive sector," and today, "many nations provide far more generous tax incentives for research than does the United States."[223]

Indeed, the move to enhance the deduction for domestic production is motivated in large part by fears that manufacturing is moving offshore and taking R&D with it. In a 2011 report, the President's Council of Advisors on Science and Technology expressed concern that the United States is losing manufacturing and, as a result, R&D.[224] The report observed that manufacturing as a fraction of U.S. GDP has declined by more than 50% over the past fifty years,[225] and that the number of U.S. manufacturing jobs has declined even more rapidly in recent years.[226] The report suggests that as manufacturing moves offshore so does R&D, noting that between 1999 and 2007, U.S. firms' spending on foreign R&D grew three times as quickly as their spending on domestic R&D.[227]

Senator Joe Lieberman has echoed these concerns, stating that "[if our engineering, design, and research and development (R&D) capabilities continue to follow the manufacturing and services facilities going abroad, our competitiveness will be weakened, putting our economic prosperity and national security at risk."[228] Noting that R&D spending by U.S. corporations in China has increased markedly in recent years, Senator Lieberman suggested that "U.S. corporations are moving sophisticated design and R&D overseas to their own subsidiaries abroad or contracting the work to third parties to assist product development in existing manufacturing facilities abroad."[229]

Of course, the fact that firms are shifting both manufacturing and R&D to China does not necessarily indicate that the location decisions are driven by the need to colocate R&D and manufacturing. Location choices for R&D and manufacturing are sometimes influenced by different considerations. Paul Krugman has observed that increasing returns to scale, combined with higher transaction costs arising from cross-border trade, may result in a home-market effect–firms locating a disproportionately large fraction of their manufacturing in their home country.[230] Other scholars have pointed out that the location choices of MNEs will also be influenced by the advantages of having production located near consumers.[231] Thus, decisions of where to locate manufacturing frequently involve a tradeoff between home country advantage and locating near consumers. There are also, of course, advantages to locating manufacturing where labor and land are cheap. However, firms also often want to locate their R&D labs near other firms' R&D labs in order to benefit from geographical spillovers.[232] Thus, while it may be advantageous to locate manufacturing in rural areas, where land is cheaper, firms may want to perform R&D in large cities to be close to other R&D facilities.[233]

So, the locations of manufacturing and R&D are often influenced by different factors, but colocation of R&D and manufacturing is advantageous when it facilitates the testing of ideas and designs.[234] Thus, manufacturing and R&D are often colocated, with the likelihood of colocation depending on the type of R&D performed at a given lab. As the economics literature discussed below attests, basic research is less likely than applied R&D to be colocated with production.

Several economic studies describe the conditions for colocation of manufacturing and R&D, the kinds of R&D most often colocated with manufacturing, and, in some cases, the advantages of such colocation. In a study of large U.S. firms in the chemicals and allied products industry, for example, Isabel Tecu found that manufacturing and R&D were significantly colocated. Specifically, using patent activity as a measure of R&D, she found that a firm's R&D productivity in that industry is 2.5 times as high in a metropolitan statistical area where one of its manufacturing facilities is located than in one where no facility is located.[235]

In a survey of forty-nine German MNEs, Björn Ambos found that 79% of research laboratories were colocated with production.[236] Based on the companies' responses regarding the activities of each lab, Ambos classified the labs as "capability exploiting" ("CBE") or "capability augmenting" ("CBA"), with CBE labs focused on exploiting existing technology and CBA labs focused on acquiring new knowledge and capabilities. The CBE and CBA categories closely correspond to applied and basic research, respectively. Of the 130 research facilities in the survey, 103 were colocated with a production facility.[237] Seventy-seven of the ninety-one CBE labs (about 85%) were colocated with production facilities, while twenty-six of the thirty-nine CBA labs (about 67%) were colocated.[238] Therefore, while Ambos found a significant degree of colocation overall, CBE labs were somewhat more likely to be colocated with production.

In a study of 156 foreign R&D sites of MNEs, Walter Kuemmerle also concluded that CBE labs were more likely to be colocated with production.[239] Kuemmerle found that forty-six of the ninety-six CBE labs (about 48%) were located near factories, while twenty (about 21%) were located near universities and seventy-nine (about 82%) were located near important markets.[240] Of the sixty CBA labs, eleven (about 18%) were located near factories, fifty-two (about 87%) near universities, and twenty-two (about 37%) near important markets.[241] Thus, CBE labs were more likely to be colocated with manufacturing and marketing facilities, while CBA labs were more likely to be located near universities. In total, about one-third of labs were located near production facilities. Kuemmerle's results are consistent with other studies that have found that applied research facilities are the most likely to be colocated with manufacturing facilities.[242]

There is some evidence that high-tech companies, which are defined as those that perform the most R&D overall,[243] are less likely to colocate R&D and production. Based on a study of Japanese operations in Europe, Myriam Mariani found a significant degree of colocation but also observed that high-tech businesses were less likely to colocate.[244] The study divided affiliates based on whether they performed only R&D, only manufacturing, or both. Affiliates that performed only R&D tended to be located in the same region with other operations. R&D was clustered in particular locations—around London, Frankfurt, and Paris in particular–while manufacturing and combined R&D and manufacturing operations were located in those areas and others. While her data suggests that R&D is often colocated with production, Mariani found that high-tech businesses were less likely to colocate manufacturing and R&D.[245]

Mariani's results conflict somewhat, however, with a more recent survey by Mikko Ketokivi and Jyrki Ali-Yrkkö.[246] Ketokivi and Ali-Yrkkö surveyed CEOs of Finnish companies in an effort to determine the factors that might affect the likelihood of R&D and manufacturing colocation. The CEOs were asked about 1) their colocation needs, 2) the complexity of their products and the degree of R&D-manufacturing interaction required, 3) the complexity of their process, 4) how quickly they introduced new products, and 5) their R&D intensity.[247] The authors found that companies with higher product complexity, process complexity, and frequency of developing new products tended to consider colocation of R&D and manufacturing to be more important.[248] But, unlike Mariani, Ketokivi and Ali-Yrkko found that R&D intensity was not significantly correlated with likelihood of colocation.[249]

In sum, the economics literature suggests that R&D and manufacturing are often colocated, and that such colocation may in some cases improve productivity, although the degree of colocation varies from study to study. The literature also indicates that colocation is less likely for R&D facilities that perform basic research than for those that perform applied research.

The level of R&D performed by manufacturing firms varies substantially by industry. A National Science Foundation report, *Science and Engineering Indicators 2012*, provides data on the R&D intensity of various industries.[250] Business R&D intensity is defined as the ratio of domestic R&D performed and paid for by the company to domestic net sales. The report found that in 2008, the ratio across all industries was 3.0.[251] The ratio for manufacturing as a whole was 3.5.[252] Certain manufacturing industries, like semiconductor machinery and semiconductor and electronic components of computers, have exceptionally high ratios—28.8 and 20.2, respectively.[253] Pharmaceuticals and medicines also have a high ratio of 12.2, while computer and electronic products as a whole have a ratio of 10.1.[254] However, primary metals, food, beverage, tobacco products, textiles, apparel, leather, and wood products all have ratios below 1.[255] And certain nonmanufacturing industries have exceptionally high ratios, well above the manufacturing average. For example, software publishing has a ratio of 10.6, and electronic shopping and retail of mailorder houses has a ratio of 13.4.[256] Therefore, the link between R&D and manufacturing varies greatly by industry, and such a link is not limited to manufacturing. In general, chemicals, computer and electronics products, and information industries have particularly strong links to R&D. Yet these high-tech industries also seem to be less likely to colocate their manufacturing with their R&D.

2. *Other Justifications for Manufacturing Incentives.*—In addition to the claim that manufacturing incentives will indirectly promote R&D, proponents justify such incentives on the grounds that manufacturing generates crucial, well-paying employment and that manufacturing produces important spillovers.[257] However, it is not at all clear that providing manufacturing incentives is a sound or cost-effective way to generate employment. President Obama's *Framework*, quoted above, emphasizes the substantial number of scientists and engineers employed by manufacturing firms.[258] Yet, as discussed above, manufacturing may take place in the United States without generating R&D or science and engineering jobs in the United States.

Nor is it likely that U.S. manufacturing jobs lost in recent decades can be recaptured.[259] Productivity has increased, reducing the number of employees required to produce similar output.[260] The average American factory worker now produces $180,000 worth of goods a year, which is more than three times what he would have produced in 1978 in today's dollars. Further, while the number of U.S. manufacturing jobs has decreased from twenty million in 1979 to twelve million today, value added in U.S. manufacturing increased by more than two-thirds during that period.[261] And the recent expansion of manufacturing capabilities in China and other developing countries has contributed to the decline in the United States' relative share of manufacturing.[262]

Nevertheless, in remarks before the Conference on the Renaissance of Manufacturing, Gene Sperling, Director of President Obama's National Economic Council, argued that the decline in U.S. manufacturing is not irreversible.[263] Sperling emphasized evidence that increased productivity does not necessarily lead to job loss, pointing out that productivity increased significantly in the 1990s, yet manufacturing employment increased by 700,000 jobs from 1993 to 1999.[264] Of course, economic growth was especially robust between 1993 and 1999—U.S. GDP increased by 40%.[265]

Sperling also pointed to a study by William Nordhaus that found that, within a given industry, increases in the rate of productivity growth were generally associated with increases in the rate of job growth over the 1948-2003 period.[266] According to Nordhaus, the decline in U.S. manufacturing employment is not due to increased productivity in the United States. He emphasizes that higher productivity leads to lower prices, which leads to increased demand and therefore increased employment. According to Nordhaus, the U.S. decline is attributable to the fact that gains in productivity and decreases in costs have been larger in other countries, such as China.[267] However, Nordhaus's findings do not necessarily support Sperling's claim that the decline in U.S. manufacturing is reversible or merits special incentives.

The 425,000 new manufacturing jobs created in the past two [268] hardly compensate for the millions lost over past decades.[269] To take just one example, Intel is building a new U.S. factory that will add 1,000 jobs, but the company reduced its U.S. employment by about 5,000 jobs from 2000 to 2010.[270] There is little reason to believe that, even with tax incentives, MNEs would prove willing to move all or even most of their foreign manufacturing employees back to the United States. As General Electric CEO Jeff Immelt said, "We see the opportunity to bring certain jobs, not every job, back."[271]

President Obama's final justification for manufacturing tax incentives is the claim that manufacturing causes valuable spillovers. There is some support for this assertion. A study by Michael Greenstone and his colleagues, for example, considered the impact of opening a large manufacturing plant on the productivity of plants in the same county.[272] The study compared the county in which a new plant chose to locate (the "winning county") to one or two other counties that were at the top of the new plant's list but ultimately were not chosen (the "losing counties"). Before the opening of the new plant, winning and losing counties were similar in terms of most economic variables. However, five years after the new plant opened, the total factor productivity of plants in winning counties was 12% higher than in losing counties, suggesting benefits to agglomeration.[273] The study found that "[e]stimated spillovers are larger between plants that shared labor pools and similar technologies."[274] Greenstone and his coauthors suggest that "[t]his is consistent with intellectual externalities, to the extent that they occur among firms that use similar technologies or are embodied in workers who move between firms."[275]

Christina Romer, on the other hand, argues that large clustering effects among manufacturers have in fact been hard to find and suggests that spillovers may not be significant after all.[276] Glenn Ellison and Edward Glaeser have also examined the concentration of U.S. manufacturing and found that, in many industries, clustering is minimal.[277] Further, as Romer points out, clustering benefits are not exclusive to manufacturing; entertainment industries, for example, exhibit significant clustering, suggesting the presence of positive externalities.[278]

Thus, it is not at all clear whether manufacturing produces substantial spillovers, and even if it does, whether they are any greater than spillovers produced by other industries. This contrasts sharply with the widespread agreement among economists that R&D produces significant spillovers and tends to be underprovided by the market in the absence of government incentives.[279]

In a recent paper, Michael Spence and Sandile Hlatshwayo divide the economy into an internationally tradable sector, which operates in a global market and is subject to competition from foreign firms, and a nontradable sector, which they claim is comprised of industries that by their nature are confined to operation within the United States.[280] These divisions are based on geographic concentration—the more geographically concentrated an industry, the more tradable the authors consider it.[281] According to their methodology, industries like health care and construction are geographically dispersed and therefore nontradable, while mining is geographically concentrated and therefore tradable.[282] The authors found that most manufacturing is tradable, though certain categories of manufacturing, such as those consisting largely of capitalintensive manufactured goods like heavy machinery, are said to include a substantial nontradable component.[283]

The authors found that over the 1990-2008 period, most U.S. job growth was in the nontradable sector.[284] They project, however, that job growth in the nontradable sector is not sustainable.[285] After the financial crisis, nontradable industries like health care and real estate have not continued to grow at their precrisis pace.[286] The authors argue that, unless we can generate tradable sector jobs, the United States is going to face a long-term employment problem.[287] The authors find no market failure, since MNEs are functioning efficiently, but conclude that the outsourcing of tradable sector jobs has disquieting implications for the United States.[288] Therefore, they urge incentives designed to change the behavior of tradable sector firms.[289] Specifically, they suggest tax reform favoring "investment in a broad range of productive assets of all kinds, including hard and soft infrastructure and human capital."[290]

While Spence and Hlatshwayo suggest that some kinds of tax incentives might be beneficial, a broad tax incentive for domestic manufacturing fails to meet their criteria. Their concern is the loss of jobs in the tradable sector, and to address that concern an incentive should focus on the tradable sector. However, some manufacturing activities are nontradable, and many nonmanufacturing activities are tradable.[291] For example, in a recent report, the Congressional Research Service (CRS) indicated that the most highly mobile jobs include computer programmers, systems analysts, telemarketers, and bookkeeping, accounting, and auditing clerks.[292] Machine operators, team assemblers, and production worker helpers are less likely to move offshore.[293]

Many analysts have suggested that it would be better policy to repeal the special deduction for domestic production income. For example, President Obama's Fiscal Commission and the Debt Reduction Task Force both proposed the repeal of corporate tax expenditures, including the domestic production deduction, in exchange for a lower overall corporate tax rate.[294] Another report by the CRS suggests that the revenues generated by repealing the current domestic manufacturing deduction might be used to lower the regular corporate tax rate by 1.2 percentage points.[295] The CRS report also suggests that any special benefit should be limited to activities—such as R&D—that tend to produce positive externalities and are therefore underprovided by the market.[296]

Before turning to an overall evaluation of the incentives for technological innovation, this Article will provide important context by briefly describing some of the techniques MNEs are now using to reduce their taxes on income from IP. The success of MNEs in shifting IP income to low-or zero-tax countries compounds the difficulties of fashioning sound tax policy in support of technological innovation.

IV. Tax-Minimizing Games Multinationals Play

Large MNEs influence the scope, shape, and efficacy of tax incentives for technological innovation in two ways. The first, and most obvious, is through their political sway. It is now a cliche in the political science literature that democratic legislative bodies are especially responsive to exhortations from business interests.[297] In the United States, for example, the R&D Credit Coalition has become legendary for its ability to maintain R&D tax incentives.[298] Indeed, the annual game of threatened expiration and extension of these incentives has become a well-known fundraising gambit for members of Congress who serve on the tax-writing committees.[299] And as a particularly powerful example from abroad, a few companies–including GlaxoSmithKline–played a significant role in shaping recent U.K. tax reforms, including the patent box and new corporate tax rate, by threatening to relocate jobs.[300]

Second, whenever local law fails to conform to the interests of powerful multinational interests, the option of shifting funding and operations, and therefore income, to a more favorable jurisdiction is always present. Although Adam Smith, writing more than two centuries ago, could not have foreseen today's interconnected world economy, he was prescient when he observed:

> The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was . . . assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left.[301]

MNEs obviously have an incentive to locate profits in low-tax jurisdictions to reduce their tax burdens. And they are quite formidable in doing so—deploying tax-minimizing strategies that have made taxing IP income especially difficult. The facility of MNEs in locating IP income in low-tax jurisdictions limits the ability of national governments to achieve their preferred policy outcomes and clearly has influenced the tax incentives for technological innovation considered here. Some of the incentives described above—Luxembourg's patent box, for example—simply reflect a nation's attempt to capture for its treasury a larger share of revenues from MNEs' worldwide income resulting from their innovative activity, regardless of where the innovative activity itself actually occurs. Income from IP is much more mobile than the highly skilled workers and entrepreneurs who create it. In order to understand the challenges national governments now face, it is necessary first to briefly describe some of the common income-shifting techniques.[302]

One way that MNEs shift IP income is by concentrating certain expenses, functions, or IP ownership in a related corporation in a low-tax jurisdiction. Then, through advantageous intercompany transfer pricing, the MNE may allocate a large share of profits to the low-tax entity. The key element making such transactions valuable to MNEs, of course, is large differences in corporate income tax rates.[303]

However, concentrating profits in a low-tax jurisdiction often requires an MNE to restructure its operations. The OECD has identified four common mechanisms for accomplishing such restructuring, and the staff of the Joint Committee on Taxation ("JCT") has presented to Congress six case studies of U.S. MNEs' income-shifting in several different industries.[304] All of the companies in the JCT study had effective tax rates of less than 25% on their worldwide income, and all had a much greater ratio of U.S. sales to worldwide sales than of U.S. income to worldwide income—in some cases five or six times greater.[305] Indeed, the JCT selected the companies it examined based on these criteria.[306] In each of these cases, the MNE designated an entity in a low-tax jurisdiction as a "principal" and then transferred a significant portion of its IP to that principal.[307] Once the IP had been transferred to the principal, the low-tax jurisdiction taxed the IP income, even when the underlying R&D took place in a higher-tax country. The benefits of these kinds of transfers are enhanced whenever the principal pays an artificially low price for the higher-taxed entity's IP. There are four basic methods of transferring IP to a principal, which are described below.

In general, the low-taxed principal takes over some of the MNE's high-value functions, while low-value functions are allocated to higher-taxed affiliates.[308] Even though all the risks are borne by the MNE's consolidated group, this allocates a greater share of the MNE's profits to the principal. The functions taken on by the principal may include developing marketing strategies and organizing research for entities in other countries. The principal may then oversee the development, production, and sale of goods in certain regions, or, in some cases, globally. Alternatively, a foreign affiliate might be in charge of regional distribution for its area. The fact that the affiliate is subject to the oversight of such a principal may allow it to book a smaller portion of the MNE's profits, while the exercise of oversight by the principal and the funding of expenses may let it book a larger portion. If so, more of the MNE's profits will be taxed in lower-tax jurisdictions.

At the same time, foreign subsidiaries may be converted into low-risk distributors, or new entities may be created for that purpose. While a traditional sales subsidiary would purchase inventory from the parent corporation and assume the risks as well as the responsibility for sales and advertising, a low-risk distributor does not assume risk, but instead, in effect, merely acts as a commissioning agent of the principal.[309] In such a case, advantageous intercompany pricing may allocate a lower proportion of the MNE's profits to entities that bear little risk. The MNE wants to sell its products in high-tax jurisdictions, but it also wants to minimize its tax burden in those jurisdictions. So, the low-tax principal bears the risk and receives a high proportion of the profits, while performing sales through the low-risk distributors, which are allocated a smaller portion of the MNE's profits.[310]

In addition, manufacturing subsidiaries may be converted into low-risk service providers (contract manufacturers) acting at the direction of the principal.[311] Or the principal may enter into contracts with unrelated (usually low-cost) contract manufacturers. The principal then does not perform the MNE's manufacturing itself, but by bearing risk and exercising oversight over contract manufacturers, the principal may retain a substantial share of the MNE's profits, even as the contract manufacturers produce the products that will be sold. In such arrangements, in addition to exercising oversight, the principal may own raw materials and goods, as well as the IP related to the product being manufactured, further enhancing its profit share. As with low-risk distributors, contract manufacturers are allocated smaller portions of the profits than full-risk manufacturers would be since they bear little risk and are subject to the control of the principal.

In each of these cases, the IP is owned or licensed by an entity in a low-tax nation. Generally, there are four methods by which an MNE can transfer IP from an entity in a high-tax jurisdiction to an affiliate in a low-tax jurisdiction.[312] First, the entity may simply transfer all of the rights in the IP. This can be achieved by selling the rights. To the extent that the entity in a high-tax jurisdiction receives an artificially low price for the IP, the MNE reduces its tax burden.

Alternatively, the entity may license the IP to its affiliate. The staff of the JCT has said that licensing is the favored method of transferring IP out of the United States.[313] With a licensing agreement, the entity transfers less than all of the substantial rights in the IP and, in return, receives royalties from the affiliate. While the IP may have been developed in the

United States, U.S. international tax rules source royalty income where the IP is used rather than where it is developed.[314] So, royalties received by a U.S. corporation that licenses IP to a foreign affiliate will be classified as foreign source income, even though there may be little or no foreign income tax imposed on the royalties, and the U.S. corporation may offset the U.S. tax that would otherwise be due on the royalties through the use of foreign tax credits from high-taxed income elsewhere.[315] The U.S. tax question then becomes an issue of transfer pricing, prompting an inquiry whether the royalties adequately compensate the licensor. Resolving such transfer pricing questions is often complicated by the fact that licensing agreements are bundled with agreements for related services or to fund additional research.[316] This may allow royalties to be lower than they should be.

As a third alternative, instead of the U.S. company transferring the IP itself to a low-tax jurisdiction, it may provide services using the IP, for which it is compensated by the low-tax affiliate.[317] Again, the tax question becomes whether such services are appropriately compensated, since underpricing the services will result in tax savings for the MNE.

As a fourth variation, the U.S. entity and its affiliate may enter into a cost-sharing arrangement for the development of a new intangible asset. Typically, the entity in the high-tax jurisdiction contributes the right to use its existing IP for R&D to develop the new product. The entity may also contribute other resources or rights to be used in the development process. The IP and any other contributed resources and rights constitute the "platform" contribution. The affiliate in a low-tax jurisdiction makes a "buy-in payment" in return for the rights and resources and often agrees to fund a share of future R&D expenses. The ownership of the newly developed intangible asset is then divided between the entities in proportion to their contributions, with the total value of the IP based on projected profits. Because the new asset is jointly owned, no royalties flow between the two entities when the product is sold to customers. A critical issue, of course, is whether the cost-sharing buy-in is appropriately priced at an arm's length rate. This inquiry is generally impossible to resolve with any confidence since comparable transactions do not occur between unrelated parties. Whenever the price is artificially low, income will be shifted from the high-tax to the low-tax jurisdiction.[318]

In 2010, the JCT published a detailed study illustrating how six U.S. MNEs take advantage of the structures and IP-shifting techniques discussed above to move income to low-tax foreign jurisdictions.[319] Two of these illustrations are summarized below. In one example, "Bravo," a U.S. MNE that sells industrial technology products, utilizes a cost-sharing agreement between U.S. and Swiss entities.[320] Bravo's Swiss subsidiary is responsible for the manufacture and sale of certain existing and yet-to-be-developed product lines worldwide. Bravo and its domestic affiliates (collectively Bravo U.S.) and the Swiss entity (Bravo Switzerland), which is itself owned by a wholly owned Bravo subsidiary, enter into a costsharing agreement, which makes preexisting IP owned by Bravo U.S. available to Bravo Switzerland. In return, Bravo Switzerland makes a buy-in payment of several billion dollars in the form of a declining royalty adjusted to zero over the useful life of the IP, set at four years. Bravo U.S. includes these royalties in its U.S. income upon receipt, but Bravo Switzerland recovers the costs of its buy-in payment within three years. If the useful life of the IP is in fact greater than three years, the cost-sharing agreement allows Bravo to shift income to Switzerland, where it is subject to much lower tax rates than in the United States.

In another example, "Delta," an MNE that manufactures and markets technology-based consumer products, uses a licensing agreement to shift income.[321] Delta U.S. (Delta and its domestic affiliates) is primarily responsible for product-related R&D and the development of new products. Once a new product is nearly fully developed, Delta U.S. licenses the rights to exploit the IP to Delta Netherlands, a wholly owned CFC, in exchange for a royalty. Delta Netherlands then exploits the IP globally. Delta Netherlands finances the minimal amount of R&D that is necessary to complete the development of the product, allowing it to lower the royalty rate it pays to Delta U.S. After licensing the IP, Delta Netherlands or one of its manufacturing affiliates manufactures the product and sells it to Delta U.S. and other distribution affiliates. A substantial share of the IP profits remains in the Netherlands, where it is taxed at the 5% patent box rate. Virtually all of the R&D costs are incurred in the United States, where they are deducted on Delta's U.S. tax return, offsetting income that would otherwise be taxed at a much higher rate, even though profits from the resulting IP are shifted to the Netherlands.[322]

All six businesses profiled in the JCT study concentrated their "profitable" functions in low-tax foreign jurisdictions while relegating less profitable functions to higher-tax jurisdictions.[323] All six of the MNEs also performed a substantial portion of their R&D in the United States but transferred or licensed their IP to affiliates in low-tax jurisdictions. Moreover, the U.S. portions of all these companies' worldwide sales were much greater than the U.S. portions of their worldwide income.

In many instances, complex tax planning structures are used by U.S. MNEs to reduce taxes to the low single digits or even zero on a substantial portion of their IP income. Some of these arrangements have been given clever names. Google, for example, which together with Apple has become a poster child for these arrangements in the press, uses a complicated structure known as the Double Irish Dutch Sandwich.[324] The details of these kinds of income-shifting techniques are less important for the purposes of this Article than their consequences. They allow MNEs to deflect IP income to low-or zero-tax countries even in circumstances where the value of the IP as created in the United States and the resulting products are sold in the United States. Structures such as those used by Google and Apple also often involve further shifting of IP income from low-tax countries like Ireland to even lower-or zero-tax countries like Bermuda and the Cayman Islands.[325]

In September 2012, the Senate Permanent Subcommittee on Investigations held a hearing entitled "Offshore Profit Shifting and the U.S. Tax Code," which explored techniques Microsoft used to shift IP income to low-tax countries and to minimize its U.S. taxable income. In his opening statement, the subcommittee's chairman, Carl Levin, said that although 85% of Microsoft's R&D is conducted in the United States, Microsoft USA shifted $8 billion offshore to subsidiaries in Ireland and Singapore and, during the three years examined by the subcommittee, saved over $4.5 billion of taxes on goods sold in the United States by selling its rights to market its IP in the United States to a Puerto Rico subsidiary. [326] Chairman Levin said:

> Microsoft U.S. avoids U.S. taxes on 47 cents of each dollar of sales revenue it receives from selling its own products right here in this country. The product is developed here. It is sold here, to customers here. And yet Microsoft pays no taxes here on nearly half the income.[327]

The United States, of course, is not the only country losing revenue to these income-shifting techniques. Two months after Senator Levin's hearings, Parliament's Public Accounts Committee grilled executives from Starbucks, Google, and Amazon on their techniques for avoiding U.K. income taxes on their large U.K. operations.[328] The Parliamentary Report that followed concluded (in the British style): "[W]e were not convinced that [these three companies'] actions, in using the letter of tax laws, both nationally and internationally, to immorally minimize their tax obligations are defensible."[329] In response to this report and consumer pressures, Starbucks announced it would voluntarily pay an additional £20 million to the U.K. Treasury.[330]

In a joint statement at about the same time, Germany's Finance Minister Wolfgang Schauble and Britain's Chancellor of the Exchequer George Osborne called on the G20 countries to coordinate efforts to prevent profit-shifting by MNEs.[331] Through a combination of IP-shifting and entity creation and structuring, MNEs are able to allocate a large amount of income offshore. As Julie Roin has said, "At best, taxing authorities have found themselves engaged in a never-ending game of 'whack-a-mole'; more often they appear to be looking on helplessly as the moles eat the produce in the garden and move inexorably closer to the foundations of the house."[332]

No one really knows how much income-shifting costs the United States annually; estimates range as high as $60 to $90 billion.[333] The mobility of IP and of some of the functions associated with exploiting it, coupled with the inadequacy of mechanisms used by governments to combat transfer pricing, allow the shifting of much IP income to low-tax countries. When such shifting is done from the United States, it depletes the U.S. tax base and also undermines the nation's innovation incentives. The United States subsidizes R&D performed in the United States by allowing the deduction of R&D costs and through the R&D tax credit on the assumption that this nation will recoup some of those revenue losses through taxes on profits from sales of the resulting products.[334] Other countries have made similar assumptions, but have also experienced disadvantageous income-shifting.[335] In such cases, the R&D may create benefits wherever it occurs, but income-shifting makes R&D incentives more costly because a nation's costs of subsidizing the R&D will not be recouped through taxation of the income that results.

Because of the ubiquity of intercompany transfer pricing issues in MNE arrangements of these sorts, it is tempting to regard the tax-motivated structures described here as presenting a problem only of designing an effective transfer pricing regime or an appropriately constraining alternative. Suggestions for the latter frequently involve the allocation of an MNE's international income using a formula based on its property, payroll, or sales, but, as discussed in the next Part, this is not an obvious solution.[336] Others have urged that the United States tighten its CFC rules, as several OECD countries have recently done.[337] The Obama Administration has also advanced related proposals. The Obama Administration's *Framework* suggests, for example, a "minimum tax" on international income.[338]

Unfortunately, the problems of international income taxation that these kinds of transactions bring to the surface are much more fundamental. First, by demonstrating the flexibility MNEs enjoy to create and operate new entities resident in low-tax countries, they expose the tenuous foundations that ground international income taxation of corporations based on their residence. These kinds of income-shifting examples also expose the fragility and manipulability of relying on the "source" of income as the second foundation block of international income taxation.[339] But, despite their shortcomings, the world is, for now at least, stuck with both. Of course, the ultimate question then is, given these strictures, current knowledge about the efficacy of these tax incentives, and the ability—and success—of MNEs to shift their IP income to low-or zero-tax jurisdictions, what are the most sensible policy responses? That is the challenge to which this Article now turns.

V. Resolving the Tax Policy Challenges

This Article has described the three most important types of tax incentives that have been adopted in the United States and Europe to support and stimulate technological innovation in an effort to enhance economic growth: (1) tax credits and super deductions for R&D, patent (or innovation) boxes—the latest European fashion–and special deductions or lower income tax rates for "advanced manufacturing."[340] The economic evidence estimating the efficacy of such incentives, however, is sparse and often conflicting—only R&D incentives garner anything like passing marks on a cost-benefit basis. Nevertheless, serious proposals for all three continue to be put forward in the United States.

A. Evaluating the Incentives

R&D incentives predate the successful techniques now used by MNEs to shift IP profits to low-tax jurisdictions. They were also generally enacted before the recent expansion of global economic activities.[341] As a result, their international implications have been little explored. Patent boxes are of more recent vintage and not only take international developments into account, but seem to have been enacted by various European nations in an effort to capture a share of mobile innovative activity or at least some revenue from such especially mobile income. Manufacturing incentives exhibit a somewhat similar finger-in-the-dike quality, as they are promoted principally as a way to keep manufacturing jobs from moving abroad.

All three of these categories of tax incentives now reflect competition among nations to retain and attract activities that are thought by many to have especially high value for the countries that house them. Advocates and detractors may debate whether this competition reflects a race to the top or to the bottom, but no one denies that the race exists.[342] Unfortunately, when nations compete over such tax policies, there is no governmental equivalent to Adam Smith's "invisible hand," which produces economic efficiency in competitive markets.[343] Nevertheless, cooperation among nations to harmonize income tax policies is quite limited–even within Europe, where the EU treaties have served to create an economic, but not a fiscal, union.[344]

Talk about "winning" this kind of international competition has become ubiquitous in today's political discourse, but there is surprisingly little consensus, or even analysis, of what the competition entails.[345] Needless to say, technological innovation should not be viewed as a zero-sum game;

the economic growth it generates may enhance living standards around the world. The economist Eric Toder has offered the most compelling analysis of inter-nation tax competition to date.[346] Toder nods to the longstanding economic consensus that firms compete but nations do [347]---a consensus dating back to David Ricardo, who demonstrated that international trade was a "win-win" proposition among nations,[348] and a conclusion shared by Paul Krugman, who regards "'the obsession with competitiveness [as] both wrong and dangerous.'"[349] But then Toder asks how one might think about tax competition among nations if it were a "zero-sum game" and analyzes five potential objects of such international competition: (1) labor supply, (2) financial and physical capital, (3) intangible capital, (4) tax revenues, and (5) natural resources.[350] This Article adds to that list nationally based firms, especially headquarters activities of MNEs, given the mobility of corporate residence coupled with the home country bias in portfolio investment.[351] All of these factors, except for natural resources, are implicated in the policies addressed here. R&D incentives are intended to attract and benefit high-value workers, especially scientists and engineers; to lure the physical and financial capital essential for technological innovation; to reward national MNEs' activities; and to create valuable intangible capital. Patent boxes are an effort to garner tax revenues from highly mobile IP and, in some cases at least, to attract R&D with its attendant benefits.[352] Manufacturing incentives are intended to increase labor supply, manufacturing jobs in particular; to attract and retain the physical capital used in manufacturing; and, when R&D and manufacturing are colocated, to attract and retain R&D.[353] The critical questions, of course, are how well designed these tax policies are to accomplish these goals and, ultimately, whether they are cost effective.

As mentioned earlier, one major difference between R&D incentives and patent boxes is their timing. R&D incentives are provided when expenses are incurred, at the front end of the innovation process. Patent boxes, in contrast, are provided at the back end, when income is earned. If capital markets were complete (making liquidity of no concern), and if returns from R&D expenditures were certain, one might be indifferent to this choice.[354] But the argument for subsidizing innovation is grounded in our inability to measure the amount and location of returns to innovation, and the economic evidence concerning the spillover benefits from R&D

emphasizes their geographic proximity, implying that beneficial spillovers turn more on the location of R&D than on where IP income is earned.[355] A lower tax rate on innovation income may affect where mobile IP income is reported, but there is little reason today to believe that the decision regarding where to locate such income turns on where the related R&D is performed or where the spillovers occur. National desires to capture beneficial spillovers now favor R&D incentives over patent boxes.

Some national benefits may also accrue when IP is owned by the nation's MNEs, regardless of where the IP is developed or exploited. If, for example, a U.S. MNE owns IP developed or enhanced in China and exploited there, the rents from that IP and the benefits of further enhancements to it may accrue predominately to U.S. shareholders, even when China captures the income taxes on such rents and the geographic spillovers.[356] This potential benefit also favors R&D incentives over patent boxes, even when the R&D takes place outside of a nation's borders, so long as the resulting IP is owned by a U.S. MNE.

Practical problems plague all three types of these incentives. Designing R&D tax incentives requires that the government define where R&D ends and where production or commercialization begins. Whenever the incentives are aimed at applied, as well as basic, research, disputes over such line drawing become inevitable and especially difficult. But drawing appropriate lines is important because the scope of the tax incentives clearly affects what research will be undertaken.[357]

As already described, the U.S. R&D credit is available only for incremental R&D that exceeds a base-period level.[358] This structure is not unique, but it is unusual. Most foreign R&D tax incentives turn simply on the volume of annual R&D expenditures.[359] In principle, an incremental credit has advantages: It will reduce subsidies to R&D that would be performed without an incentive, and the size of the subsidy can be greater per dollar of revenue cost than one applicable to all R&D expenditures. On the other hand, defining an appropriate base period for an incremental R&D incentive is hardly trouble-free. The 1984—1988 base for the current U.S. R&D credit surely makes little sense now, nearly three decades later. But a rolling base period creates a disincentive for a company to rapidly expand its R&D, since, as a company's R&D spending grows, it becomes more difficult to qualify for the credit going forward.[360]

Finally, there is the question of whether an R&D credit should be refundable. Generally, nations have answered this question "no,"[361] which disfavors start-up companies, companies with losses (whose number increases during economic downturns), and companies that are liquidity-constrained.

R&D tax incentives are inevitably overbroad, rewarding spending that would have occurred without the tax break, and subsidizing R&D that produces little or no positive spillover. Direct government aid in the form of grants, loan guarantees, and purchases, in principle, can be more narrowly targeted. It is difficult, however, at least in the United States, to eliminate political rewards to constituents and contributors when Congress determines where and to whom such direct subsidies will go.[362]

Patent boxes create different, but equally daunting, problems, as the discussion of the United Kingdom's recent patent box legislation illustrates.[363] First, patent boxes subsidize only those companies whose R&D proves profitable, without regard to the size and scope of any spillovers from the R&D. Of course, subsidies are less necessary the more profitable the IP, at least when viewed ex post.

Second, as described above, the scope of IP income eligible for reduced tax rates varies significantly among countries, creating controversial definitional problems and making meaningful cross-country comparisons difficult. If patent boxes applied only to royalty income, eligible income would be comparatively easy to identify (although, even here, one would have to eliminate royalties for marketing intangibles). However, companies often realize their IP income through sales of their products, and patent and innovation boxes generally apply to such income. This is the case in, for example, Belgium, Luxembourg, and the Netherlands, as well as in the United Kingdom.[364] Identifying the income attributable to the IP may be accomplished by subtracting out some level of "routine" returns, on the ground that these relate to production, distribution, and marketing, with excess returns deemed attributable to IP (even though some non-routine returns may instead result due to positive results from taking business risks).[365] A formula can be used to make this division. Differences in the size of “routine returns” across industries may be ignored,[366] and whenever different countries define eligible income differently, gaps in taxation or double taxation may occur.

Third, patent box tax reductions apply in the country where the income is earned, usually without regard to where the IP is legally protected or where the IP is owned. In Europe, the EU treaties make it impossible to limit income eligible for the tax break to situations where the IP was developed locally,[367] but the United States would face no such barrier.

As we have seen, it is common for countries to offer *both* R&D incentives and patent boxes. However, doing so without requiring that the income eligible for the patent box rate reduction be offset by the R&D costs (which is required, at most, only by the [368]) opens up the potential for negative tax rates that may serve to shelter unrelated income from tax. The following example, developed by PricewaterhouseCoopers analysts, illustrates the potential problems.

> A patent is developed at a cost of $100 and generates a stream of licensing income with a present value of $200. Under the Belgian patent box, the present value of the taxable income will be *negative* $60 (20 percent of $200 license income less $100 of R&D expense) because only 20 percent of the license income is subject to tax due to the 80 percent patent income deduction.
> At the Belgian CIT rate of 33.99 percent, the present value of tax liability on patent income in this example is *negative* $20.4 (negative $60 times 33.99 percent), corresponding to an ETR of *negative* 20.4 percent.[369]

Negative tax rates can also occur, of course, when the R&D tax incentive is used to reduce taxes on high-taxed income in one country and the resulting IP income is shifted to a low-tax jurisdiction–whether the jurisdiction is low-tax because of a patent box or otherwise.[370] Combining manufacturing incentives in the form of accelerated deductions or tax credits with a patent box may also produce negative taxes. On balance, as between R&D incentives and a patent or innovation box, the case for the former is more compelling.

Based on the economic evidence described in Part III, a broadly applicable manufacturing incentive does not seem a sensible way to encourage R&D. Generally, basic research produces larger spillover effects than applied R&D.[371] Because spillovers are the fundamental reason to provide an R&D incentive, the incentive should focus primarily on basic research, yet the literature suggests that basic research is rarely colocated with manufacturing.[372] If the goal is to stimulate more applied R&D, expanding the category of R&D eligible for incentives would be a more targeted approach than a manufacturing incentive. As shown earlier, while manufacturing companies on average perform somewhat more R&D than other types of companies, many types of manufacturing require little R&D.[373] Therefore, if the goal of a manufacturing incentive is to encourage R&D, a broad incentive for domestic manufacturing is very difficult to justify. The other justifications offered by proponents of manufacturing incentives are no more availing.

While some have argued that manufacturing jobs are a particular source of well-paying jobs for less educated workers, others dispute this. Whether manufacturing jobs appear especially well-paying depends on exactly what is counted and how comparisons are made. Laura Tyson, an advocate of government subsidies for manufacturing, says that in 2009 "the average manufacturing worker earned $74,447 in annual pay and benefits compared with $63,122 for the average non-manufacturing worker."[374] In contrast, J. Bradford Jensen, who argues that the United States should be promoting business services rather than manufacturing, points out that "[t]he average business-service job pays about $56,000 a year–more than 20 percent better than the average manufacturing job."[375] He also observes that "[b]usiness services employ 25 percent of U.S. workers, more than twice as many as the manufacturing sector," and that "over the past 10 years, business-service employment grew by more than 20 percent, while manufacturing employment decreased by more than 20 percent."[376]

Christina Romer, who served as President Obama's first chair of the Council of Economic Advisers, agrees with Jensen that the manufacturing sector is no longer a special source of well-paying jobs.[377] Because of technological innovation, many manufacturing jobs now require greater education, and there are many nonmanufacturing industries in which educated workers may get well-paying jobs.[378] Romer points out that while manufacturing has been in decline for the past thirty years, unemployment was less than 6% for most of that period.[379] Therefore, she insists that manufacturing should not receive special treatment when other industries offer just as much promise for job creation.[380] The Bureau of Labor Statistics estimates that, by far, the bulk of job growth in the years ahead will occur in service industries and that these jobs will include both high-and low-skilled workers.[381]

Finally, proponents of manufacturing incentives claim that spillovers from manufacturing are especially important. But–in sharp contrast to R&D—the economic evidence does not demonstrate that positive economic spillovers from manufacturing are any greater than those produced by other industries.[382]

The push for generous government tax incentives for domestic manufacturing seems to be grounded more in their political appeal and nostalgia than sound economics. If the goal is to create incentives for applied R&D or for employment of scientists and engineers, broad manufacturing incentives are poorly targeted. And if the goal is to stimulate employment or to promote economic growth, the revenue costs of a domestic manufacturing incentive would be better spent lowering income tax rates on businesses generally, rather than singling out particular business sectors for especially advantageous treatment.

In his 2011 book, *The Next Convergence*, Michael Spence concludes that a targeted manufacturing incentive could actually be detrimental to the United States' potential for sustained economic growth.[383] Spence points out that countries should consider their comparative advantages in determining what to produce and export, and he observes that countries' comparative advantages shift over time.[384] For example, he notes that in the 1970s Hong Kong, Singapore, Taiwan, and South Korea were major exporters of apparel and shoes. In the 1980s, as wages in those countries rose, those manufacturing markets moved to other locations. The shift was a natural response to rising wages—a desirable phenomenon—and attempts to resist the shift in comparative advantages by, for example, depressing local wages would have been seriously misguided.[385] Instead, these nations moved into more complex industries. According to Spence, adaptation to such structural change is crucial to long-term growth. He describes resistance to such change by subsidizing particular sectors that are losing their comparative advantage as akin to "throwing sand in the gears of an otherwise well-oiled machine."[386]

B. Efforts to Limit IP Income-Shifting

Both the U.K. patent box initiative and the more limited patent box proposal offered by House Ways and Means Committee Chairman Camp would combine their proposed tax reductions for IP income with provisions intended to restrict MNEs' ability to shift IP income to low- or zero-tax jurisdictions.[387] These proposals, in effect, combine patent box incentives with efforts to limit IP income-shifting. In each of his budget proposals since taking office, President Obama has also advanced proposals to limit IP income-shifting.[388] His *Framework* suggests a minimum tax on U.S. MNEs' worldwide income, along with proposals for increased R&D and manufacturing incentives.[389]

As described earlier, neither the systems of taxing domestic corporate residents on their worldwide income with a credit for foreign income taxes nor the rules for allocating MNE income to the country of its source have proved effective barriers to MNEs shifting IP income to low-or zero-tax jurisdictions. The United Kingdom and Chairman Camp have both advanced their (quite different) proposals to reduce income-shifting in the broader context of moving from a foreign tax credit system to a system that exempts 90%-95% of dividends paid from foreign subsidiaries to their domestic parents—a system that basically allocates international taxation of business income to the source country.[390] President Obama, on the other hand, offered his proposals to limit income-shifting in the context of retaining the existing foreign tax credit system.

The Camp and Obama proposals to restrict shifting of IP income, like many other suggestions in the tax policy literature,[391] are varied and complex. Analyzing them in detail would fill another lengthy article, a task eschewed here. However, since these proposals have been regarded as necessary companions to the kinds of incentives for technological innovation explored here, this Article will offer some general observations about their scope, their structure, and the major differences among them.

Proposals to limit IP income-shifting generally fall into one or more of five categories: (1) strengthening transfer pricing rules; (2) using a formula based on one or more of an MNE's domestic sales, wages, or property to allocate its income among jurisdictions; (3) revising the source rules; (4) expanding rules requiring immediate taxation of certain categories of mobile income earned by foreign subsidiaries (CFC rules); and (5) imposing some minimum tax on MNEs' domestic, foreign, or worldwide income.

The first two of these, transfer pricing improvements and formulary apportionment, can be viewed as efforts to redress gaps in source-based taxation. This includes efforts to redefine as U.S.-sourced income that which is appropriately attributable to activities within the United States. Since every nation, including the United States, claims jurisdiction to tax income earned within its borders,[392] if a country tightens its transfer pricing rules or imposes formulary apportionment, such changes would apply to all MNEs, whether domestic or foreign, doing business within the country. So would the third alternative, an explicit revision of the source rules. In contrast, the fourth approach, expanding the scope of CFC income to tax income earned abroad currently at domestic rates, can be viewed as an expansion of residence-based taxation because such a change would only affect national MNEs, even if aimed, for example, at income shifted from the United States to a low-tax foreign jurisdiction.

The final approach, enacting a minimum tax, which is a new idea, might be structured either as a way of redefining income that the United States regards as appropriately sourced to the United States, in which case it might apply to both U.S. and foreign MNEs, or like an expansion of CFC rules, in which case it might be limited to U.S. MNEs. President Obama's minimum tax proposal explicitly takes the latter approach.[393]

Filling the gaps in transfer pricing rules is far easier said than done. In 1986, Congress amended the U.S. transfer pricing statute to allow the Treasury and the IRS to allocate prices in a manner "commensurate with . . . income."[394] Subsequently, large penalties were added to the tax code in an effort to bolster the transfer pricing requirements.[395] Beginning in the early 1990s and since, the Treasury has issued hundreds of pages of regulations endeavoring to implement this broad grant of regulatory authority.[396] Similar efforts to improve transfer pricing rules have also been ongoing on a multilateral basis at the OECD, which issued revised transfer pricing guidelines in 1995 and 2010 and a discussion draft of proposed changes in 2012.[397] However, success remains elusive. The reason, of course, is that these rules continue to apply an "arms-length" pricing standard when, as has been described, MNEs shift the ownership and management of their IP–along with associated economic risks and rewards—among related companies to an extent and in a manner that they would never do with unrelated parties. This makes any search for a "comparable uncontrolled price" quixotic. The response has been increased efforts to produce rules that will provide an equitable and appropriate split of profits among related companies and of tax revenues among relevant nations. While these efforts, to be sure, are an improvement, multilateral agreement on how to determine the location or source of such profits—how to split profit—has proved controversial. As David Bradford and Hugh Ault pointed out long ago, international income has no particular source, even in principle:

> The idea that income has a locatable source seems to be taken for granted, but the source of income is not a well-defined economic idea. The [Schanz-Haig-Simons (SHS)] definition describes a quantity that is, in principle, measurable, whatever the practical problems may be (and they are substantial). The emphasis placed by tax reform advocates on the objective of taxing income "from whatever source" has obscured the fact that the SHS concept is not susceptible to characterization as to source at all. Income in this definition attaches to someone or something that consumes and that owns assets. Income does not come from some place, even though we may construct accounts to approximate it by keeping track of payments that have identifiable and perhaps locatable sources and destinations.[398]

Nevertheless, profit-split methods continue to evolve and offer some promise for ongoing improvement.[399]

As illustrated in Part IV, MNEs have been quite successful at exploiting gaps and differences among nations in their transfer pricing rules. The effort to find appropriate intercompany prices for IP or for assets embodying substantial proprietary IP has largely devolved into a contest among companies and governments over both the total level of taxes to be imposed and how those taxes will be divided among nations. No doubt gaps in our current transfer pricing rules might usefully be filled, and profit-split methods could be tightened and more widely applied.[400] However, given the failures of two decades of efforts, it is difficult to be optimistic that looking solely to improved transfer pricing rules as a solution to IP income-shifting will prove successful.

Concerned about the limitations of using transfer pricing restrictions to halt IP income-shifting, quite a few analysts have urged that nations should instead allocate MNE income according to a formula based on some combination of sales, payroll, and property, as is now done in U.S. states.[401] The European Commission has proposed a version of such formulary apportionment for dividing revenues among European nations in connection with its proposed Common Consolidated Corporate Tax Base.[402] There are both conceptual and practical disadvantages to such proposals, however.[403] The economist James Hines has found that such formulas do not serve well to measure the profits earned in a jurisdiction,[404] and Walter Hellerstein, the nation's leading legal expert on U.S. state income taxation, has pointed out many practical difficulties both in existing state law and in the European Commission's proposals.[405]

Importantly, including wages and physical capital in the formula creates incentives for shifting labor and capital to low-tax jurisdictions, directly contravening the goals of nations attempting to attract rather than repel jobs and physical capital.[406] This is why some proponents of formulary apportionment have urged that the formula apply based only on the amount of sales within the jurisdiction,[407] an option that has proven attractive to some U.S. states.[408] This single-sales-factor approach avoids an incentive for shifting jobs and capital abroad, and, while no panacea, it might prove appealing to countries with large markets, such as the United States, and perhaps also China, India, Russia, and Brazil. A sales-based formula also seems better targeted to address the specific concerns with IP-shifting than a formula that also includes property and payroll. Recall that for its study of IP income-shifting techniques, the JCT selected companies that had a much higher ratio of U.S. sales to worldwide sales than of U.S. income to worldwide income.[409] Even with a formula or other income-shifting limitation based on domestic sales, some IP income-shifting techniques, such as shifting the location of wholesale versus retail sales, would remain.[410] However, these gambits would be easier to police and substantially less harmful economically than the techniques now being used or that might occur under a formula that includes payroll and property.

However, if the United States—or any other large country, for that matter–were to move unilaterally to a sales-only formula to apportion income, absent any international consensus ratifying such a move, current bilateral and multilateral arrangements might come unglued. The OECD has remained firm in its commitment to separate entity accounting, coupled with enhanced rules for and greater policing of transfer pricing, so the disruptions in the current international order that might be caused by a move to sales-only formulary apportionment might stimulate retaliatory actions by other nations. In addition, double taxation could also result from countries using different methods to allocate income. The numerous U.S. bilateral income tax treaties rely on intercompany pricing procedures and on bilateral agreements to reduce the potential for double taxation. The potential consequences– especially the increased potential for taxation of the same income by more than one country—would almost certainly produce resistance among U.S. MNEs to such a unilateral move by the United States.

A third alternative is to revise the rules that currently determine the "source" of income from IP. Put most simply, the source rules are used to fix the geographic location of income. It is frequently said that the country to which income is sourced has the first claim to tax business income, but if payments are deductible in computing net income of the source jurisdiction, as royalties are, taxation is shifted to the country where the royalties are received.[411] For the purposes of this Article, it is sufficient to note that services are sourced to the country where they are performed, so contract R&D will generally be deductible to the payor and includible in the income of the provider of the R&D services.[412] Royalties from the license of intangible property, such as patents, copyrights, or other IP, are sourced to the country where the IP is used.[413] If the IP is sold, rather than licensed, gains from the sale are sourced in one of two ways. If the sales proceeds are not contingent on the use of the IP, any gain in the sale is sourced based on the residence of the seller.[414] However, if the sales proceeds are contingent on the productivity, use, or disposition of the IP by the purchaser (for example, when the purchase price equals a specified percentage of gross profits), the source of the sales proceeds is the same as if the payments were royalties.[415] When transactions among related entities are involved, the differing source rules give taxpayers considerable flexibility about where income will be sourced, depending on how they structure their transactions.[416]

Although none of the current congressional proposals take this approach, the source rules might be revised to eliminate some of the current flexibility and to curtail opportunities for shifting IP income to low-or zero-tax countries. The question such proposals raise is whether IP income should be sourced to (1) the country where the R&D activities take place, (2) the country where the IP is exploited, (3) the country that grants legal protection to the IP, or (4) the country where ultimate consumption of the product created with the IP occurs. Choosing among these alternatives would surely be controversial, and achieving multilateral consensus would no doubt be difficult.

The disadvantages of three-factor formulary apportionment, plus the potential disruptions of unilaterally adopting a sales-only income apportionment formula or new source rules, along with the limited prospects of successfully addressing IP income-shifting through transfer pricing revisions, have led Chairman Camp and President Obama to propose addressing IP income-shifting by tightening U.S. CFC rules and imposing a U.S. minimum tax on foreign-source income, respectively.

Currently, CFC rules require that specified categories of income earned by foreign subsidiaries are taxed when earned to the domestic parent at the home country tax rate. The classic example is mobile passive income, such as interest or dividends.[417] Chairman Camp has proposed three options for tightening U.S. CFC rules to limit IP income- shifting. His first option ("option A") would add to the category of CFC income "excess returns" associated with IP transfers from the United States to a low-taxed foreign related entity.[418] The inclusion in U.S. income would apply only if the excess returns were not taxed abroad at an effective tax rate greater than 15%.[419] Excess returns are defined as the excess of gross income over 150% of the costs attributable to such income.[420] This option replicates a proposal advanced by President Obama in each of his annual budget proposals.[421]

Chairman Camp's second option ("option B") is modeled somewhat on a Japanese provision. It would tax at the U.S. rate income earned by a CFC that is not subject to a foreign tax rate of at least 10% and also is not derived from the CFC's conduct of an active business serving the market in the country where the CFC is organized.[422]

The third alternative offered by Chairman Camp ("option C") would combine current U.S. taxation of any CFC's foreign IP income taxed at a foreign effective tax rate less than 13.5% with a patent box at a 15% rate for all foreign intangible income of a domestic corporation (including royalties).[423] Under this option, IP income would be determined by applying the transfer pricing rules. Chairman Camp describes this alternative as combining "the carrot of an 'innovation box' and royalty relief with the 'stick' of a current . . . inclusion for intangibles-related income of CFCs in low-tax jurisdictions."[424]

Finally, President Obama's *Framework for Business Tax Reform* proposes that all income earned by subsidiaries of U.S. corporations operating abroad be subject to a minimum rate of tax.[425] In effect, the proposal would impose some minimum tax rate on all low-taxed CFC income. Although it is clear that this minimum tax would not be limited to IP income or to "excess returns," the *Framework* neither specifies the U.S. minimum tax rate, nor what would be considered a "low-tax" foreign jurisdiction. Instead, the *Framework* states only that the minimum tax "would be designed to balance the need to stop rewarding tax havens and to prevent a race to the bottom with the goal of keeping U.S. companies on a level playing field with competitors when engaged in activities which, by necessity, must occur in a foreign country."[426]

Even this brief description of these CFC and minimum tax proposals reveals their complexity and crucial variations in their potential coverage and impact. The proposals differ in the nature and scope of foreign-source income to be taxed currently by the United States and also diverge in the rates of U.S. income tax they would impose and the scope of entities whose income would be covered.

The most fundamental issue is determining what income will be covered. There are three dimensions on which the proposals vary: first, whether the income to be covered is linked to IP and, if so, how that link is defined; second, whether there is a different rule for sales or active business income earned abroad; and third, whether the U.S. tax turns on the rate of foreign tax and, if so, how.

As this Article has argued, determining how much income from the sales of a product is appropriately attributed to IP is hardly straightforward. The proposals that are limited to IP income (Camp's options A and C) differ in how that income will be defined. Like the new U.K. patent box described earlier,[427] Camp's option A (and President Obama's earlier budget proposals on which it is based) would, in effect, treat as IP income any income that reflects an "excess return."[428] The apparent assumption is that only "normal" returns result from manufacturing, distribution, advertising, and other sales activities. So, when greater returns occur, they are assumed to be due to IP, including not only patents but also other IP, such as trade secrets, know-how, trademarks, etc. Normal returns are defined by reference to a specified markup on costs. The size of the markup matters greatly. The Camp proposal, for example, exempts profits up to 50% of costs; the U.K. proposal, in contrast, treats profits in excess of 10% of costs as attributable to IP.[429] Thus, the former kicks in when profits are 150% of costs, the latter when they reach 110%.

This, of course, is a large difference that greatly affects the scope and bite of the proposals.

Chairman Camp's option C would rely on transfer pricing rules to distinguish IP income attributable to foreign versus U.S. sales. His option B makes no attempt to separate IP income from other income. Both Camp's option B and President Obama's minimum tax focus on low- taxed foreign income. Whenever foreign source CFC income is taxed below a specified threshold—generally in the 10% to 15% range–either the CFC rules (Camp) or the minimum tax (Obama) would apply. Chairman Camp's option C, on the other hand, would require the existence of both IP income (measured by excess returns) and a low effective foreign tax rate, which Camp defines as a rate below 15%.

Each of these options is designed to provide an exception from U.S. tax for income that is appropriately earned abroad. But the range of these exceptions varies significantly. Chairman Camp's options turn on the existence of either sales to foreigners or active business activities within the foreign jurisdiction. President Obama's *Framework* says it will exempt from the minimum tax "activities which, by necessity, must occur in a foreign country."[430] Hotel activities are the only example that spokesmen for the White House have offered since the *Framework* was released, but others no doubt would exist.

Proposals to expand coverage of the CFC rules would apply only to the income of foreign subsidiaries of U.S. MNEs. President Obama's *Framework* indicates that his minimum tax proposal is intended to have similar scope, but there is no reason in principle for a minimum tax to be so limited if it is intended to apply to any income characterized as having a U.S. source. Foreign MNEs may be just as adept as U.S. MNEs at shifting income to low- or zero-tax countries that otherwise would be taxed by the United States.[431] Tightening transfer pricing rules or formulary apportionment would apply to foreign MNEs as well as U.S. MNEs and to noncorporate businesses, such as partnerships. So might a minimum tax.

IP income-shifting that erodes the domestic tax base is especially detrimental to the national interest and should be a priority for redress by tightening anti-abuse rules. If one accepts the proposition that the fundamental goal of a nation's international tax policy is to advance its national interests principally by improving the standards of living of its citizens and residents,[432] the following observations should help in choosing among the alternatives:

From the U.S. point of view, the greatest concern is shifting income out of the United States—so-called base erosion—not shifting income that would be taxed in a foreign country to a zero-tax jurisdiction. Shifting income from the United States to a tax haven costs the United States tax revenue, which presumably would otherwise benefit U.S. citizens and residents.[433] When a U.S. MNE shifts income from a foreign country to a haven, it is the foreign treasury that loses the revenue, and the tax savings may, in substantial part, accrue to the benefit of U.S. shareholders, who typically constitute the largest group of owners of a U.S. MNE. So foreign-to-foreign income-shifting should principally be the concern of the foreign government from which the income is being shifted. The recent attention to this phenomenon in Europe suggests that foreign governments have become aware of the problem.[434] If, however, the ability to achieve very low effective tax rates on foreign income causes MNEs to locate real assets, such as plants and equipment, and jobs abroad rather than in the United States, then foreign-to-foreign shifting should concern the United States. Also, if other countries permit foreign-to-foreign income-shifting and the United States does not, U.S. MNEs may suffer a competitive disadvantage versus foreign MNEs, and this might stimulate inversions by U.S. MNEs or acquisitions of U.S. MNEs by foreign MNEs. In any event, the greatest abuses occur when IP is developed in the United States from R&D subsidized by the U.S. Government and utilized in products that are sold and consumed in the United States. While this most often occurs with U.S. MNEs, such as high-tech and pharmaceutical companies, it may also occur with foreign MNEs.

If the United States were to enact a minimum tax, formulary apportionment, or a transfer pricing change limited to U.S. MNEs that is substantially different from and more inclusive than those typical in other countries, this will introduce new incentives for inversions by U.S. MNEs.[435] It may also advantage foreign MNEs over U.S. MNEs in acquisitions of U.S. businesses. This prospect seems to weigh in favor of a minimum tax, formulary apportionment, or a transfer pricing change rather than a tightening of CFC rules, which would apply only to U.S. MNEs.

Using a low foreign income tax rate as the sole criterion for applying U.S. CFC or minimum tax rules may induce other countries to raise their income taxes to the threshold level or encourage U.S. MNEs to incur higher foreign effective income tax rates to meet the tax-rate threshold whenever the applicable U.S. tax rate is greater than the threshold rate, perhaps finding other benefits to offset the increased taxes. These kinds of responses might provide little benefit to the United States. While such an approach might be effective, for example, in removing incentives for U.S. MNEs to strip income from Ireland (with its 12.5% rate) to Bermuda or the

Cayman Islands (with their zero rates), it would fail to address concerns with stripping income from the United States.

Because of the difficulties of identifying income attributable to IP, any effort to calculate and apply a special regime only to IP income creates measurement and definitional difficulties that are fraught with both policy risks and opportunities for political mischief.

On balance, then, it seems worthwhile to begin by endeavoring to limit income-shifting in those circumstances where the staff of the JCT focused its transfer pricing efforts—instances where the U.S. share of a company's sales is a multiple of the U.S. share of its profits.[436] Treasury economist Harry Grubert, in an analysis of 1996-2004 tax returns of 754 large, nonfinancial, U.S.-based MNEs, also found that the existence of low foreign income tax rates, along with lawful opportunities to shift income to low-tax jurisdictions, has led to a substantial increase in the foreign share of income of these U.S. MNEs but has had no significant impact on the foreign share of their sales.[437]

In the first instance, this raises the question whether to revise the way we measure income from U.S. sales of goods and services. As described earlier, gain from the sale of personal property is sourced to the residence of the seller,[438] royalties are sourced to the country where the IP is used,[439] and services are sourced to the country where the services are performed.[440] This means that royalties paid by a company in the United States to a foreign entity for the rights to manufacture abroad and then sell products in the United States are treated as foreign, not U.S., source income, even if the IP was produced in the United States. Aligning the source of income more closely with the location of sales suggests that income from royalties, sales of personal property, and services might more consistently be sourced to the country where the product is sold and where services are delivered.[441] Consideration should also be given to sourcing royalties based on where the IP is produced to better align the location of R&D activities with the taxation of the income they yield.

If looking more closely at U.S. sales as a basis for determining income subject to U.S. tax, rather than directly revising the source rules, were accepted, the United States might measure U.S. income by reference to U.S.

sales. In effect, the United States would be dividing a MNE's sales revenue between the U.S. domestic market and foreign markets. Expenses, in turn, might be attributed—with the exception of the costs of domestic R&D—to foreign and domestic sales.[442] Worldwide R&D expenses (and royalties paid to unrelated third parties) could then be allocated based on the ratios of foreign and domestic sales to worldwide sales. Alternatively, if one wanted to provide a benefit for U.S. R&D, all U.S. R&D might be allowed to offset U.S. sales with only foreign R&D allocated between domestic and foreign sales. The effort here would be to match the costs attributable to U.S. sales with those sales. This calculation might be used either to determine a profit split for transfer pricing purposes or as the income base for a minimum tax. In the context of an expansion of CFC rules, as Congressman Camp has suggested, the above calculations would be required for each CFC, with the amount of net income attributed to the U.S. sales this way included in the CFC's income subject to current taxation.

The current source rules were developed long ago in a very different global economic environment, and they could undoubtedly benefit from updating. However, they are widely followed throughout the industrial world, and a unilateral U.S. modification may not be practical, although such a change might be acceptable if it were to occur in the context of a minimum tax with a relatively low corporate rate. Also, if such a change were to occur in the context of obtaining multilateral agreement on more flexible methods of splitting profits for transfer pricing, that change might more likely produce a multilateral consensus. Each of these offers the potential to ground transfer pricing, CFC inclusions, or a minimum tax on the MNE's U.S. sales.

As stated earlier, weaknesses in the current rules have led a number of analysts to call for a sales-based formulary apportionment of income.[443] Alternatively, transfer pricing rules might be modified to reallocate profits to the United States when the domestic share of an MNE's sales exceeds the domestic share of its profits. Likewise, a new CFC income inclusion or minimum tax could similarly be based on the domestic share of an MNE's sales. Unlike expansion of the CFC rules, both a transfer pricing and minimum tax approach could be applied to foreign-based MNEs as well as to U.S. MNEs.

The most straightforward way to accomplish this would be to require that the MNE's ratio of U.S. income to worldwide income must not be less than its ratio of U.S. sales to worldwide sales. This would require consistent ways of measuring income and locating the place of sales, which is, to be sure, easier said than done.[444] One disadvantage of such an approach is that intermediate sales from businesses to businesses would be taxed, which produces some cascading of the tax. These kinds of calculations of U.S. income for CFC, transfer pricing (profit-splits), or minimum tax purposes are similar to sales-only formulas that some U.S. states apply to determine their share of multistate income. They raise the problems of multilateral coordination described above, but the potential dislocations from a unilateral U.S. action might be substantially lower in the context of a minimum tax imposed at a rate substantially lower than the U.S. corporate rate.

Basing the U.S. tax on the amount of U.S. sales of goods and services also resembles the destination-based allocation of revenues typical of consumption taxes, such as the value-added taxes ("VATs") used in all OECD countries except the United States, and around the world.[445] Such consumption taxes are imposed in the country where consumption occurs, not where production takes place.

One of the authors has suggested elsewhere that the United States enact a VAT and use a portion of its revenues to lower the U.S. corporate income tax rate to 15%.[446] This would have the salutary economic effect of shifting U.S. tax burdens from investment to consumption and from the location of production to where consumption occurs. The current U.S. corporate income tax rate of 35% is the highest in the OECD,[447] and that does not serve the country well—the greater the difference between the U.S. and foreign corporate tax rates, the greater the incentives for shifting income abroad. Obviously, a U.S. corporate tax rate of 15% would dramatically reduce the incentives for shifting income away from the United States. It would also make the United States a more attractive location for investment. So, a significantly lower corporate tax rate should be an important goal for U.S. tax policy. Enacting a VAT, however, has so far proven politically difficult.[448] This has resulted in calls for VAT variations that look more like the current income tax.[449] These are typically based on business accounts, rather than directly on sales, and generally are variations on subtraction-method VATs.[450]

Some commentators have advanced minimum tax proposals for the United States that resemble such consumption taxes. Roseanne Altshuler and Harry Grubert, for example, have proposed a 15% minimum tax (determined country-by-country) on foreign income with a deduction for expensing of real investments abroad.[451] They indicate that this kind of minimum tax would put no U.S. tax burden on normal returns and advance this proposal as a way of taxing U.S. MNEs' excess returns abroad. Many economists regard the presence of excess returns in low-tax countries, which cannot be attributed to location-specific assets, such as natural resources, as evidence of IP income-shifting.[452] By exempting the "normal return" on investments abroad, this proposal resembles a consumption-type tax, but it is based on the MNE's residence rather than the destination of sales.[453]

In an even more dramatic shift toward consumption-and destination-based taxation, Alan Auerbach has proposed substituting what he calls a "Modern Corporate Tax"—in essence, a destination-based consumption tax with wages taxed only at the individual level—for the U.S. corporate income tax.[454] Auerbach offers the following example of how his tax base would be calculated and how it would differ from current law:[455]

> [The following] lists an industrial company's annual revenues, expenses, and purchases from domestic operations (first column); its tax base under the current tax system (second column); and its tax base under the proposed system (third column).

Hypothetical Nonfinancial Company (figures in millions of dollars)

		Tax base under currnet system	Tax base under new system
Sales Revenues			
Domestic	1,500	1,500	1,500
Export	300	300	

		Tax base under currnet system	Tax base under new system
Expenses			
Labor Costs	750	(750)	(750)
Costs of goods sold			
Domestic	100	(100)	(100)
Imported	150	(150)	
Interest	250	(250)	(250)
Depreciation	250	(250)	
Capital purchases			
Domestic	150		(150)
Imported	150		
Inventory investment	50		(50)
Borrowing	200		200
Principal repayment	100		(100)
Tax Base		300	300

This proposal provides different treatment based not only on the location of production but also on where borrowing occurs. Foreign borrowing and lending is omitted from the tax base, while domestic borrowing and lending is included. The potential for distortions based on the movement of financial flows complicates tax planning and may create opportunities for tax arbitrage.[456]

Two other related alternatives should be considered. One possibility is a destination-based, consumption-type minimum tax with a deduction for wages, which, unlike Auerbach's version, would omit financial flows from all calculations. [457] The U.S. tax base for minimum tax purposes would then be calculated as follows. Export sales would be excluded from revenues, but imported inputs would not be deductible. Depreciation deductions would be eliminated, but deductions for new investment in fixed capital and inventories purchased from domestic vendors would be allowed:[458]

Sales Revenues		
Domestic	1,500	1,500

Export	300	1,500
Expenses		
Labor Costs	(750)	(750)
Costs of goods sold		
Domestic	100	(100)
Imported	150	
Interest	250	
Depreciation	250	(250)
Capital purchases		
Domestic	150	(150)
Imported	150	
Inventory investment	50	
Borrowing	200	
Principal repayment	100	
Tax Base		200

A third alternative would be to treat purchases of goods and services on a destination basis, as above, but to include all financial flows on a cash-flow basis, without regard to whether they are domestic or foreign.[459] Each of the three alternatives would tax sales in the United States, whether made by a foreign or U.S. MNE, on a destination basis.[460] They differ, however, in their treatment of lending and borrowing, with the first and third varying in their treatment of cross-border borrowing.[461] Assessing their advantages and disadvantages is beyond the scope of this Article. The important point here is that any of the three offers substantial advantages as a minimum tax backup to the current system and has considerable potential to redress the techniques for shifting IP income with that from the United States described in Part IV.

To be sure, imposing a U.S. minimum tax based on a destination-based subtraction-method VAT with a business deduction for the costs of labor would be a more radical departure from existing law than any of the other suggestions this Article has discussed.[462] Nevertheless—in the absence of a U.S. VAT—a minimum tax or a transfer pricing regime, based either on such an approach or on equalizing the ratio of U.S. income to worldwide income with that of U.S. sales to worldwide sales merits serious consideration, especially if the revenues produced were used to reduce the U.S. corporate tax rate.

The crucial point is that all of the alternatives this Article has suggested—revising transfer-pricing rules, adopting formulary apportionment, or enacting a destination-based minimum tax—concentrate on achieving greater alignment between U.S. sales and U.S. taxable income. This is the direction U.S. international tax policy should now take.

One additional point warrants discussion. Australia has surprisingly loose CFC rules and income-shifting limitations, even though it is a small, open economy with a 30% corporate tax rate (to be reduced to 29% in 2013) and a dividend exemption system for foreign-source business income. Australia's lack of concern with income-shifting may be due to its integrated system of corporate taxation.[463] When a corporation pays dividends out of income that has been subject to Australian income tax, the shareholder receives a credit for the corporate tax paid. In essence, because these credits are refundable to Australian residents, this regime converts the Australian corporate tax into the equivalent of a withholding tax for dividends paid to individual shareholders resident in Australia ("franked dividends").[464] Because Australian companies want to pay tax- free or low-taxed dividends to their shareholders, they have much less incentive than U.S. companies to erode their domestic tax base.[465] Doing so would reduce their ability to pay franked dividends to residents and may require additional withholding taxes when dividends are paid to foreign shareholders.[466]

When corporate integration—albeit through a dividend exemption, rather than an imputation credit system such as Australia's—was proposed by the U.S. Treasury, the Treasury proposed that the exemption be limited to dividends paid out of profits that had been subject to U.S. corporate taxes.[467] But, instead, Congress enacted a lower rate on dividends that applies without requiring that any income tax be paid at the corporate level.[468]

Imposing a requirement that the lower rate apply only if U.S. corporate taxes are paid might substantially relieve income-shifting incentives for U.S. MNEs. For example, if the corporate rate were 25%, as Congressman Camp has proposed, and the top individual rate were 39.6%, treating the corporate tax as a withholding tax would produce a top tax rate for individuals on dividends equal to 14.6%, which is very close to the 15% top rate of pre-2013 law. However, the scope of the tax relief for dividends would be narrowed to situations where the corporation actually pays the U.S. corporate tax, a much more focused benefit than under current law.

In the Australian context, Richard Vann has suggested that the country's integration system functions much like a minimum tax, limiting Australian MNEs' incentives and tendencies to engage in tax reduction efforts.[469] This indirect approach to limiting IP income-shifting may well be worth considering.

In sum, efforts to date to limit MNEs' ability to shift IP income to low- or zero-tax jurisdictions have been unavailing. Offering incentives to develop valuable IP without endeavoring to tax the income it produces is a mistake. The United States is not a small country with the need to attract IP income; it is a large, innovative country with a large domestic market. As the alternative proposals of Congressman Camp and the minimum tax suggested by President Obama imply, fundamental change now seems essential. Unlike the proposals they have offered, however, this Article urges forging a much closer link between a company's level of U.S. sales and its minimum U.S. taxable income. Anything less seems unlikely to succeed.

Conclusion

This Article has described income tax rules and proposals providing incentives both here and abroad for R&D expenditures, innovation, and manufacturing. The proposals for a patent box incentive in the United States seem largely a response to the widespread adoption of such incentives in Europe. However, European member states are not an apt model for U.S. tax policy; they have been severely constrained by interpretations of the EU treaties. The United States does not face such constraints. So, if a patent box were adopted by the United States, it should apply only to IP that was created domestically. However, based on extensive examination of the economic evidence, this Article concludes that, at most, only R&D incentives are justified. An R&D incentive that is more cost-effective than current law is desirable. Broad incentives for manufacturing fail to pass muster as a means to stimulate R&D or create jobs. Given the great variations among industries, targeted incentives to industries where the prospects for gains are greatest would be more cost-effective, but they would exacerbate the risks of political misjudgments or favoritism. This Article has also described techniques that U.S. MNEs currently use to shift IP income to low-or zero-tax jurisdictions and summarized the current proposals for limiting such opportunities. In that connection, the Article offers new proposals for change that emphasize imposing U.S. tax based on U.S. sales. These kinds of proposals merit serious consideration when the U.S. Congress takes up business reform.

Chapter 5

A Multilateral Solution for the Income Tax Treatment of Interest Expenses

1. Introduction

Although there has been some discussion in recent years of the treatment of borrowing and its attendant interest expenses, the tax treatment of this expense has generally received less analysis than that of business income. Some recent developments, however—including greater taxpayer sophistication in structuring and locating international financing arrangements, increased government concerns with the role of debt in sophisticated tax avoidance techniques, and disruption by decisions of the European Court of Justice (ECJ) of a host of Member States' regimes for limiting interest deductions—have stimulated new laws and policy controversies concerning the international tax treatment of interest expenses. Recent developments make clear the complexity, the incoherence and the futility of countries acting independently to limit interest deductions.[1] They also raise fundamental questions about the proper treatment of interest expenses and whether other expenses, such as for headquarters costs or research and development (R&D), should raise similar concerns.

National rules are in flux regarding the financing of both inbound and outbound transactions. When outbound investments are financed by debt, the question arises whether the fact that the foreign-source income will be deferred or taxed at lower rates justifies the home country limiting the deductibility of interest expenses. In the United States and the United Kingdom, for example, attention has recently focused on whether to allocate and disallow interest deductions connected to foreign-source income under a dividend exemption system.[2] Also in the U.S., House Ways and Means Committee Chairman Charles Rangel (Democrat, New York) has introduced legislation under the U.S. foreign tax credit system that would allocate and postpone interest deductions on outbound investments until dividends are repatriated.[3]

The EU Member States have recently been revising their treatment of interest deductions with special concern for the taxation of inbound investments. As in the outbound context, the critical questions stem from government concerns about the potential for a disappearing corporate tax base. In Europe, the greatest attention has focused on the treatment of "fat" or "thin" capitalization rules (known in the U.S. as "earnings stripping rules"). Reconsideration of Member States' limitations on interest deductions in this context was required by the ECJ in its 2002 decision in the *Lankhorst-Hohorst* case (and subsequent decisions), which struck down Germany's thin capitalization rules as applied to interest paid to companies from other Member States as a violation of the freedom of establishment guarantee of the EC Treaty.[4] These ECJ decisions require equal treatment of borrowing by domestic and non-domestic companies that are from the EU Member States. In response, Germany now limits interest deductibility to a specified percentage (30%) of "earnings before interest, tax, depreciation and amortization" (EBITDA) without regard to whether the borrowing is from a foreign lender or a related company. Similar rules are being enacted or considered by certain other EU Member States.

In November 2007, the U.S. Treasury issued a report on earnings stripping in response to a congressional mandate requiring such a study as part of legislation dealing with corporate inversions from U.S.-headquartered to foreign-headquartered companies. In Canada, questions about limitations on interest deductions have arisen in the context of a broad review of international tax policy. And in Belgium, for example, a notional interest deduction based on a company's net assets was enacted in 2006 in an effort to reduce the advantages for debt over equity financing. In addition to the foregoing specific rules, interest deductions may also be disallowed under general anti-abuse rules or transfer pricing regimes.

Some countries levy withholding taxes on cross-border payments of interest, although most do not. Where applicable, the withholding tax rates vary from about 12.5% (Italy) to nearly 42% (Mexico), but are often reduced or eliminated by bilateral tax treaties. (The OECD Model Tax Convention sets a maximum rate of 10%.) These treaty reductions are, in turn, restricted to residents of the treaty country by limitation on benefits clauses in the treaties. Obviously, a sufficiently high withholding tax on payments of interest can substitute for disallowing interest deductions.

As this very brief overview implies, the treatment of cross-border interest payments is now one of the most complex aspects of income tax law. Rules differ among countries and contexts. As a result of the decisions of the ECJ, some uncertainty remains in Europe about what rules are permissible. The subject is further complicated by different countries' varying approaches to distinguishing interest payments from dividends. Moreover, because money is fungible, it is difficult in both theory and practice to know the "purpose" of specific borrowing. Nevertheless, many countries attempt to "trace" borrowed funds to their use, creating opportunities for creative tax planning and inducing inevitable disputes between taxpayers and tax collectors.

These disparities in law and practice create opportunities for either double or zero taxation. Since taxpayers generally have great control over the location of their borrowing, there is considerably greater risk of the latter.

Heretofore, in both the literature and policymaking, the question of the proper treatment of interest expenses has generally been looked at from the perspective of either inbound or outbound investment and with the view that nations are either debtors or creditors, not both. As a result, the issues of residence countries' limitations on interest deductions on borrowing to finance low-taxed, exempt or deferred foreign-source income, on the one hand, and of source countries' restrictions on interest deductions intended to limit companies' ability to strip income from a higher-tax to a lower-tax country, on the other, have generally been treated as separate issues. Each of these issues has been discussed in the literature, but there has been no real effort to show how they relate. A fundamental contribution of this article is to demonstrate their linkage and to call for a multilateral solution that would address both of these problems.

I shall use the following simple and stylized example to illustrate the fundamental issues and to show how they are connected. At the outset, the example assumes that the purpose of the taxpayer's borrowing is known; I shall deal subsequently with this oversimplification.

2. A Simple Example to Illustrate the Issues

Assume three countries: *H* – with a corporate income tax rate of 35%, *M* – with a 25% rate, and *L* – with a 15% rate. *H* is a high corporate tax rate country, such as the U.S. or Japan; *M*, like most of western Europe, has a corporate tax rate a bit below the OECD average; and *L*, like China and Ireland for example, has a low corporate tax rate. For simplicity of exposition, *H* is assumed to want to tax only the domestic-source income of both its residents and non-residents, and it therefore exempts foreign-source dividends.[8] The policy choice for *H* is (1) allowing interest deductions in full whenever borrowing occurs in *H* without regard to where the investment it finances occurs, or (2) disallowing interest deductions when borrowing is determined to be used for investing abroad. Thus, to the policymakers of *H*, the question is whether to disallow interest deductions when interest is incurred to finance exempt (or low-taxed) income. For reasons that will be made clear subsequently, an interest disallowance regime should disallow interest deductions only when the company's borrowing is disproportionately greater in *H* than elsewhere based on an allocation of interest expenses that compares the ratio of the company's *H* borrowing to *H* assets with the ratio of its worldwide borrowing to worldwide assets.

Take a simple case where an *H* resident company borrows 100 in *H* to finance an investment of 100 in *L*. Assume that the interest expense is 10 and the income from the *L* investment is 15. If the interest expense were deducted against the *L* income, the net income from the *L* investment would be 5, which at the 15% *L* rate would yield an *L* income tax of 0.75 and after-tax income of 4.25 to the *H* company. There would be no domestic income or deduction in *H* and no *H* tax.

If borrowing could be traced to its use, this seems a plausible answer. But, because money is fungible, such tracing is not feasible in practice (despite the commonplace efforts to do so). So it seems reasonable to conclude that the company borrowed in order to keep all of its worldwide assets (rather than selling one or more assets to make the investment in *L*) and to avoid issuing new equity. This explains why *H* should treat borrowing as occurring proportionately to the *H* company's worldwide assets.[9]

If, however, *H* has no interest disallowance rule and allows the 10 of interest to be deducted in full against other income that would otherwise be taxed by *H* at its 35% rate, this would save the company 3.50 in *H* income taxes. The 15 of income in *L* would result in an *L* income tax of 2.25. The *H* company would have earned 6.25 after tax on an investment yielding just 5 before tax—implying not just zero taxation of the *L* income, but in fact a negative rate of taxation, a subsidy for this investment. From the point of view of *H*, this investment would have cost it 3.50 in foregone revenue, 1.25 of which would go to the *H* company and 2.25 of which would go to the treasury of *L*.[10] Perhaps some argument (presumably on competitiveness grounds) can be made for *H* subsidizing this investment by the *H* company, but what argument is there in a case such as this for transferring revenues from *H*'s treasury to the treasury of *L* simply because the company chose to locate its borrowing for this investment in *H*? If *H* is revenue constrained, the 3.50 of revenue lost on this investment must be made up from somewhere else, and important economic and distributional consequences will turn on who and what is taxed.

Moreover, at its 15% tax rate, the government of *L* should get only 0.75 in income taxes on an investment yielding a pre-tax profit of 5, rather than the 2.25 it did receive—an amount equivalent to levying a 45% tax on the company's before-tax profits. Under current arrangements, however, *L* will allow no deduction for interest expenses when the borrowing takes place in *H*, so the government of *L* might get 2.25 in taxes whether *H* allows the interest deduction or not. But the consequences will be very different depending on whether that money comes from the *H* company or from other *H* taxpayers. If *H* disallows the entire interest deduction in this case and *L* does not allow any deduction because the borrowing occurred in *H*, *H* will collect its 35% tax on the company's domestic income and, as indicated above, *L*'s income tax of 2.25 would produce a tax rate of 45% on this investment—a rate higher than that in either of these countries. In other words, there would be a significant element of double taxation.

The *H* company, of course, could avoid this double tax by, for example, locating the borrowing in *L* rather than *H*. And if each country is to tax the net domestic income earned there, the interest deduction should be allowed by *L*, not *H*.

Internation equity also supports this result. In this example, the source country is given not only the first bite at taxing the active business income earned there, but the sole claim on taxing such income. Given the priority of source countries on the asset side, why should the residence country also be required to lose revenue on the liability side? The source country, by not allowing deduction of the interest, is the cause of the double tax. Why should it be the residence country's responsibility to undo that result—especially when the residence country is not even making a residual claim to tax the foreign income?

For an important variation on this basic example, assume now that *M*, with its income tax rate of 25%, has no interest disallowance rule. If the *H* company also has income and assets located in *M*, it might choose to borrow in *M* instead of *H* or *L* and deduct the 10 of interest against income that *M* would otherwise tax. In that case, the *H* company would save 2.50 of tax in *M* and pay income tax to *L* of 2.25 for an after-tax return of 5.25 on an investment yielding 5 before tax—again earning a return that is higher after tax than before tax. In this case, however, the 0.25 subsidy to the *H* company and the 2.25 transfer to the treasury of *L* would come from the taxpayers of *M* rather than *H*.

The policymakers of the *M* government would view this transaction as a problem of earnings stripping (or thin capitalization) by the *H* company. Thus, economically similar transactions will fit into different traditional analytic boxes depending on which country is examining the transaction and where the borrowing takes place.

Here again, if the borrowing company were resident in *M*, it is perhaps conceivable that some argument or empirical claim could be advanced for this treatment (as before, no doubt grounded in the competitive advantages to *M*'s residents of a resident company making this investment[11]), but it seems impossible to fashion an argument that this transfer from the treasury of *M* to both the *H* company and *L*'s treasury makes any sense at all as a deliberate policy choice of *M*. Of course, if *M* is an EU Member State, the decisions of the ECJ in *Lankhorst-Hohorst* and subsequent cases might not allow it to treat an *H* company any differently than an *M* company.[12] And it is also possible that the non-discrimination clause of *M*'s bilateral tax treaties might foreclose it from making such a distinction.[13]

To complete the analysis, it is worth noting that an *M* company contemplating a debt-financed investment in *L* would have an incentive to do its borrowing in *H* (if it had assets and income there) so that its interest deduction would offset income that would otherwise be taxed at *H*'s higher 35% rate. Thus, *H* will also have earnings stripping (or thin capitalization) problems to deal with.

3. How Interest Expenses Should Be Allocated

3.1 A word about source

It is fundamental that, except in the context of a system of current taxation of worldwide income with an unlimited foreign tax credit—a system that no country now has, ever has had, or is likely ever to have—it is essential for each nation to distinguish between domestic-source income and foreign-source income. The consequences of this distinction vary depending on a country's tax rate and its system for avoiding double taxation. In the U.S. foreign tax credit system, for example, the distinction between foreign-source and domestic-source income is important principally for determining the limitation on foreign tax credits; in an exemption system, it is important for measuring taxable versus exempt income.

But, as is well known, the "source" of income is not well grounded economically, nor is it conceptually straightforward.[14] In many instances (not discussed here), archaic rules and distinctions prevail.[15] Moreover, the current rules often stem from political decisions and compromises made scores of years ago when capital was far less mobile. The sourcing of interest, for example, was a contentious decision made in the 1920s during the initial formulation of international agreements for relieving double taxation.[16] Since both net foreign-source and domestic-source income must be measured, however, it is necessary to source both income and deductions, even if the current sourcing rules seem arbitrary and archaic.

3.2 The effect of different rules in different countries

As the foregoing example illustrates and the empirical economics literature amply demonstrates, different tax rates in different countries create incentives for companies both in choosing where to locate real investments and in shifting income and deductions around the world.[17] And, as the example above illustrates, when countries differ in their rules for determining the source of a particular kind of income, both double taxation and zero (or even negative) taxation can occur. U.S. multinationals frequently complain, for example, about the double taxation that occurs because the U.S. allocates and disallows interest (for foreign tax credit limitation purposes) while other countries do not allow deduction of the interest disallowed by the U.S. They stifle such complaints, however, when in other contexts the lack of harmonization allows them to avoid taxation in any country.[18] In the absence of multilateral agreement, these difficulties, opportunities and issues will persist.

As a result, it is treacherous to evaluate companies' claims of competitive disadvantage based on pairwise distinctions of specific rules. To know whether a company headquartered in one country is advantaged or disadvantaged compared to another company headquartered elsewhere, one would have to compare the totality of consequences of similar investments. In the literature, this typically occurs only through efforts to measure the overall effective tax rates. These exercises typically simply assume a certain proportion of debt and equity finance, and therefore do not address the issues I am addressing here, in particular, the location of borrowing. In any event, piecemeal policy-by-policy comparisons should be taken with a grain of salt; a disadvantage in one aspect of tax policy may be compensated for by an advantage elsewhere. Taxpayers obviously have incentives to highlight their disadvantages rather than their advantages.

3.3. The particular difficulty of tracing interest deductions to the income the borrowing finances

Given the fungibility of money, knowing the purpose of borrowing is an impossible quest. Nevertheless, even for purely domestic investments, the U.S. tax law, for example, distinguishes among categories of personal interest, investment interest and a wide variety of business interest costs. The U.S. has essentially been undaunted by the folly of attempting to trace borrowed money to its use. So have many other countries. This is one reason why the tax provisions governing interest deductions, which frequently condition the deductibility of interest on the purpose of the indebtedness, are now among the most complex in the income tax. These complexities, and the controversies about them, often occur, as in the instant context, because of the tax-favoured treatment of assets financed with borrowed funds.

In the context of cross-border investments, beginning with the regulations issued in 1977, the U.S. generally accepted the fact that money is fungible and apportioned the interest expense of U.S. corporate entities for foreign tax credit purposes according either to the (book) value of assets or to gross income.[19] The assets approach was most widely used; thus, interest deductions (for foreign tax credit limitation purposes only) were generally computed using the following (simplified) formula: allowable U.S. interest expense equals worldwide interest expense times the ratio of U.S. assets to worldwide assets. The Tax Reform Act of 1986 refined this concept by looking at interest expenses on a consolidated basis for affiliated corporations rather than on an entity-by-entity basis. The 1986 law, however, unfortunately and erroneously ignored foreign subsidiaries in this calculation,[20] which is why it became known as "water's edge allocation." But that defect was remedied by legislation in 2004, which will treat all members of a worldwide group as a single corporation.[21] (The 2004 corrective legislation, however, was not scheduled to take effect until 2009 and, in 2008, the legislation was delayed until 2011.[22])

A worldwide allocation system, based on the ratio of debt to assets, is the most appropriate method for measuring domestic-source and foreign-source income if interest expense is to be allocated.[23] *Importantly, worldwide allocation based on assets implies that interest deductions will not be treated as allocable to foreign-source income and disallowed except when borrowing in one country is disproportionate to borrowing elsewhere.*

4. What is at Stake in the Treatment of Interest Expenses?

4.1 Location of investment

Some argue that the failure to allocate interest deductions on a worldwide basis will create an inappropriate incentive for companies to invest abroad rather than at home. The example above demonstrates why this might be true. It is important to recognize, however, that the fundamental income tax incentive for a company to invest in a low-tax country, such as *L*, rather than in higher-tax countries, such as *H* (or *M*), is due to the lower tax rate in *L*. Extensive econometric evidence shows that, although business, not tax, considerations often dominate, the location of investments is significantly influenced by tax rate differences, and an important study by the European Commission has concluded that differences in tax rates are the principal income tax factor affecting decisions about the location of investments.[24] The essential point is this:

the incentive to invest in *L* rather than in *H* exists even if the investments are financed solely by equity and no interest deductions are at issue. An investment in *H* yielding 5 before tax will produce only 3.25 after tax, compared to the 4.25 available after tax for an investment in *L*. Only by eliminating the tax rate differential—through harmonization of tax rates or a capital-export neutrality policy of current taxation by *H* of the income earned in *L* with a foreign tax credit for *M*'s taxes, a policy no country has adopted—will that incentive be eliminated.

Careful analyses of situations where assets eligible for favourable tax treatment are acquired with debt, such as where borrowing occurs to finance domestic tax-exempt income or other tax-favoured domestic investments, for example in plant and equipment, have also concluded that it is the tax preference, not the borrowing, that is the fundamental stimulant to the investment.[25] In such instances, it may even be the case that disallowing interest deductions will inhibit the effectiveness of the underlying tax preference.[26] But these analyses focus on cases where both the income taxation on the asset side and the tax treatment of the interest expense are controlled by the same domestic policymaking process. Importantly, with the issue here, the tax preference on the asset side—the low tax rate in *L* – is outside the control of the *H* or *M* government. And, as the example demonstrates, allowing full deduction of the interest on the borrowing in *H* (or *M*) will tend to exacerbate the preference for investments in low-tax countries by producing an overall negative rate of income tax on the foreign investment.

4.2 Creating incentives for bad investments

As the example above illustrates, allowing a deduction in a higher-tax country for borrowing to invest in lower- tax countries can produce after-tax returns greater than the investment's pre-tax returns. This means that investments that would not be undertaken by anyone in a world without any corporate income taxes may become attractive in a world with varying tax rates and no interest allocation. Such investments will clearly decrease worldwide welfare and will, almost certainly, decrease welfare in the countries where the interest deductions are allowed.[27] Empirical evidence about the benefits that might justify such a policy does not exist, nor does it seem likely that any evidence will be forthcoming that would justify such negative taxes as standard policy. A far better policy, as discussed below, would be for all countries to allow interest deductions on borrowing in proportion to the assets in that country regardless of where the borrowing takes place.

4.3 Choice of debt over equity finance

Allowing an interest deduction without allocation increases the advantage of debt over equity as a source of corporate finance. However, as with the decision about where to invest, the crux of this problem lies not with the failure to allocate interest, but more fundamentally with the general corporate income tax disparity between the treatment of debt and equity. Much has been written on behalf of a variety of corporate tax integration proposals to eliminate or reduce this disparity.[28] But no country has achieved parity between debt and equity finance by disallowing deductions for interest, nor does that seem likely to occur. Interest deductions will continue to be generally allowed, but whenever debt finance is permitted to produce interest deductions that will offset income otherwise taxed at a higher rate than that on the income resulting from the borrowing, this will exacerbate the advantage of debt finance. Such a regime also affects companies' decisions about the location of debt and equity finance so as to maximize the tax savings from the disparities in their treatment.

4.4. Location of borrowing

Allowing an interest deduction in *H*, even if the borrowing is disproportionately located in *H*, will encourage companies to locate their borrowing in *H* whenever the tax rate in *H* is higher than elsewhere. For example, both companies headquartered in the U.S. and companies headquartered elsewhere will prefer to deduct their interest expense against U.S. income (if they have any) that would be taxed at 35%, rather than to use the interest deduction in a country where it would offset income that would be taxed at a lower rate.[29] Indeed, given the mobile nature of corporations' ability to borrow, borrowing may disproportionately be located in *H* almost as easily for a foreign multinational as for a domestic-head-quartered company.[30] *There seems to be no good policy reason for the U.S. to want to encourage borrowing that finances foreign investments to be located in the U.S.*

Interest is not the only expense that companies incur which produces foreign-source income taxed at a low rate. For example, expenditures for R&D may, over time, yield royalty income both domestically and abroad. Under the U.S. foreign tax credit system, the foreign-source royalties may bear little or no corporate income tax anywhere.[31] Likewise, headquarters expenses, often described as general and administrative or stewardship costs, tend to be concentrated in the country where a company locates its headquarters, even though these expenses support the company's production of income throughout the world. In both of these cases, some commentators have argued for a full deduction of these costs in the country where they occur without regard to where the income is earned or whether it is taxed anywhere.[32] These arguments, however, are grounded in the special benefits of these expenditures to the country where they occur—due, for example, to positive externalities from R&D and the high-quality jobs at stake in both R&D and headquarters activities. No similar arguments are available for the location of borrowing transactions.

4.5 Internation equity between source and residence countries

Under current international income tax arrangements, the source country is generally given not only the first bite at taxing the active business income earned there, but in many cases, through the domestic exemption of foreign-source dividends, the sole claim on taxing such income.[33] This source-country priority has been established either unilaterally, such as by the United States when it first enacted a foreign tax credit, or bilaterally through income tax treaties. Today, this priority is a fundamental element of more than 2,000 bilateral income tax treaties.[34] But these treaties do not require countries to allow interest deductions wherever the borrowing occurs.[35] Since source countries have the first claim to the tax revenues from income on business assets, it seems incongruous that the residence country should also be required to forego additional revenue due to the location of liabilities there. This is not required by tax treaties. Source countries contribute to causing the double tax by not allowing the deduction of interest expenses. Why should residence countries be responsible for eliminating that double tax by allowing interest deductions for borrowing used to finance assets abroad—especially when most residence countries do not even make a residual claim to tax the foreign-source income?

4.6 The potential for competitive disadvantage

The recent debate in the United States over the treatment of interest expenses has focused on outbound investments and the proper scope for the allocation (and disallowance) of interest expenses. In a turn away from its previous view, the U.S. Treasury Department, in its December 2007 report, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, called for the U.S. to allow interest deductions in full without regard to the location of the investments attributable to the borrowing.[36] The University of Michigan economist James Hines in a recent article[37] and General Electric's top tax officer John Samuels in his New York University Law School Tillinghast Lecture[38] have also recently advocated this policy. The Treasury report emphasizes the complexity of interest allocation. Prof. Hines focuses on its potential to result in advantages for foreign over domestic ownership of businesses. And Mr. Samuels claims that the U.S. disallowance of interest expense will put U.S. based multinationals at a competitive disadvantage compared to companies headquartered in nations that allow interest deductions without any such limitations.

I cannot address these views in any detail in this article. Nor is such discussion necessary here since my main purpose here is to point the way to a *multilateral* solution to this issue. But the breadth of the claims that the benefits to the U.S. from having U.S. multinationals make foreign investments justify full U.S. deduction of interest under all circumstances is troubling. There is an extraordinary "race to the bottom" quality to these arguments. In essence, they claim that the U.S. makes a mistake by disadvantaging U.S.-based companies in *any* aspect of the tax law where the consensus treatment among the U.S.'s trading partners reaches a more advantageous result. Such claims are particularly hard to credit in a context where U.S. multinationals have ready access to worldwide capital markets. They are likely to respond to a U.S. rule disallowing interest deductions when borrowing is disproportionately located in the U.S. simply by relocating their borrowing to a more favourable jurisdiction.

Moreover, such claims do not respond to any of the concerns expressed above. Nor have they been supported by any compelling empirical evidence that either worldwide economic efficiency would be improved by such a policy or, more narrowly, that the benefits to U.S. workers and investors from such a policy would exceed their costs. (Indeed, if the U.S. is worried about the international competitiveness of its workers and businesses, a far stronger argument exists for lowering the U.S. corporate tax rates, but that issue is well beyond the scope of this endeavour.) To be revenue neutral, allowing interest deductions without any limit or allocation requires higher tax rates than would a U.S. policy which requires worldwide allocation of interest expenses. And, for the reasons discussed above, it is difficult to see why allowing interest deductions without allocation should be a policy priority.

5. A Multilateral Solution

5.1 Worldwide allocation

The problems I have described here—the mismeasurement of income, potential distortions in the location of investment, an increased incentive for debt over equity finance, distortions in the location of borrowing, and unjustified revenue transfers among countries—would all disappear if all countries allocated interest deductions to assets on a uniform worldwide basis and allowed a proportionate amount of interest expense to be deducted against income earned domestically *without regard to where the borrowing occurs*.[39] Such a system would deny interest deductions only when borrowing in one country is disproportionately higher than in the rest of the world.

For outbound investment, the advantages of such a regime should by now be apparent. Incentives to locate borrowing in high-tax countries would disappear, as would incentives to make debt-financed investments because their after-tax returns exceed their pre-tax returns. Debt would be located wherever it is most economical. The revenue transfer from countries where borrowing is located to those where investments are made would stop. And the advantages of debt over equity finance would be reduced somewhat.

In the case of inbound investment, where the problem is typically described as earnings stripping or thin capitalization, there is also much to commend worldwide allocation as a mechanism for determining allowable interest. No country would have to fear that it was bearing a disproportionate portion of a company's interest expense. Indeed, some EU Member States now allow worldwide allocation as a safe-harbour method to protect companies against interest expense disallowance.

The practical difficulty with such an allocation rule for inbound investments is that, without international cooperation, the information about a company's total amount of borrowing and assets necessary to calculate a worldwide allocation may not be readily available to the source country. This explains why source countries have separately devised thin capitalization rules, often relying on fixed allowable debt-to-equity ratios or fixed limits on interest expense deductions as a percentage of income (EBITDA) to limit interest deductions. However, as with interest allocation for outbound investments, disallowing interest deductions through earnings strip- ping or thin capitalization rules—when, as is generally the case, the interest disallowed by the source country will not be allowed by the residence country—may lead to double taxation of the inbound income. On the other hand, allowing the interest deductions in full may produce negative tax rates and threatens the domestic tax base. Thus, worldwide allocation is desirable for both source and residence countries.

5.2 The benefits of a multilateral response

Rarely does a difficult international income tax issue produce such a clear solution. Worldwide allocation of interest expense by both source and resident countries would eliminate a host of problems now bedevilling nations throughout the world—problems that have produced varying, complex and inconsistent responses among different countries, responses that frequently may result in zero or double taxation. Given the flexibility of multinational corporations to choose where to locate their borrowing and the difficulties nations have in maintaining their domestic income tax bases in the face of such flexibility, achieving a multilateral agreement for the treatment of interest expense based on a worldwide allocation should become a priority project for both source and residence countries. The OECD and the European Commission might lead the way. The European Commission should begin by incorporating such a rule into its common consolidated corporate tax base project. For the OECD, making worldwide allocation a commonplace feature of bilateral income tax treaties throughout the world, along with attendant requirements for information sharing adequate for source countries to be confident about their ability to enforce such a rule, would be fair to all nations and substantially improve economic efficiency and internation equity throughout the world. As has so often been the case, a common multilateral solution may be accomplished piecemeal through bilateral income tax treaties.

Solving the problem of interest expense deductions on a multilateral basis would offer great benefits to virtually all nations. Unlike some other areas of international income tax law where a nation may see substantial advantages from pursuing a beggar-thy-neighbour tax policy, there is no important national competitive advantage available in departing from the solution I have offered here. That alone does not make achieving a multinational solution easy, but it might make it possible.

Chapter 6

Structuring an Exemption System for Foreign Income of U.S. Corporations

The OECD nations have split virtually evenly over the best structure for taxing foreign source business income earned by multinational corporations. About half the OECD countries provide a tax credit for foreign taxes; the other half exempt from domestic taxation active business income earned abroad (OECD, 1991). Discussions of international tax policy often treat this choice as grounded in different philosophies or normative judgments about international taxation. Foreign tax credit systems are frequently said to implement "worldwide" taxation or a "universality" principle, while exemption systems are described as "territorial" taxation (U.S. Treasury, 2000). Likewise, tax credit systems supposedly implement "capital export neutrality" while exemption systems further "capital import neutrality"[1] (U.S. Treasury, 2000; Joint Taxation, 1991). However, tax credit and exemption systems are far closer in practice than these dichotomies suggest. The OECD nations have all conceded that the country of source-the nation where income is earned-enjoys the primary right to tax active business income, with the residence country-the nation where the business is incorporated or managed-retaining at most a residual right to tax such income.

Since the enactment of the foreign tax credit in 1918, the United States has never seriously considered replacing it with an exemption system (Graetz and O'Hear, 1997; Graetz, 2001). In 2000, however, the U.S. Congress, in an apparently unsuccessful effort to thwart World Trade Organization disapproval of U.S. tax benefits for "foreign sales corporations," characterized as normal U.S. exemption of foreign business income (Westin and Vasek, 2001; U.S. Congress, 2000). Issues under foreign trade agreements may push the United States to consider replacing the foreign tax credit with exemption. Recent analyses by economists suggest that moving to an exemption system for direct investment (with appropriate anti-abuse rules) could increase U.S. revenues without precipitating any substantial reallocation of capital by U.S. firms (Grubert and Mutti, 1999; Altshuler and Grubert, 2001). Moreover, the existing U.S. foreign tax credit rules are extraordinarily complex, requiring U.S. companies doing business abroad to spend large and disproportionate amounts to comply. One study estimates that nearly 40 percent of the income tax compliance costs of U.S. multinationals is attributable to the taxation of foreign source income, even though foreign operations account for only about 20 percent of these companies' economic activity (Blumenthal and Slemrod, 1995). Some analysts are now calling for the U.S. to take a serious look at exemption of foreign source business income, often on the grounds that an exemption system might be simpler than the existing credit system (Graetz, 2001; Chorvat, 2001). To date, however, little work has been done in identifying the issues that must be resolved for exemption to be implemented and discussing the potential structure of an exemption system for the U.S. Such analysis is essential to assess the likelihood of accomplishing simplification goals. We undertake a preliminary foray into those questions here.

Implementing either a foreign tax credit or an exemption system for foreign source business income demands resolution of similar questions. Most of the issues raised by an exemption system parallel those that have been debated over the years under the current credit system. This is not surprising; both systems share the same general goal: avoiding international double taxation without stimulating U.S. taxpayers to shift operations, assets or earnings abroad. Domestic and foreign source income must be measured in both systems. Both systems must answer the question of what income qualifies for exemption or credit. Whether income earned abroad by a foreign corporation should be included currently in U.S. income or included only when repatriated as a dividend has long been debated under our foreign tax credit system (Altshuler, 2000). If not all foreign source income is exempt, this question remains important in an exemption system. And it is necessary to decide the appropriate treatment of foreign corporations with different levels of U.S. ownership. Likewise, transfer pricing issues are significant and difficult to resolve under either a credit or exemption system.

Detailed analysis and evaluation of each of these issues is not possible here. We start, therefore, by assuming that the political and economic determinations that have shaped current law will continue to exert great influence over the design of an exemption system. We also assume that if the U.S. were to adopt an exemption system, it would generally resemble exemption systems of other OECD nations that have used exemption rather than foreign tax credits. But, even with these constraints, investigating the potential structure of an exemption system spurs reconsideration of issues long taken for granted under our foreign tax credit regime.

Our analysis illustrates that shifting to an exemption system might well afford an opportunity to simplify U.S. international income tax law, but only if simplification is made a priority in enacting such a change. Our discussion here also points to potential simplification of the rules governing international taxation of business, whether or not exemption is enacted. As a political matter, however, such simplification may be more likely when Congress is making a substantial change in the regime for taxing international business income. We begin with a brief overview of current law and then take up the major issues that must be resolved in an exemption system.

Brief Overview Of Current Law

Corporations incorporated in the United States are considered U.S. residents. Income earned abroad by branches of U.S. corporations is taxed currently by the U.S. with a credit allowed for any foreign income taxes imposed on the branch's income. Foreign subsidiaries of U.S. corporations are not considered U.S. taxpayers and thus generally are not taxed by the U.S. on income earned outside the U.S. Normally the earnings of foreign corporations are subject to U.S. taxation only when distributed to their U.S. owners as dividends, treatment commonly characterized as "deferral." The U.S. parent is entitled to foreign tax credits (the "indirect" or "deemed-paid" foreign tax credits) for taxes paid by the subsidiary on the foreign source income distributed as a dividend. U.S. parents routinely control the timing of distributions of dividends from their foreign subsidiaries in order to control the timing of U.S. taxation of foreign source income in a manner to maximize the use of foreign tax credits. For corporations owned or controlled by U.S. corporations or other U.S. persons known as controlled foreign corporations (CFCs)—a variety of limitations apply to limit deferral to active business income. The most important of these "antideferral" regimes are found in Subpart F of the Code and in the rules governing passive foreign investment companies (PFICs). The former applies only to CFCs but the latter rules require current taxation (or its equivalent) of foreign source passive income for U.S. owners of interests in foreign corporations not subject to Subpart F but which earn mostly passive income.

Foreign tax credits are limited to the amount of U.S. tax that would have been paid on the foreign income.[2] To limit the ability of U.S. corporations to use foreign tax credits on one type of income to offset taxes on a different category of income, the foreign tax credit limitation is now calculated separately for nine different categories or "baskets" of income.[3] The ninth basket–the "residual" or "general limitation" basket–contains almost all active business income, income from manufacturing, marketing, sales of inventory and services other than financial services, regardless of the rate of tax imposed on such income by the relevant foreign government, and items of passive income subject to foreign tax rates equal to or higher than the U.S. tax rate. The need to allocate income to each of these baskets and calculate separate foreign tax credit limitations for each is a major source of the complexity of current law.

Income Eligible For Exemption

Alternatives

The first issue in designing an exemption is deciding what foreign source income is exempt. Potentially such an exemption could apply broadly to all foreign source income or narrowly, for example, only to active business income that is subject to tax by a nation with which the U.S. has an income tax treaty or which taxes income at rates comparable to the U.S. rate. Some OECD countries limit their exemption systems to countries with which they have tax treaties or to income taxed at a certain level abroad; others do not. We consider first the potential structure an exemption system applicable generally to active business income without regard to whether the income is generated in a treaty jurisdiction and without regard to the rate at which it is taxed by the foreign country where it is earned.

Following the practice of other nations which exempt foreign source income, such an exemption would apply generally to the branch profits of any U.S. corporation and to dividends received by U.S. corporate taxpayers from foreign corporations. This means that interest income and royalty income, both of which are deductible abroad and therefore not subject to foreign income tax, would be subject to U.S. tax. Under current law, U.S. businesses are often able to shelter interest and royalties earned abroad from U.S. tax through foreign tax credits. Thus, an exemption system would increase the tax on this type of income for many U.S. companies compared to current law.[4]

Definition of Active Business Income

Since active business income but not other types of income earned abroad would generally be exempt, it becomes essential to determine what constitutes eligible active business income. The Internal Revenue Code today does not provide any direct precedent. Nonetheless, the current Code does provide guidance, which probably would be used in defining eligible active business income. Identifying business income eligible for exemption and determining how to treat income not eligible for exemption raise questions parallel to those under current law in determining what income earned through foreign corporations should be taxed currently or eligible for deferral of U.S. tax until repatriated and how the foreign tax credit should apply when that income is subject to U.S. tax. Business income eligible for exemption might be defined first by excluding income that is "passive," drawing on existing Code provisions that identify and tax currently types of passive income earned abroad, particularly Subpart F of the Code. The rationale for excluding passive income from exemption parallels that for taxing such income currently under Subpart F.

Because such income has no nexus to business activity, it is highly mobile and easily shifted abroad to low or no tax jurisdictions. Thus, exempting such income would create an unacceptable incentive to move assets offshore and potentially would lose large amounts of revenue. Consequently, income that constitutes passive income (technically foreign personal holding income) under Subpart F (mostly interest, dividends, rents and royalties) would not be eligible for exemption. Special rules will be necessary when such amounts are earned by entities in which a U.S. corporate taxpayer has a certain minimum ownership interest. (In the latter case, as we discuss below, "lookthrough" rules would be applied to characterize some types of passive income.) The distinction between income eligible for exemption and non-exempt passive income would raise definitional issues similar to those long debated under Subpart F. For example, banks, securities dealers, insurance companies and other finance–related businesses earn interest and other types of "passive" income that are considered active business income under current law; we believe that such businesses should probably be eligible for exemption as are other active businesses, at least when their financial–service business is located predominately in the country of incorporation.[5]

Once passive income earned abroad by U.S. corporations is excluded from exemption–as we believe it should and will be–the risk occurs that an exemption system might become about as complex as current law. For example, every active foreign business utilizes working capital, and earns passive income from the temporary investment of such capital. Without a *de minimis* rule which ignores small amounts of passive income, every corporation will have to take into income some amount of passive income and presumably calculate foreign tax credits allowable with respect to such income. A *de minimis* rule based on a proportion of total gross income or total assets might promote substantial simplification by allowing the income of foreign corporations engaged in an active business to be completely exempt without leading to an unacceptable level of tax planning.[6]

A separate question is whether other "non-passive" types of Subpart F income should be exempt from U.S. taxation. In some cases, for example, Subpart F currently taxes certain sales and services income. In most cases such sales and services income, which is active business income, is taxed currently under Subpart F because of the ability of taxpayers to locate the activities that generate this income in low-tax jurisdictions thereby minimizing both U.S. and foreign source-based income taxes. These Subpart F rules were first adopted in 1962 and some business organizations have recently called for revision, urging, for example, that the transfer pricing rules are adequate to address "abuse" cases (NFTC, 1999). The fundamental policy issue to be faced by an exemption system is whether these (and other) types of "mobile" active foreign business income, which can sometimes be moved to low tax jurisdictions, should be eligible for exemption. Transfer pricing enforcement throughout the OECD has become more vigorous and sophisticated. A simpler system would no doubt result if the transfer pricing rules (which in this case would be enforced by the country from which the sales or services income is deflected to a low or no tax jurisdiction), rather than an exclusion from exemption, could be relied on to constrain tax avoidance.

A further question is whether certain types of foreign source active business income that are not likely to be taxed in any jurisdiction on a source basis should be eligible for exemption. For example, income from personal services, which is foreign source income when the services are performed outside the United States, is generally treated as active trade or business income. However, when the services are not attributable to a local fixed base in the nation where they are performed, most countries do not tax the services on a source basis. Similarly, shipping, telecommunications and other types of income from international waters and space clearly are active business income, but these kinds of income typically are not taxed by any foreign jurisdiction unless they are earned by a company residing in that jurisdiction. Many companies earning these kinds of income are resident in low-tax jurisdictions. Extending exemption to such income would inevitably be controversial.

Finally, it will be necessary to determine whether exemption applies to gain on the sale of assets in connection with an active business. A consistent exemption policy should provide that gain on the sale of assets would be exempt if the assets generate exempt income. For example, gains on the sale of business assets used in a foreign branch would be exempt (and losses would be disallowed) if the income from such assets would be exempt.

Likewise, gain on sales of shares in a foreign corporation should also logically be exempt if the dividends of the entity would be exempt, since the gain reflects the present value of the future stream of potentially exempt income. Where not all of the income of the foreign corporation would be eligible for exemption, however, the appropriate treatment of gain when shares are sold is not obvious. An allocation between exempt and non-exempt gain might be required, but such a rule would be complex and the basis for making such an allocation is not completely clear. In principle, gain attributable to retained active business earnings should be exempt. This could be accomplished by adapting the rules of current law that recharacterize gain on the sale of shares of a foreign corporation as a dividend to the extent of retained earnings; the recharacterized dividend would be exempt to the extent that an actual dividend would be exempt.[7] However, exempting gain attributable to the appreciation in the value of assets that produce passive income seems inappropriate, thus probably making necessary a look-through rule when shares of a qualifying foreign corporation are sold. In essence, the purpose of such a look-through rule would be to tax gain attributable to appreciation of passive or other non-exempt assets.[8]

Treatment Of Non-Exempt Income Earned By U.s. Taxpayers

Foreign Tax Credits

The discussion above makes clear that not all foreign source income earned by a U.S. corporation will be eligible for exemption. Non-exempt income would surely include foreign source interest, rents and royalties not attributable to an active foreign business, dividends on portfolio stock, income from export sales not attributable to an active foreign business and any other types of active business income (perhaps such as space or shipping income or interest and royalties attributable to an active business) that are specifically determined to be ineligible. However, to the extent that these types of income are potentially subject to foreign tax (including withholding tax) on a source basis, the U.S. should make an effort to avoid double taxation. Thus, as under today's rules, such income should probably continue to be allowed a credit for the foreign taxes paid on that income.

If a foreign tax credit is permitted for any income, in principle all the questions that exist today regarding limitations on foreign tax credits would have to be resolved. However, if the nonexempt income were limited to only these classes of income, much simplification would be possible. For example, given this limited application, a single worldwide foreign tax credit limitation could be applied. A worldwide limitation seems reasonable since taxpayers almost always will be subject to tax abroad on these types of income at rates lower than the U.S. corporate tax rate, and therefore they will almost always have foreign tax credit limitations in excess of creditable foreign taxes.[9] A single worldwide limitation would be far simpler than the baskets of current law, and the fact that taxpayers would virtually always have excess foreign tax credit limitations both permits additional simplifying changes and lowers the stakes in applying some rules that would be retained.[10]

If, however, averaging of credits across types of income is of great concern, separate limitations might be applied based on categories of income (similar to today's limitations) or types of taxes (e.g., withholding taxes versus income taxes normally applied to residents). Finally, a separate limitation could be applied to each item of foreign source income not eligible for exemption (much like the so-called "high-tax kickout" limitation on passive income under the current foreign tax credit). However, we see no justification for this level of complexity. In a system that generally exempts active business income, we do not find any policy justification for multiple separate limitations that outweighs the simplification advantages of a single worldwide foreign tax credit limitation.

Treatment of Non-Exempt Foreign Corporation Earnings

If not all income earned by a foreign corporation is eligible for exemption, the question occurs whether non-exempt income should be subject to current inclusion by U.S. corporate shareholders or, alternatively, should not be taxed in the U.S. until distributed as a dividend. Most passive types of income are today subject to current inclusion under Subpart F when earned by controlled foreign corporations. Investors in non-U.S. controlled foreign corporations, which earn mostly passive income, may be subject to current taxation (or roughly equivalent consequences) under the Passive Foreign Investment Company (PFIC) regime or other "anti-deferral" regimes. We see no reason that shifting from a foreign tax credit to an exemption system should delay the imposition of U.S. tax on passive income (which exceeds a *de minimis* amount) that is taxed currently under present law.[11] Thus, we assume that the U.S. would continue to subject passive types of foreign source income to current inclusion.

If some types of active business income also are not exempt, a decision must be made whether to subject that income to current taxation. Here we believe that avoiding the complexity of having three categories of income for U.S.-controlled foreign corporations-exempt income, currently included income and deferred income-is sufficiently important to argue for current taxation of all non-exempt income.[12] If non-exempt income is taxed currently and dividends are exempt, the timing of dividends becomes of no consequence under U.S. tax law. On the other hand, if a category of deferred income is retained, look-through treatment of dividends might be necessary.[13]

Assuming that all income of U.S. controlled foreign corporations is either exempt or currently included, rules are necessary to measure the income in two categories. For example, rules allocating expenses between the two categories of income would be necessary. Likewise, loss recapture rules (similar to those in Subpart F today) would be necessary to prevent losses from income-producing activities from permanently reducing nonexempt currently includable amounts.

In addition, an "indirect" (or "deemed paid") foreign tax credit would be appropriate to allow U.S. corporate taxpayers to claim foreign tax credits for foreign taxes paid by foreign corporations on non-exempt income. Such a foreign tax credit would require rules allocating foreign taxes between exempt and currently includable income. The rules would also require integration with the foreign tax credit limitation rules discussed above with respect to foreign source income earned directly by U.S. taxpayers. Thus, many of the foreign tax credit issues that exist today would remain although they would apply to a much smaller category of income earned by foreign corporations and therefore might be substantially simplified.

Distinguishing Among U.S. Corporate Shareholders

In addition to rules establishing the scope of exemption and the treatment of dividends received from foreign corporations, it becomes necessary to decide whether all U.S. corporate shareholders should be entitled to exemption. In theory, the answer to this question should be yes; otherwise some international double taxation at the corporate level will occur. However, applying an exemption system, as discussed above, requires that U.S. corporate shareholders receive significant amounts of information from those foreign corporations in which they have the requisite level of ownership. The U.S. recipient would, for example, have to know the amount of the foreign corporation's passive earnings and the amount of foreign taxes imposed on those earnings. It thus seems impractical to apply an exemption system on a look-through basis to all U.S. corporate shareholders of foreign corporations.

In determining whether U.S. tax applies currently or is delayed until earnings are repatriated and for foreign tax credit purposes under current law, the U.S. has three different regimes relevant to this issue:

(1) Subpart F limits deferral but allows foreign tax credits to shareholders owning 10 percent or more of the voting stock in controlled foreign corporations (CFCs). (CFCs are defined as foreign corporations in which U.S. persons each owning 10 percent of the voting stock own a total of more than 50 percent of the stock by vote or value).

(2) To avoid international double taxation, the "indirect" foreign tax credit is allowed to U.S. corporations that own at least 10 percent of voting stock in a foreign corporation which is not a CFC.

(3) No foreign tax credit and no limitation on deferral applies to a U.S. corporation whose ownership in a foreign corporation is less than 10 percent of the voting stock.

In designing an exemption system these categories should be rethought. Today a U.S. corporation, which owns less than 10 percent of the voting stock of a foreign corporation, is treated as a "portfolio" investor. Full double taxation of foreign source income at the corporate level is justified largely on the assumption that such corporate investors cannot get the information necessary to determine their foreign tax credits under U.S. law.

A 10 percent voting stock threshold could also be adopted for distinguishing "portfolio" from "direct" investment for the purpose of applying exemption.[14] The issue remains, however, whether U.S. corporate investors owning less than 10 percent should be fully taxed or fully exempt on dividends (and capital gains). If, as we assume, rules similar to the current Passive Foreign Investment Company regime continue to apply to all investors in foreign corporations that hold predominately passive assets, dividends (and gains) from nonPFIC foreign corporations might be treated as exempt by U.S. corporate shareholders owning less than 10 percent of voting stock in all cases without requiring any significant information and without creating undue potential for tax planning mischief. [15]

A second question is whether any distinction should by made in the application of an exemption system to U.S. corporations that own more than 10 percent but not more than 50 percent of a foreign corporation-in other words, to direct investment in non-CFCs. That decision should probably tum on the kinds of limitations that apply to passive income and whether obtaining the necessary information to apply these limitations would be onerous for U.S. minority shareholders. Under legislation recently passed by Congress, beginning in 2003, the foreign tax credit look-through rules will be applied to 10 percent owners of non-U.S.controlled foreign corporations, although Subpart F will continue to apply only to foreign corporations meeting the definition of a controlled foreign corporation. An exemption system might reconcile these disparities, applying similar rules to all 10 percent or greater corporate shareholders. This would be much simpler than current law. Alternatively, despite the complexities, an exemption system might follow a path similar to current law, exempting all active business income on a look-through basis, but requiring current inclusion only from foreign corporations that are controlled by U.S. shareholders. This would, however, require creation of a "deferral" category for "10/50" shareholders in foreign corporations, which would add considerable complexity. Countervailing difficulties might result, however, if current inclusion is required with respect to undistributed passive earnings of foreign corporations which U.S. shareholders do not control. In such cases, the U.S. corporation may not be able to obtain the payment of sufficient dividends by the foreign corporation to cover the U.S. tax cost. Under such circumstances, creating a limited class of deferred foreign income might be a practical alternative.

The desire for simplification coupled with concerns about imposing current U.S. tax in circumstances where a corporation cannot compel sufficient dividends to pay the tax suggests a third alternative. Perhaps two categories of investors could be created, for example, by expanding the category of "portfolio" investors to those U.S. corporations that own less than 20 percent of the foreign corporation (by vote and value) and applying an exemption regime with current taxation of non-exempt income to all larger investors.[16] Itis likely that a 20 percent or greater investor will be able to participate meaningfully in corporate decision-making, including decisions about paying dividends. We believe this alternative has merit as a way of balancing simplification and equity concerns.

Treatment of Taxpayers Other Than Corporations

Finally, the question arises how to tax foreign source business income of U.S. investors other than corporations. Foreign business income earned directly by individuals could be eligible for exemption. However, since under the U.S. classical system corporate earnings are fully taxed when distributed to non-corporate shareholders, an exemption for dividends paid by foreign corporations to non-corporate U.S. taxpayers would make little sense.[17] The fundamental question is whether all income of such persons that is earned through foreign corporations should be currently included (subject to foreign tax credits) or whether the taxation of some or all of that income should be deferred until repatriated. Parity with corporate investors argues for deferral at least of earnings that would not be currently included by a U.S. corporate owner, and it may well also be simpler to defer taxation of such income to individuals (whether earned directly or through mutual funds) until dividends are paid.

Allocation Of Expenses

Under an exemption system along the lines we have described above, there would be three general categories of gross income: U.S. source income, foreign source exempt income, and foreign source non-exempt income. Expenses allocable to U.S. source income would not be affected by changing from a credit to an exemption system. And presumably amounts allocable to non-exempt foreign source income would be taken into account in determining the (one or more) foreign tax credit limitation amounts, much like our rules today. However, because (as we have discussed) U.S. corporations would typically have excess foreign tax credit limitations under an exemption system, the stakes of that allocation would be far lower than is currently the case. Indeed, usually nothing would tum on such an allocation. On the other hand, expenses allocable to exempt foreign income are properly described as deductions incurred to earn exempt income, which the Code typically disallows. Such deductions should be disallowed or allowed only to the extent they exceed exempt income in any year and are subject to recapture out of exempt income in subsequent years. To the extent the rules allocate expenses to exempt income they will take on heightened importance compared to today's deduction allocation rules. Under an exemption regime, such allocation rules potentially will disallow an amount of otherwise deductible expenses; under current law they serve only to limit foreign tax credits for taxpayers who have excess foreign tax credits.

Consequently, rules will be necessary for allocating expenses to each category of income. To begin with the most important example, interest expense allocation rules will clearly be necessary. But because of the serious consequences to taxpayers that would result from disallowing interest deductions allocated to exempt income, it becomes essential to rethink the rules. A system that allocates interest expense first to interest income (whether or not eligible for exemption) with the remaining interest expense allocated to each category of income pro rata based on assets, but taking worldwide assets into account, would be a better starting point than current law.[18]

We have assumed throughout this article that in an exemption regime, following the general practice in other OECD countries, royalties from foreign corporations would be non-exempt income (and that a complementary rule imputing royalties to foreign branches of U.S. taxpayers would be adopted). Under these circumstances, providing for the allocation of research and development (R&D) expenses would be essential, but would have less serious consequences for taxpayers than current law. R&D expenses need not be allocated to foreign dividend income or to branch profits because the dividend payer or branch would be separately paying a royalty that would be taxable in all cases.[19] Thus, R&D expenses need be allocated only between foreign source income eligible for a foreign tax credit (such as royalty income) and domestic source income. As we have discussed above, in an exemption system, any foreign tax credit limitation will typically be applicable only to income subject to withholding tax and passive trade or business income and therefore would not likely limit the available foreign tax credits of most non-financial multinational corporations. Since the allocation of R&D expense under current law is important only for taxpayers with excess foreign tax credits, how much R&D expense is allocated to foreign source income under an exemption system should have little or no effect on U.S. taxes. Therefore an exemption system would not raise the serious policy issues that exist for R&D allocation under the current foreign tax credit system.

Finally, as with interest expenses, the rules that provide today for the allocation of a portion of general and administrative expenses as "stewardship expenses" to foreign source income would become much more important than under current law because such expenses might be allocated to exempt income and disallowed as a deduction. By definition these expenses are not properly charged out to foreign corporations. (Otherwise the expenses would be directly allocated to the income from the charge and thus fully deductible.) If these expenses were allocated to exempt earnings, they would not be deductible in any jurisdiction, an inappropriate result for expenses that clearly are current costs of earning business income. Consequently, it would be important to define the category of allocable "stewardship expenses" narrowly in an exemption regime.[20]

Other Structural Issues

Many other issues present in our foreign tax credit system would persist in an exemption system. For example, transfer pricing issues that arise today would continue to be important under an exemption system, although the incentives would be different in many cases. There would, for example, be an incentive to lower royalties and increase dividends in an exemption system (Grubert and Mutti, 2001; Grubert, 1998; Grubert and Mutti, 1991). Depending on the scope of the exemption, transfer pricing issues might become even more important. The changes we have suggested limiting Subpart F to passive income under an exemption system, for example, assume transfer pricing enforcement by OECD nations in lieu of the Subpart F "base-company" rules when sales or service income is shifted to low or no tax jurisdictions. Likewise, to the extent that rules for determining the source of various categories of income cause problems under current law, these problems would remain important in an exemption system.

The U.S. tax treatment of transfers of property from a U.S. company to a foreign corporation would also continue to be an issue, but rules simpler than those in force today could be adopted in an exemption regime. The transfer to a foreign corporation of assets that gave rise to exempt income prior to the transfer ought to be non-taxable. The transfer of other assets should generally be taxed, but where the income from those assets would continue to be fully taxed either because the assets relate to a U.S. trade or business or because such income (and gain from the sales of related assets) will be subject to current inclusion to all of the shareholders of the foreign transferee, it should not be necessary for the U.S. to impose tax at the time of the transfer.[21]

If an exemption system has only two categories of income-exempt income and income currently taxed-and therefore eliminates the category of deferred income for U.S. corporate investors in U.S. controlled foreign corporations, substantial simplification could be achieved by eliminating those provisions that under present law terminate deferral in specific circumstances. For example, the provision that treats foreign corporate loans back to U.S. affiliates (and other similar transactions) as constructive dividends to the shareholders could be eliminated. Likewise, the regulations that terminate deferral in certain inbound and foreign-to-foreign reorganization transactions could also be eliminated.

More Limited Exemption Alternatives

The exemption system we have described above is premised on the assumption that active foreign source business income would generally be eligible for exemption (except perhaps for some types of active business income now subject to current inclusion under Subpart F). In such an exemption system, all income of eligible U.S.-owned foreign corporations would be divided between exempt income and currently includable income. Some commentators, however, have urged more limited exemption systems, implying that only income taxed comparably to the taxation of U.S. domestic corporate income should be exempt (Graetz, 2001; President's Task Force on Business Taxation, 1970). For example, an exemption system might subject so-called "tax haven" income to U.S. tax even though the income is attributable to an active trade or business outside of the United States. Such a result might be achieved by denying exemption to all income earned in listed tax haven countries or to all income earned in non-treaty countries. Alternatively, exemption might apply only to active business income earned in countries specifically specified by the U.S. Treasury or countries with a statutory (or an effective) tax rate higher than a specified minimum rate, for example, 75 percent of the U.S. rate.

Any of these more limited forms of exemption would make it more difficult to treat all non-exempt income of U.S. controlled foreign corporations as currently includable. If, for example, an exemption system were limited to active business income earned in a treaty country, the current inclusion of similar active business income earned by foreign corporations doing business in (and subject to tax by) non-treaty countries would place great pressure on whether a treaty is in force. Similar pressures would occur if the distinction between exemption and current inclusion turns on the tax rate of the foreign country. Thus, as a practical matter, if a more limited form of exemption system were adopted, three categories of income exempt income, deferred income, and currently includable income-for dividends from eligible U.S. owned foreign corporations might result. Such a system would likely be at least as complex as today's system. The anti-deferral rules of today's law would continue in force and the rules discussed above with respect to exempt income would also be necessary. On the other hand, if the exemption is limited to income in countries with relatively high tax rates, the justification for reducing the number of baskets for determining the limitation of foreign tax credits–i.e., that companies would be in an excess limitation position-would be as strong as with a broader exemption system.

Transition Issues

The most important transition issue in moving from the current foreign tax credit system to exemption is the treatment of income earned by foreign corporations in periods prior to exemption but not yet repatriated to or taxed by the United States. The issue is whether and how U.S. tax should be imposed on future dividends treated as paid out of such deferred income and to gain on the sale of stock of such corporations. Several alternatives are possible.

The simplest approach would be to forgive the U.S. tax on such income with all dividends eligible for exemption (ignoring whether it would qualify as exempt income if earned currently). Taxation of gain on the sale of stock would be unaffected by retained pre-exemption system earnings. Such a generous approach would be consistent with Congress' decision to not tax accumulated DISC income when the FSC regime was enacted in 1984.[22] In that instance, however, Congress had never intended to tax accumulated DISC income, whether or not the DISC regime was changed. Such forgiveness of tax seems unlikely here.

An alternative would be to enact an ordering rule for dividends that would subject dividends paid out of pre-exemption earnings as taxable but eligible for foreign tax credits. If the pre-exempt earnings were treated as being paid last, the complexity of an additional category of earnings would be minimized for a large number of taxpayers. A precedent for this alternative can be found in both the rules applicable to C corporations that elect S corporation status and in the enactment of the 1986 foreign tax credit limitation rules. Presumably, under such a regime gain on the sale of stock in foreign corporations would be taxed as a deemed dividend (with accompanying foreign tax credits) to the extent of pre-exemption retained earnings.

A third alternative would be to levy a toll charge on existing corporate direct investments in foreign corporations as a condition for exemption of dividends in future periods. We regard this as the least appealing alternative. As a practical matter, it would give taxpayers an election between deferral and exemption. It also would provide a large incentive for companies to separate future business income-generating activities from current earnings and profits, a complex task which we have no doubt tax planners could readily accomplish if the stakes are sufficiently large.

Conclusion

We have attempted here to identify the issues that Congress must resolve if it were to replace the existing foreign tax credit system with an exemption for active business income earned abroad. In this discussion we have stuck rather close to present law in addressing how these issues might be resolved under an exemption system. In other words, we have treated a potential change to exemption as an incremental move in U.S. international tax policy rather than viewing such a shift as an occasion to rethink fundamental policy decisions reflected in current law.

Our analysis reveals that virtually all of the questions that must be answered in a foreign tax credit regime must also be addressed in an exemption system. There is little simplification necessarily inherent in moving to an exemption system, but such a move does provide an opportunity to reconsider a variety of issues that might simplify the taxation of international business income. While, in principle, much simplification of current law is possible without abandoning the foreign tax credit, it may be politically unrealistic to think that such simplification will occur absent a substantial revision of the existing regime, such as that entailed in enacting an exemption system.

Our analysis suggests that much of the complexity of an exemption system occurs in the scope and treatment of non-exempt income. If this category generally can be limited to passive non-business income with meaningful de minimis rules applied to the treatment of such income, the impact of these rules can be minimized. Surely the basket system limiting foreign tax credits could be eliminated. Moreover, under an exemption system along the lines we have described here, the timing of the payment of dividends would be of no consequence. Thus, under an exemption regime significant simplification could be achieved for many companies and the costs of complying with U.S. international tax rules might well decrease substantially for U.S. corporations.

Chapter 7

Can a 20th Century Business Income Tax Regime Serve a 21st Century Economy?

It is an honour and great pleasure to be with you here today to deliver the 2015 Ross Parsons Lecture. As you know, my lecture's title is in the form of a question: can a 20th century business income tax regime serve a 21st century economy? That, in substance at least, is the question governments around the world—including mine in the US and yours here—are asking as they consider reforming their tax laws. In the meanwhile, at the Organisation for Economic Co-operation and Development (OECD), in its effort to address base erosion and profit shifting (BEPS), an affirmative answer to my question is taken as a given. Rather than engaging in a fundamental *Re:Think*—to borrow a phrase from the Australian Government—the BEPS process is tinkering with the paradigms and concepts of the past century in the hopes that they might better confront this century's economic realities. That observation, by the way, is meant solely as description, not criticism. The OECD has had little choice given its marching orders and the timetable that the G-20 set for it. I have more to say about US and Australian tax reform and BEPS shortly, but first, I want to briefly review the challenges of making international tax policy today.

International tax policy challenges

In a talk to New Zealand's International Fiscal Association meeting last month, I described getting a handle on international tax policy as "like trying to catch whitebait without a net". But in reality, making international tax policy is even harder than that: to borrow an image from Sting, it is more like trying to "write on the surface of a lake". Before the ink dries, conditions have changed. There are so many moving pieces that are affected by international tax rules around the world—so many choices being made by both multinational businesses and by national governments, which often have very different objectives. These choices are no doubt quite familiar to you, but let me briefly mention some of the most important.

Multinational businesses must decide, for example:

(1) where to locate operations, including personnel and plant and equipment, where to sell products and where to produce products;
(2) how to choose between labour and capital, where to locate different kinds of labour and management, where to employ

skilled labour and unskilled labour;

(3) where to locate headquarters;

(4) where to report income and deductions—this, of course, is the tax planners' game (international tax law frequently attempts to override the tax consequences of the managers' decisions); and

(5) how and where to finance operations—most obviously, the choice between debt and equity, but also between internal versus external sources of funds.

The economics of all this are complex. The facts are often uncertain—or at least unknown to tax authorities, and the stakes are often large. Will a domestic company be able to compete on a level playing field with a foreign firm where both are in third countries? Are domestic firms and foreign firms on the same footing in the domestic firm's home country?

Answers to these questions turn on issues such as the various countries' treatment of debt and equity, including limitations on interest deductions, whether the country has an imputation system, the treatment of hybrid instruments, and tax rates, all of which vary among countries. Decisions by *both* the companies and the governments of the relevant countries are important.

Moreover, the consequences of these decisions are frequently unclear. For example, there is debate in the economics literature about when investment abroad is a complement to investment at home and when it is a substitute for investment at home. This is obviously a key question for policymakers but is often in dispute among economists.[1]

Even today, we think of multinationals as of a particular nation: as a German multinational or a UK multinational. This is typically a reference to the location of headquarters. But ongoing changes in the ownership of securities are diminishing the so-called home country bias in portfolio investment. An increasing share of securities is held by foreign investors. And when financial intermediaries are involved it is hard (indeed, sometimes impossible) to know who actually owns what.

As a further complication, although who bears the corporate income tax has long been controversial, it now seems that some substantial part—there is dispute about how much—is borne by labour. This may vary depending on the national economy and the tax system. Treasury's recent *Re:Think* estimates that about half the Australian corporate tax burden is borne by labour in the form of lower wages. In the US, the estimates range from less than 20% to half.

Finally, in making international tax policy, each nation must take account of what other nations are doing and anticipate how they might react to changes. The decline in corporate tax rates around the world and the proliferation of so-called patent boxes suggests that—although we tend to think of firms as competing—nations are currently also engaged more in competition than in cooperation. A big question going forward is whether the OECD's BEPS effort will halt or even reverse that trend.

What are nations competing for?

- First, to be the supplier of labour—jobs.
- Second, to be the location of physical capital—especially of R&D facilities and headquarters (because of important regional geographic benefits from both)—and to be financial centres (for some countries, such as the UK and the Cayman Islands).
- Third, for intangible capital, for innovation, patents etc.
- Fourth, to supply natural resources.
- Fifth, in some cases, for tax revenues from multinational corporations.[2]

Then, even if we knew all of the key economic responses and had answers to the contested empirical facts, it remains crucial to understand that tax policy is a *political* exercise, not an endeavour grounded in economic theory. Let me offer just two observations about that.

(1) In a relatively small, open economy such as Australia's, there is a consensus among economists that no tax on foreign capital, including foreign-owned corporate income, should be imposed—except perhaps based on certain locational

advantages, such as natural resources. But, if such a country is going to tax income from domestic businesses, it is politically impossible for a government to exempt a foreign multinational's domestic income from tax. Sometimes lowering the corporate tax on foreign multinationals is accomplished indirectly, for example, by allowing foreign companies to strip income through interest deductions or royalties. But at some point, this becomes too much. The public and their political representatives balk: the UK's experiences with Starbucks, Apple, and Google—and the recent parliamentary inquiry on multinationals' taxes here in Australia—offer ample evidence of that phenomenon.

(2) The OECD and economists generally tend to agree that a corporate income tax is the worst kind of tax economically. But the person in the street thinks he or she doesn't suffer from taxing corporations, especially corporations doing business abroad, so the corporate income tax is very popular with the public. Indeed, the worst tax economically is often the best tax politically.

This has been a good bit of preliminary table setting, but I hope it helps to explain why international taxation is so challenging. Now on to the past, the present and the future.

The 20th century

As the title of this talk implies, we are living in today's 21st century high-tech, integrated, global economy with a 20th century international tax system.

The formative period ended in the late 1920s. By then, the United States, Australia, and other countries had adopted corporate income taxes, foreign tax credits or exemptions for business income earned abroad to reduce or eliminate double taxation, and a system of bilateral income tax treaties. The key concepts, including source rules, arms-length pricing, the permanent establishment concept, and non-discrimination principles, had come into place.

The world then was much simpler: there were no innovative financial instruments. The residence of a corporation was generally fixed, and it made little difference whether one looked to the place of incorporation, the place of management and control, the location of most jobs and assets, or the residence of the companies' shareholders to determine residence: all four typically gave the same answer. The source of income was also usually clear. If one sourced royalty income, for example, to the place where the intellectual property is used, one had little difficulty knowing where that was. Perhaps most importantly, nations were *either* capital exporters (like the UK and the US) or capital importers (like France, Italy and Spain) so their interests were clear. Today, of course, the interdependencies among the locations of specific contributors to a multinational company's total global income undermine any clarity of the notion of source. Knowing how to allocate such income among the nations—or entities—of production, consumption, asset ownership and deployment, financing, and/or management is inevitably contested and controversial. And today, of course, virtually every country is both a capital importer and capital exporter, which seriously complicates its national interests. Despite all the changes, however, the rules of the 1920s have remained remarkably stable over time.

Beginning in the 1960s, led by the US, controlled foreign company (CFC) rules came into existence and spread throughout the OECD. Importantly, in the US, this signaled a strong effort to tax business income based on residence—which reversed the idea in the US before that, which had regarded source-based taxation as superior, at least for business income. I have written about this history extensively;[3] for my purposes here, it suffices to say that the key principle for the US Treasury then was "capital export neutrality", which implies that domestic taxpayers should be taxed the same whether they earn income domestically or abroad. Business interests opposed this norm with a principle of their own, which we now know as "capital import neutrality", and which implies that all investments in a particular country should be treated the same whether they are owned by foreigners or by residents. It is now well known that these two principles can hold simultaneously only when income is taxed the same in both countries—this requires identical tax systems, including identical tax rates, an identical tax base, and identical choices between source and residence-based taxation. That has never happened, and it never will, so politicians for more than half a century have been able to describe any set of rules as a "compromise" between the two competing principles. This is an invitation for unprincipled decision-making. But governments—including the Australian Government in its recent *Re:Think*—continue to claim that capital export neutrality and capital import neutrality are the proper polestars for guiding international tax policy.

About 30 years ago, countries around the world began broadening their income tax bases and lowering rates. In the business tax arena, this has led to the inter-nation competition and sophisticated tax planning by multinational companies that we now live with. At the same time, we have witnessed a technological revolution that allows information and money, and in some cases products and services, to be moved around the world with the click of a mouse; financial innovation and engineering that, among other things, breaks down the lines between debt and equity; a new aggressiveness in tax minimisation by large business entities; dramatically lower transportation costs; the emergence of important new economies especially in Eastern Europe and Asia; huge growth and globalisation of portfolio investment opportunities; and the ability of business entities to amass large pools of capital without going to the public capital markets through, for example, endowment funds, private equity, and sovereign wealth funds. In the US, this last development has badly blurred the line between pass-through entities, such as limited liability companies and partnerships (which are not taxed at the entity level) and taxable corporations. In 2012, only 54% of total business income was reported on corporate income tax returns; 46% was reported on individual returns, most of which was flowed through from partnerships, including very large partnerships.[4] This has seriously complicated the ability to reform business income taxation in the US.

Finally, toward the end of last century and continuing now, in Europe, the European treaties have played a major role in shaping international tax policies, for example, in the arenas of CFC and thin capitalisation rules, and in dismantling European imputation systems.

In sum, we have a 20th century international tax regime trying to govern a 21st century global economy. The critical question is: can that work? If not, what will replace it?

That brings me to the present—where nations and businesses are striving throughout the world to achieve tax reform at home and also some consensus on the BEPS effort in the OECD and G-20.

I will first say a few words about the US and the potential for business tax reform there, comment a bit on the Australian Government's Re:Think, and then turn to some of the key aspects of BEPS — at least to describe the current US perspective.

Tax reform in the US

Let me begin my discussion of the current US tax reform efforts with three important background facts. First, the US has no GST or VAT—we are the only OECD country in this position. This makes US tax reform much more difficult. Second, again peculiar to the US, the combination of our high corporate tax rate, our foreign tax credit system, and financial accounting rules have combined to limit repatriations to the US of foreign earnings. US corporations have now accumulated more than $2tr in such unrepatriated foreign earnings. This,—along with a recent spate of corporate transactions, so-called "inversions," that replace US parents with foreign parents—is the main catalyst for tax reform in the US. Our broken political system may not be able to act, however, despite massive efforts by US multinationals to get legislation.

There is widespread political agreement in the US that the corporate rate should be reduced. At 35%, it is now the highest in the world. Since our 1986 tax reform, our rate has stayed the same, while other countries have reduced their corporate rates. Everyone now understands that deductions flock to high-rate countries and income seeks low-rate countries. So, businesses have incentives now to borrow in the US for investments and income elsewhere. The Obama Administration's goal is to reduce the US corporate rate from 35% to 28%; for US multinationals and most congressional Republicans, the target is 25%. Some companies want even lower special rates on "innovation income" — a US version of a patent box. Others are urging special low rates for domestic manufacturing. Either of these would require higher general rates. One significant substantive barrier to reform is that partnerships and other pass-through entities will not benefit from the lower corporate rates and reducing the top individual rate to 28 or 25% is not a practical option. Partnerships will, however, be subjected to any broadening of the business tax base. No politically acceptable solution to this conundrum has yet emerged. Last week, US small business organisations emphasised this as a barrier to tax reform.

There seems to be a consensus in the US to move away from a foreign tax credit system toward a dividend exemption system, but there is dispute over how high a tax to impose as a transition tax on prior years' unrepatriated foreign earnings—the $2tr mentioned earlier. There is also considerable dispute about what to do about situations where US multinationals strip income from high-tax foreign jurisdictions to low-tax foreign jurisdictions or tax havens. US multinationals are quite opposed to any substantial tightening of our CFC rules to tax currently income taxed at low or zero rates abroad. The Obama Administration has proposed a 19% minimum tax to address that issue. US multinationals are objecting, of course, but might settle for a lower rate. The US Treasury is currently relying on this CFC minimum tax concept in its BEPS discussions.

The conceptual difficulty is this: shifting income from the US to a tax haven costs the US tax revenue, which presumably would otherwise benefit US citizens and residents. When a US multinational shifts income from a foreign country to a haven, however, it is the foreign treasury that loses the revenue and the tax savings may, in substantial part, accrue to the benefit of US shareholders, who often constitute the largest group of owners of US companies. Foreign-to-foreign tax reductions accomplished by a US multinational company may, therefore, largely benefit US shareholders at the expense of a foreign treasury. On the other hand, the ability to achieve very low effective tax rates on foreign income may also create incentives to locate real assets, such as plant and equipment, and jobs abroad, rather than domestically. Moreover, if other countries permit foreign-to-foreign income shifting and the US does not, US multinationals may suffer a competitive disadvantage versus foreign companies, and this might stimulate further inversions by US companies or, more likely, acquisitions of US companies by foreign multinationals. The magnitude of such cross-cutting considerations is unclear. And the stakes are very high.

This is a key issue in US tax reform. Of course, multinational tax planning has already stimulated the UK's diverted profits tax and talk of something similar here in Australia.[5] Our thin capitalisation rules will also certainly be tightened in any tax reform legislation. I have also argued recently that the US should adopt an imputation credit system along the lines of the New Zealand and Australian models. More about that soon.

Everyone agrees that the kind of US tax reform I have described will happen—the question is when. Some US multinationals and congressional Republicans are optimistic that it will happen this year. If I were betting, I would say not until our next presidential election, so not before 2017.

Australian tax reform for business income

In preparing for this talk, I've taken the opportunity to read the recently released materials related to potential tax reform in Australia. I want to share a few reactions with you, for whatever they may be worth. Today, I will generally limit my observations to business tax reform and, because of time, limit those comments to a few issues. First, I must acknowledge how much better positioned the Australian tax system is than the US's. For starters, you have a GST; we don't. This decreases your need to rely on income taxation. Second, your corporate rate at 30% is already five percentage points lower than ours. And, for Australian companies and shareholders, imputation credits to shareholders mean that the corporate tax is essentially serving as a withholding tax for shareholders on their dividends. By not acknowledging this fact in the official revenue statistics, the Australian Treasury overstates the amount of corporate taxes. The *Re:Think* (p 17) describes corporate taxes as nearly 19% of revenue in 2012, characterising that as "among the highest in the developed world and significantly higher than some key regional competitors." But properly taking imputation credits into account would reduce this number by about a third, down to no more than 12.6% of total revenue—still a bit higher than the OECD average but far from the outlier depicted by the Treasury (the US gets 11.6% of its revenue from the corporate income tax, for example). Moreover, Australia's imputation system serves well to limit tax planning and minimisation by your home country multinationals, something an observer from the US can view only with envy. It came as a surprise to me, therefore, that both the Australian and New Zealand

Governments appear to be giving serious consideration to repealing imputation. At first blush—reading what Treasury says—this seems to be based on some misunderstandings of its role. The Australian Treasury, for example, understates imputation's advantages and ignores that the demise of imputation in Europe was based not on policy grounds, but rather because of legal constraints under the European treaties—to which Australia, happily, is not a party.

But there are also more fundamental challenges at stake. In particular, the government wants to reduce the statutory corporate rate, especially, it seems, to encourage inbound investment—a position, which unlike some tax specialists here and abroad, I agree with. Australia, however, unlike many countries around the world, is uniquely hampered in its ability to make the simple, natural, and commonplace move: namely to broaden your porous GST base, and use at least some of the revenues from that to lower the corporate income tax rate. This barrier, as you all no doubt know, is due to what I've come to think of as Australia's great GST mistake—a mistake no doubt borne out of political necessity. The mistake, as I see it, has two components: the first is the requirement of unanimity among the states. As we have seen in Europe, a unanimity requirement for making tax policy inhibits useful change and privileges the status quo long after the status quo undermines progress. The second is the decision to allocate *all* GST revenue to state governments. Earmarking the entirety of such a general revenue source to the states—rather than, for example, committing a percentage of total revenues—essentially takes the GST off the table as a potential mechanism for helping to finance a change in the mix of federal revenues. The federal government, therefore, cannot use GST reforms as a way to finance a corporate rate reduction without causing major political upheaval.

Nor, given the politics here at this moment, are other potential sources of revenue readily at hand. The carbon tax repeal has taken energy taxes off the table, and the recent elimination of the mining tax makes increasing taxes on natural resources a political non-starter. While there is some potential for individual base broadening—eliminating negative gearing and perhaps cabining the use of losses, for example—the government is obviously and understandably, given the politics, reluctant to raise individual income taxes to reduce the corporate rate. The talk of indexing the individual income tax in the *Re:Think* would (mistakenly in my view) move in the opposite direction. Without much more multilateral cooperation than is now on the horizon, a unilateral financial transactions tax has little to commend it here. There may be some room for increasing taxes on financial institutions (and keeping the revenue at the federal level), but this will be a heavy lift. The lack of any apparent alternative revenue source, and the large amount of imputation credits now being claimed, seem to imply that repeal could finance a substantial reduction in the corporate rate—perhaps in the range of nine or ten percentage points. This would no doubt make imputation an inviting target. But an analysis by PwC suggests a considerably smaller rate reduction could be financed by imputation, perhaps only three or four percentage points.[6] This is a far less appealing trade-off, given the integrity benefits of imputation.

Given the misleading budgetary accounting I mentioned earlier, it might seem to Treasury that a corporate tax increase would be funding a corporate rate reduction if imputation were repealed. But, if such a change is made, individual taxpayers, including many of the elderly, will soon notice that they are now paying taxes up to 45%—rather than 15%, or even getting refunds in some cases—on their dividends from Australian companies. In addition, repealing imputation to fund a lower corporate tax rate would spread tax relief now focused on Australian companies to inbound foreign investors. From an economic perspective, given the size and openness of the Australian economy, this may prove beneficial, but, as a political matter, it would likely produce pressures for other tax benefits for domestic companies or activities. In any event, this seems the key business tax reform question put by the government in its *Re:Think* document: should imputation credits be repealed to finance a corporate rate-cut? I have long been a supporter of imputation credits in the US and have recently published an article urging them, but our nations' circumstances are very different. It may be that the trade-off the Treasury is suggesting would benefit the Australian economy, and at the same time, almost certainly increase tax progressivity, but I remain unconvinced that such a change would be wise.

BEPS

Let me say a few words about BEPS, though given my time constraints, I can only gloss over the key substantive issues. Nevertheless, I will offer a few comments and attempt to put the US position into context. First, and most importantly, the OECD's BEPS project is different from any previous multilateral effort. What makes it unique and historic is that it was largely generated by and promoted at the prime minister level of the G-20. This has not been the case with previous efforts. So BEPS must succeed—at least in the sense that a moment must come when the OECD declares victory, or at least spins whatever it has accomplished as a victory. The key question, of course, is what will count as success.

One thing seems absolutely clear. The BEPS project itself will persist in attempting to refine and adapt 20th century concepts—"permanent establishments," "arms-length pricing" and the like—to our 21st century economy. This may be because of a steadfast belief in these concepts, or because it is the only way to achieve the necessary consensus in a timely fashion. But, whatever the reason, it means that the BEPS effort will, at best, enjoy only limited success over time.

Before BEPS, the OECD has had its greatest success with regard to information reporting and sharing. And, of course, the US adoption of, and its numerous international agreements on, the Foreign Account Tax Compliance Act (FATCA) have changed the world of information reporting. So has the European Commission's effort to obtain releases of special tax deals for specific multinational companies by countries like Ireland and Luxembourg. The OECD effort to obtain country-by-country reporting will no doubt prove irresistible. This, of course, is going to increase the difficulty and intensity of audits—something we are already seeing. From the business perspective, this makes new mechanisms for securing bilateral or even multilateral agreements for dispute resolution especially important. The competent authority process will not suffice.

The business community has been pressing for new mechanisms, especially arbitration. What we in the US call baseball arbitration—where each party submits one bid and the arbitrator must choose among them—has worked somewhat well in the US domestic context. In any event, the

US Government is now involved in the effort for new dispute resolution methods and this is an encouraging development. A recent protocol between the US and Japan, for example, expands the potential uses of arbitration.[7]

On interest deductions, the BEPS discussion draft (like the Obama Administration's tax reform proposals) pushed for a group-wide allocation of interest expense based on income, or assets or sales, or a combination of such an approach with a German-type limit of the ratio of interest expense to EBITDA (earnings before interest, taxes, depreciation and amortization) as a backup. But business interests resisted that proposal, even with a liberal ability to move debt among related parties, and now seem to have managed to get the OECD to accept the ratio test as the rule with a group-wide allocation as a safe harbor. The key question, of course, is what will be the percentage limitation. I think there is an emerging consensus that 25 or 30% is too high. The US is apparently pushing toward 10% of EBITDA and it is possible that the German Government won't object to that low a number. Australia should probably join in that push. Business, of course, wants a higher ratio but 10 to 15% may not be out of the question.

I am reluctant to mention transfer pricing, and I hope that by doing so I will not stimulate questions or discussion. Here, of course, the relationship between ex ante agreements among related parties and ex post results is the key issue. I just want to observe that I have been surprised by how wedded the US Treasury has been to maintaining an ex ante perspective and to respecting a related group's allocation of risks. The US generally has opposed the risk recharacterisations of the OECD draft, wants to give an equity return to the entity that bears financial risks, and is reluctant to allocate risks to where the risks are actually managed. This is consistent with the current Treasury's general view that, with some statutory changes to deal with low-taxed income, CFC rules can and should serve as an appropriate and adequate backup to tax any income taxed at low or zero rates abroad. In essence, I view the Treasury as operating in the OECD as if our Congress has, or certainly will, accept its proposals to impose a minimum rate of tax on low-taxed foreign source income of CFCs. Not only does this seem unduly optimistic about what our Congress will enact, but—by focusing its efforts on CFC rules and therefore on outbound investments by US multinationals—the Treasury is taking significant risks of income stripping through transfer pricing and other techniques by foreign multinationals doing business in the US. I have argued myself for a different approach that would address both outbound and inbound efforts to shift income away from the US by focusing more closely on domestic sales.[8] This may be a direction that Australia should at least consider.

With regard to CFC rules in the BEPS context, the OECD seems willing simply to offer a broad menu for countries to choose from. Each member country seems to want to defend their own rules.

Before concluding my discussion of BEPS with implementation issues, I want to say a bit about patent boxes. In a recent article, I report that the economics literature demonstrates that incentives for R&D are more effective than the kinds of low rates on patent or other intellectual property income—the so-called patent boxes—that we have seen proliferate in Europe.

In its February report to the G-20 finance ministers in Turkey, the OECD announced that it had, at the behest of Germany and the United Kingdom, reached a consensus of all OECD and G-20 countries that a low-rate patent box will not constitute a harmful tax practice, so long as there exists a sufficient nexus between the location of the R&D and other activities generating the preferentially taxed income and the location offering the low tax rate. This would, for example, uphold the regime in the Netherlands, but not the one in Luxembourg. There will be a grandfather of existing regimes until 2021 and more work must be done on the role of outsourced, contracted-for R&D, for example. And this may not be the last word, because the European Commission might take a different view under the treaties for members of the European Union. Embracing the patent box trend hardly seems a step forward.

Finally, the OECD has announced the development of a multilateral instrument to implement the treaty-related aspects of BEPS—a move necessary to avoid having to update the more than 3,000 bilateral tax treaties. Work on this instrument is to start in July and be completed by December 2016. Let me list some barriers to a multilateral agreement. First, nations are generally interested in the wellbeing of their national residents and citizens, not overall worldwide welfare. Second, as I mentioned earlier, the OECD includes many countries that are bound by the European treaties, and the meaning of the four freedoms under those treaties has been, and will be in the future, interpreted by the European Court. How will the European limitations (e.g., on CFC rules) interact with the OECD's BEPS actions? How will European Commission actions inhibit other non-European countries from joining in—or induce reservations to any multilateral agreement? Third, there are 130 countries, some of which badly need revenue and others of which happily serve as tax havens, that are not in the EU, OECD, or G-20. How will those countries be affected by and respond to the BEPS actions, including a multilateral treaty, if one does come about?

Unanimous multilateral agreement on BEPS action items, if it occurs at all, will likely be limited to "lowest common denominator" principles. Moreover, implementation of BEPS recommendations will generally require participant country action: through domestic law changes or treaty amendments. Participant countries may not implement BEPS recommendations uniformly or on a timely basis. The US raises special problems because subsequent domestic law may override treaty obligations—the opposite rule from France, for example, which is bound by its treaties.

At this month's Australian Parliamentary hearings on corporate tax avoidance, two distinguished members of this University's faculty expressed quite different views of the role the US is playing in the BEPS endeavour. One claimed that the US was playing the role of a spoilsport; the other described the US role as more benign. Let me close my remarks about BEPS with a brief comment about their dispute.

The political impetus for BEPS arose out of a series of disclosures, initially in US Senate hearings and then in the UK, about tax avoidance efforts and successes of specific US multinationals—Google, Microsoft, Apple, and Starbucks—and widespread publicity about low effective tax rates of certain US multinationals, which were generally accomplished through very low rates on their foreign source income. Not surprisingly, this created some concern in the US that BEPS was an exercise intended to increase foreign governments' taxes on US multinational corporations.

Some members of our Congress, which plays little or no role in the BEPS process, reacted. Here is an excerpt from a 2 June 2014 statement by Dave Camp, the then-chairman of the House Ways, and Means Committee, and Senator Orrin Hatch, now Chairman of the Senate Finance Committee, both Republicans:

> "We are concerned that the BEPS project is now being used as a way for other countries to simply increase taxes on American taxpayers. The process established by the OECD raises serious questions about the ability of the United States to fully participate in the negotiations. The extremely ambitious time frame…limits our ability to review, analyze, and comment on the rules being proposed. We will not be rushed into a bad outcome. Ultimately, we believe that the best way for the United States to address the potential problem of BEPS is to enact comprehensive tax reforms that lower the corporate rate to a more internationally competitive level and modernize the badly outdated and uncompetitive U.S. international tax structure."

A key treasury official puts the matter more succinctly. He says that when he is participating in the BEPS exercise at the OECD, his feeling is that everyone else in the room wants the US to pay for all the drinks.

That said, the US Treasury is participating and, I believe, participating constructively in the BEPS project. But it is doing so tied to the international tax policy positions of the Obama Administration—the centrepiece of which is the minimum tax on the foreign source income of US multinationals. It may go without saying, but I'll say it anyway: the US Treasury wants the revenue from US multinationals—and that is the same revenue that many other countries want.[9]

Obviously, countries that want to adopt anti-base erosion measures are free to do so (subject to treaty obligations) and do not need to wait for completion of the BEPS project. The UK's diverted profits tax legislation is exhibit number 1 for this. Unsurprisingly, that was not a welcome development in the US. And it may well violate the European treaties. A crucial, if obvious, point about uncoordinated unilateral actions of this sort is that there is no reason to believe that they will be coherent taken all together. But political enticements for mischief abound.

The future

This brings me to a few concluding observations about the future—about international tax policy in a post-BEPS, ever-more-global economic world. This, of course, brings us back to the challenges of international income taxation with which I began. I offer two quotes as a prelude to some predictions about the future. The first is by Thomas Sewell Adams, an economist who was by far the key US person in fashioning the US international tax law and the League of Nations Model Treaty in the period from 1918 to 1928: "Anyone," he said, "who trusts wholly to economics, reason, and justice will in the end retire beaten and disillusioned" in that "hard game" of tax law making. The second, and perhaps more relevant, quote is from Yogi Berra, a New York Yankees baseball catcher and everyday philosopher, who said: "It's tough to make predictions, especially about the future."

Nevertheless, here are my top dozen.

First, BEPS will not usher in a new era of international cooperation, rather than competition, in international taxation. Nations will continue to compete—especially for good jobs and will offer low rates and special tax breaks in an effort to get them. Not only will R&D incentives and patent boxes survive and thrive, but we will also see other incentives for domestic manufacturing and perhaps for specific industries or products, such as green energy, and for headquarters activity.

Second, each country—perhaps with the exception of the US—will try to shift taxes onto someone else's multinational companies and a wide variety of so-called anti-abuse rules will proliferate. The UK's diverted profits tax proposal is just the beginning of that process. Australia's entry into that realm shows that imitation and proliferation are likely. The very different efforts of large market countries, like India, offer further confirmation of this trend.

Third, the need for revenue everywhere, along with its political popularity, will combine to maintain the corporate tax as a source of revenues in most non-tax haven countries. So, we will see ongoing BEPS-type efforts. The OECD will endeavour to provide the institutional home for those efforts. This is just the beginning. The old slogan, "Don't tax you, don't tax me, tax the fellow behind the tree" is becoming, "Don't tax you, don't tax me, tax the corporations across the sea."

Fourth, multinationals around the world will engage in ongoing, complex tax planning and will tend to stay at least a step ahead of governments. This will create more conflicts and opportunities for double or multiple taxation of the same income, which, in turn, will produce new dispute resolution mechanisms and more cooperation among tax administrators. As markets in developing countries continue to grow, weak tax administrations will cause more and more difficulties for multinational businesses.

Fifth, sooner or later a variety of backup measures, perhaps in the form of minimum taxes, will ease pressures on transfer pricing, which is hardly going to be more rational or certain after BEPS than before. Formulas and ex post profit splits will become more important over time. In large market countries, these will be based largely on sales; in high export countries, on production. The UK "diverted profits" tax is just an opening salvo.

Sixth, the BEPS effort to link tax consequences to the location of "real" "value enhancing" activity will introduce greater distortions than now exist into firms' decisions about where to locate real activities, such as personnel and plant and equipment. As an example of what I mean, take the US case of corporate inversions. In the old days, you could put a foreign parent on top of a US multinational through a purely paper transaction — and move the parent to Bermuda, for example. Now, you have to move real activities, so recent inversions of US companies have been into real countries like Canada, the UK, and the Netherlands. The US was probably better off when only paper had to move.

Seventh, the complexities of arrangements and multiple avenues with which I began this talk imply that countries are going to rely more and more on general anti-avoidance rules or overriding economic substance requirements to challenge tax planning and transactions. This is already happening in Australia, the US, and elsewhere. The limits of that approach will be severely tested through litigation in the years ahead.

Eighth, the increasing need for revenues from destination-based consumption taxes—from GSTs and VATs—will mean that more and more countries will try to make their VATs look more like New Zealand's GST, with varying degrees of success. This will put more and more pressure on taxing international services, which already is causing major headaches. Europe will be slow to make changes because of treaty barriers. Australia will also be slow because of the institutional and political barriers I mentioned earlier.

Ninth, countries will look to tax or otherwise obtain revenues from location-specific activities, especially natural resources, tourism, the use of deep water ports, and the like. They will have to be very careful not to overdo it.

Tenth, because of concerns with inequality, there will be greater efforts to tax individuals' capital income. Archaic exemptions for capital gains, for example, will erode and ultimately disappear. And the need to tax capital income to address inequality will make it impossible for developed countries to jettison their corporate income taxes.

Eleventh, countries will search for new sources of taxation. Excise taxes may make a comeback, especially on financial institutions or certain financial transactions and perhaps on fossil fuel consumption. Cap and trade will give way to carbon taxes—Australia's recent decision to the contrary notwithstanding.

Twelfth, and finally, people like us who have made or will make tax planning, tax policy, or tax compliance their vocation have nothing to worry about. Business of all sorts will long be robust. BEPS is closer to the beginning of this story than the end.

Of course, the only one of these predictions that I'm certain about is the last. Thank you.

Part 3

Portfolio Income

Chapter 8

Taxing International Portfolio Income

I. Introduction

Most analyses of the taxation of international income earned by U.S. corporations or individuals have addressed income from direct investments abroad. With the exception of routine bows to the "international tax compromise" and sporadic discussions of the practical difficulties residence countries face in collecting taxes on international portfolio income, the taxation of international portfolio income generally has been ignored in the tax literature.[1]

Analysis and reassessment of U.S. tax policy regarding international portfolio income is long overdue. The amount of international portfolio investment and its role in the world economy has grown exponentially in recent years. In most years since 1990, the total market value of U.S. persons' foreign portfolio investments has exceeded the value of U.S. corporations' foreign direct investments, and the total amount of U.S. taxpayers' foreign portfolio income has exceeded their income from foreign direct investments.[2] Cross-border portfolio investments are no longer a tiny tail on a large direct-investment dog. International portfolio investments now play a major role in the world economy, a role quite different from that played by foreign direct investments. We can no longer afford simply to assume, as we have in the past, that the way the United States taxes the latter is obviously appropriate to the former. Instead we must ask explicitly what tax policy for income from portfolio investments best serves our nation's interest. That is the task we undertake here.

Corporations raise money to do business in three ways: They retain what they have earned, they borrow, and they issue equity to shareholders. At the corporation's inception, borrowing and raising equity capital are the only options. When U.S. equity capital is invested abroad, sometimes a U.S. corporation will open a foreign branch, but typically it invests equity capital in the shares of a foreign corporation.

Often the voting stock of the foreign corporation is wholly or majority-owned by a U.S. corporation or corporations or by U.S. persons. Even without control, important shareholders-whether individuals or other corporations-may exercise substantial influence over the company's business decisions. To have control or even significant influence over corporate decisionmaking, one must own a substantial percentage of shares in the company. In the commonly used vernacular, one must be a "direct investor." Those who do not own sufficient shares to influence business decisions are labeled passive, or portfolio, investors. If portfolio shareholders are unhappy with the company's business decisions, they may sell their shares.

In the United States, investment is classified as direct whenever a U.S. individual or company owns, directly or indirectly, at least 10% of the voting stock of a foreign corporation or, contrariwise, when a foreign individual or company owns, directly or indirectly, at least 10% of the voting stock of a U.S. corporation.[3] Investment is classified as portfolio whenever the individual or corporation owns less than 10% of the foreign entity.[4]

Perhaps the lack of discussion in the tax policy literature regarding the taxation of international portfolio income is due to the congruent structure of U.S. taxation of income from foreign direct investments of U.S. multinational corporations and income from foreign portfolio investments of U.S. individual citizens or residents. The United States allows foreign income taxes imposed by the nation where the income is earned to be credited against the income taxes that the United States otherwise would impose.[5] This system of crediting foreign income taxes first entered the U.S. income tax law in 1918.[6] In 1921 the foreign tax credit (FTC) was limited to the amount of U.S. tax that would have been imposed on the foreign source income.[7] The FTC has served as the cornerstone of U.S. international tax policy ever since.[8]

When the U.S. regime for taxing international income first came into place, policymakers focused on direct investment abroad by U.S. corporations: "The United States says, in effect, to its citizens-go abroad and trade."[9] U.S. international tax policy was essentially mercantilist, driven largely by concerns that double taxation of international income by both the United States and the country where the income was earned would inhibit U.S. direct investments abroad and also would be unfair.[10] The U.S. decision unilaterally to grant a tax credit for foreign income taxes also was grounded in the policymakers' conviction that the source country-the country where the income was earned-had a right to tax such income and inevitably would exercise that right.[11]

Soon after the United States enacted its foreign tax credit, the League of Nations, spurred in part by the United States, examined the problem of international taxation, and in 1928 the League produced a model bilateral income tax treaty.[12] The decades since have seen some changes, to be sure, but the basic structure of the League's 1928 model treaty undergirds today's model treaties of the United States, the OECD, and the United Nations, which, in turn, form the basis for the more than 2000 bilateral income tax treaties now in effect throughout the world.[13] Like the instigators of the U.S. foreign tax credit, the drafters of the League's 1928 model treaty were overwhelmingly concerned with international business income.[14] A few moguls may have owned widespread international portfolio investments, but portfolio investments simply were not of much importance to the world economy at that time.

The tax literature frequently labels the League of Nations' basic allocation of income taxes in its model treaty between countries of source and countries of residence as the "international tax compromise." That compromise typically is described as allocating active business income to the jurisdiction where it is earned (the source jurisdiction) and passive or portfolio income to the jurisdiction from which the capital is supplied (the residence jurisdiction).[15] But this description buries the fact that source countries frequently impose income taxes on income from passive portfolio investments in the form of so called withholding taxes: final taxes imposed at a flat rate on gross dividend and interest income paid to foreigners.[16]

In 1984-both to encourage foreigners to purchase U.S. debt to help finance federal deficits and to help U.S. companies borrow in world markets-Congress repealed the U.S. withholding tax on portfolio interest income.[17] Since then zero taxation by source countries of portfolio interest income has become commonplace.[18] But source countries typically continue to impose withholding taxes on dividend income earned by foreigners. The Code imposes such a tax at a 30% rate, but the United States commonly reduces that rate to 15% by treaty.[19] In an income tax treaty negotiated in 2001, the United States and the United Kingdom both agreed to eliminate their withholding taxes on certain direct dividends, thus–in that instance at least–bringing the longstanding description of the "international tax compromise" closer to reality.[20] The U.S.-U.K. treaty may signal a fundamental change in U.S. tax policy. A similar policy was included in new protocols signed with Australia and Mexico.[21] A zero withholding tax on similar dividends will likely be considered in Treasury's forthcoming treaty negotiations with the Netherlands.[22] Income from international portfolio dividends has grown more rapidly than income from international direct dividends in recent years, but the taxation of these portfolio dividends has yet to receive serious review from Treasury.

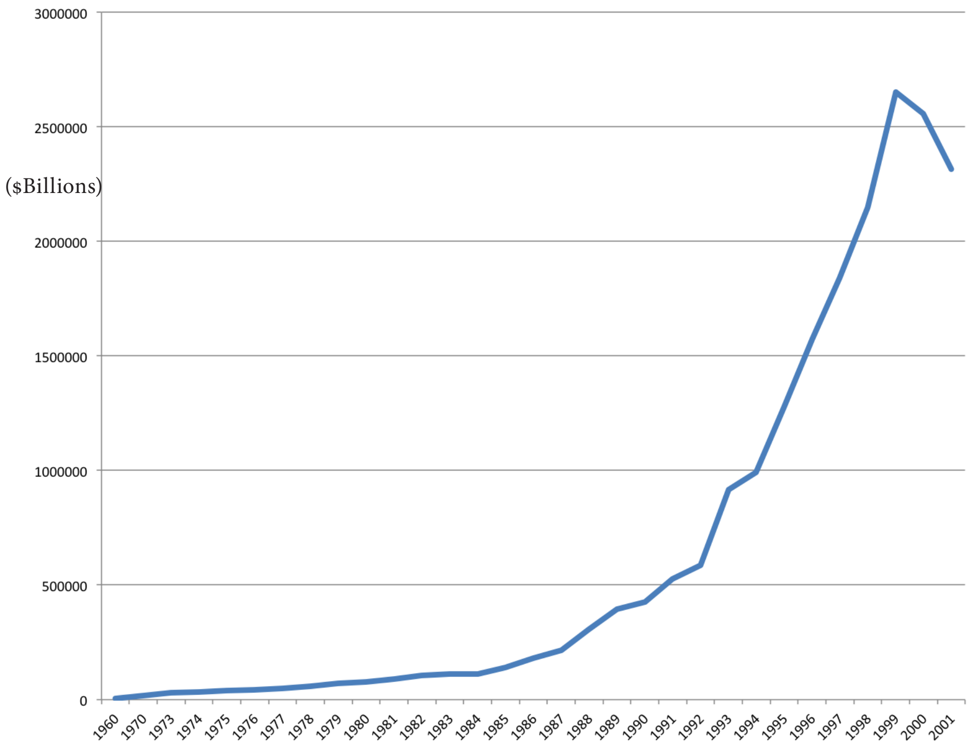
II. The Growth Of Outbound U.S. Foreign Portfolio Investment

Numerous commentators have remarked on the shortcomings of the data available about the magnitude of foreign portfolio investments (FPI) by U.S. persons and of portfolio investments by foreigners into the United States.[23] We fill that gap somewhat here by describing the growth over time of U.S. outbound and inbound FPI, and by reporting recent data on flows of U.S. outbound FPI

In 1960, outbound FPI by U.S. nationals totaled only $10 billion.[24] Portfolio investment in long-term securities by foreigners in the United States totaled $13.8 billion.[25] By 1986 U.S. outbound foreign portfolio investment was $158 billion.[26] In 1997 outbound FPI from the United States was more than $1.7 trillion,[27] while portfolio investments by foreigners in long-term securities in the United States had expanded to $2.806 trillion.[28] The $1.7 trillion in U.S. outbound FPI in 1997 accounted for 29% of FPI holdings reported worldwide.[29] By the end of 2001, the stock of U.S. outbound FPI had grown to $2.262 trillion dollars.[30] Total FPI assets owned by U.S. persons grew 21.1% per year between 1986 and 2001.[31] Between December 31, 1997 and December 31, 1999, the stock of U.S. outbound portfolio investment jumped from $1.755 to $2.456 trillion dollars.[32] Between December 31, 1999 and December 31, 2001, the stock of U.S. outbound portfolio investment fell to $2.262 trillion dollars,[33] principally due to the decrease in equity prices from the bursting of the stock market bubble of the late 1990's.

Figure 1

Taking International Income Foreign Portfolio Investment By U.S. Taxpayers Abroad



Sources: Scholl, note 24; Bach, note 26; FLTS Report, note 26; Treasury Report on Holdings, note 30.

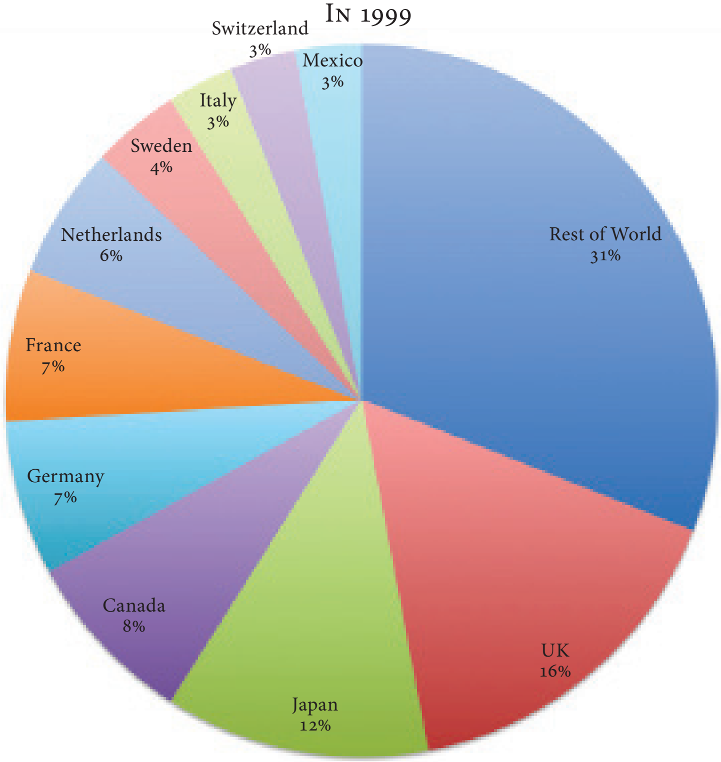
Note: 1997, 1999, and 2001 data comes from U.S. Treasury benchmark surveys on U.S. holdings of foreign securities. Earlier data is only available through the standard Survey of Current Business publication and revisions, and is likely underestimated.

In an average month in 1999, U.S. taxpayers sent $215 billion in portfolio investment abroad.[34] The average monthly outbound flow of U.S. FPI today is significantly larger than the total stock of U.S. FPI assets in 1986.[35] In 2002 alone, U.S. foreign portfolio investors bought nearly $1.26 trillion in foreign equities.[36] The level of investment flows is particularly relevant here since income tax consequences are triggered by flows of investment-sales and purchases of assets as well as payments of investment income-not the level of the stock of investment assets.

Notwithstanding the overall growth in U.S. outbound FPI, the bulk of U.S. portfolio investment abroad is still concentrated in relatively few countries. In 1999, 68% of U.S. FPI went to 10 countries.[37] These 10 leading recipients of U.S. FPI account for less than 30% of worldwide GDP.[38] U.S. FPI is therefore significantly more concentrated than is worldwide economic output. The United Kingdom leads the countries where U.S. taxpayers invest FPI dollars, accounting for 16% of all U.S. outbound FPI.[39] Figure 2 depicts shares of outbound U.S. FPI invested in specific countries in 1999.

While U.S. FPI tend to be concentrated in those countries that are most important in terms of worldwide economic activity-all of the G-7 countries, for example, are among the top 10 locations for U.S. FPI-there is surprisingly little correlation on a country-by-country basis of U.S. FPI per capita compared to GDP per capita.[40] U.S. portfolio 1investment simply does not mirror the global distribution of economic activity. The concentration of U.S. FPI in 10 or 15 countries may instead be explainable by the relative accessibility of various markets over time, the path dependence of investment patterns, and other factors, perhaps including net shareholder tax rates for investments in specific countries.[41]

FIGURE 2
DISTRIBUTION OF FOREIGN PORTFOLIO INVESTMENT BY U.S. TAXPAYERS IN 1999

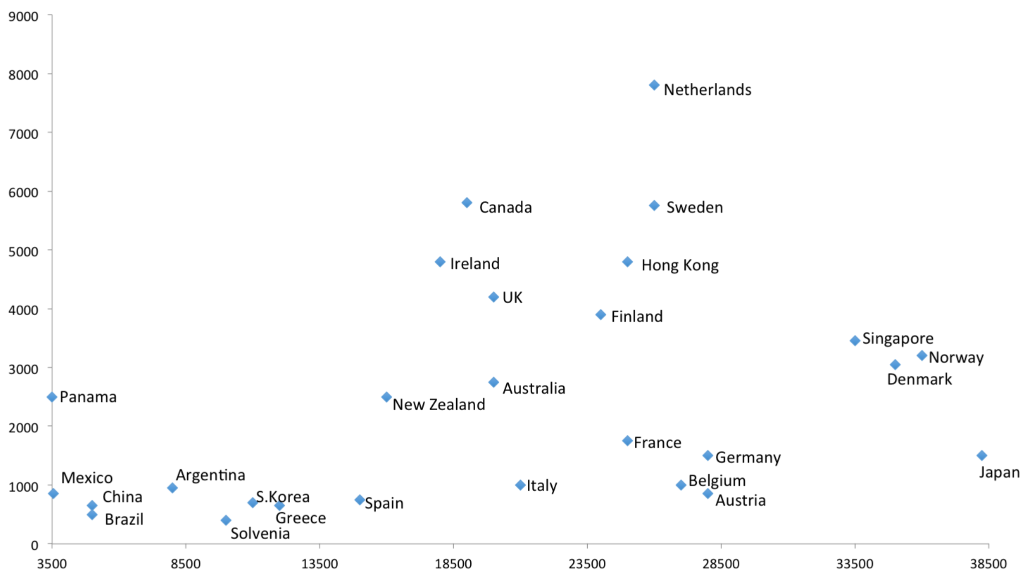


Source: Treasury FLTS Report, note 26, at 23 tbl. 16.

III. HOW ARE DIRECT AND PORTFOLIO INVESTMENTS DIFFERENT?

As we have indicated, U.S. policy for taxing income from FPI followed-without any serious independent analysis–the policies developed for U.S. foreign direct investments (FDI). But there are important economic differences between direct and portfolio investments that may imply quite different tax treatment of their income. Indeed, these economic differences suggest that the principal normative concepts used to evaluate international tax policy generally–capital export neutrality and capital import neutrality—have far less relevance to the taxation of international portfolio income than they might for evaluating the taxation of income from direct investments. This Section describes how these two types of investments diverge economically and outlines the key distinctions in the current taxation of income from direct and portfolio investments.

FIGURE 3
FOREIGN PORTFOLIO INVESTMENT BY U.S. NATIONALS ABROAD



Sources: Treasury FLTS Report, note 26. Wor1d Bank Development Indicators (1997). Population numbers are for 1997. GDP/Capita Numbers are for 1997 in 1995 Dollars estimated via the Alias Method.

Note: Three countries with GNP/Capita are off the scare of this chart. Switzerland has $9,000 FPI/Capita and GNP/Capita $43,100. Luxembourg has FPI/Capita $19,600 and GNP/Capita $46,700. Finally, Bermuda has FPI/Capita of $422,300 and GNP/Capita of $35,600. (Note that Bermuda has a population of only around 60,000 persons).

A. The Key Tax Distinction Between Foreign Direct Investment and Portfolio Investment

Foreign portfolio income often is earned today by both individuals and corporations, while FDI virtually always is made by corporations. As we noted, whether an investment in a foreign entity by a U.S. corporation is classified as direct or portfolio technically turns on the degree of ownership of the foreign company; to qualify as a direct investment, some minimum threshold of ownership-generally 10% of voting stock-must be crossed.[42] It may be simpler analytically, however, to regard income from FDI as representing the profits from conducting business activities abroad—the profits of the firm—and income from FPI as representing passive investment income-the profits realized by investors in the firm.[43] Although we follow the technical definitions here, it may similarly be helpful to think of an investment as direct when a U.S. taxpayer has sufficient control over the business decisions of the foreign entity; when the U.S. taxpayer has little or no control over the foreign entity's business decisions, the investments are typically FPI.

Although a number of U.S. tax consequences turn on the distinction between FDI and FPI, which generally corresponds to the tax law's distinction between active and passive income,[44] here we emphasize one. Whenever a U.S. company has sufficient control over a foreign corporation, it is permitted to credit against its U.S. tax liability corporate income taxes imposed by the foreign country on the foreign corporation's earnings, either when those earnings occur or when the U.S. corporation receives dividends paid out of those earnings. In other words, a direct corporate investor is entitled to the "deemedpaid" or "indirect" foreign tax credit.[45] In contrast, portfolio investors generally are not allowed any U.S. tax credit for corporate income taxes imposed abroad but instead are allowed to credit only foreign withholding taxes paid on dividend or interest income.[46] In some instances, however, most notably for portfolio investments in France, integration of corporate and shareholder taxes has overridden this dichotomy, and U.S. portfolio shareholders effectively receive a credit for some or all of corporate taxes paid abroad.[47]

In the OECD countries where U.S. corporations have substantial FDI, corporate income taxes in 2002 ranged from a low of 16% (in Ireland) to a high of 40.2% (in Belgium).[48] Most corporate tax rates in OECD countries today are in the range from 25% to 35%. By imposing these corporate income taxes, source countries exercise their right to tax international business income. On the other hand, source countries today rarely exercise any right to tax interest income earned by foreign portfolio lenders and, where bilateral treaties are in force, tend to tax portfolio dividend income at a zero to 15% withholding rate. This is why commentators frequently describe the "international tax compromise" as generally allocating the taxation of portfolio income to the country where the investor resides, although that is an oversimplification.[49]

B. The Key Economic Distinctions Between Foreign Direct and Portfolio Investment

Foreign direct investment is often undertaken by corporations to earn economic rents.[50] Foreign direct investment decisions therefore frequently are driven by opportunities to exploit economies of scale, economies of scope, or proprietary business advantages. Furthermore, considerable evidence suggests that FDI by U.S. multinationals is complementary to domestic investments, rather than a substitute for them.[51] Empirical economic evidence, however, also suggests that FDI decisions are sensitive to differences in tax burdens.[52]

In contrast, portfolio investment dollars are volatile and move rapidly throughout the world seeking the highest return possible for a given level of risk.[53] In portfolios managed by investment professionals, investments in one foreign country are frequently interchangeable with investments in countries with similar risk/return profiles.[54] One consequence is that portfolio investment dollars abroad may substitute for investments at home.

Surprisingly, economic analysis to date offers no clear consensus about the extent to which U.S. portfolio investors are tax-sensitive. While economic theory suggests that portfolio investors should be tax-sensitive, seeking the greatest after-tax returns, the empirical data is mixed. For example, empirical research by Joel Dickson and John Shoven suggests that as recently as 1993 investors did not pay much attention to the effect of income taxes on the rates of return of their portfolio investments.[55] Shoven and Dickson examined 147 of the 150 largest U.S. mutual funds in existence on October 31, 1992.[56] They convincingly showed that for these funds the relative ranking based on rates of return was substantially different pretax and post-tax.[57] In 1993, however, only one among the very large number of information sources dedicated to providing investors with mutual fund information published after-tax returns.[58] Nor had prior academic papers evaluating mutual fund performance adjusted returns for shareholder-level taxation.[59] The lack of easily available data regarding after-tax performance, combined with the disparity between pretax and post-tax rankings for mutual funds, suggests that (as recently as 1993 at least) most mutual fund investors did not make their mutual fund portfolio investment decisions on a post-tax basis. And most mutual funds apparently were little concerned with the tax consequences of their investments for their fund's shareholders.

Since 1993, however, after-tax information and after-tax results have become increasingly available and possibly important to mutual fund investors. In January 2001, the SEC approved a rule requiring mutual funds to disclose after-tax returns.[60] New mutual funds have emerged in the decade subsequent to the Shoven-Dickson study advertising themselves as "tax-efficient" or "tax-sensitive." Major non-proprietary sources of information about mutual funds, such as Morningstar, now rank mutual funds based on after-tax performance.[61] These changes suggest that both mutual fund investment managers and individual mutual fund shareholders are becoming more sensitive to tax effects on portfolio investment returns.

Nevertheless, tax-efficient funds accounted for only 12% of all inflows into equity funds in the first 10 months of 2001.[62] This figure represents significant growth compared to the 2% of equity fund in flows into tax-efficient funds in 2000,[63] but still represents only a relatively small portion of mutual fund investments. In the 2-month period ending March 2003, tax-managed funds performed only half a percentage point better than other funds, and tougher times are now predicted for tax-managed funds since most investors now have capital losses to offset gains from funds that are not tax-sensitive.[64] The extent to which U.S. portfolio investors' investment decisions are now tax-sensitive therefore remains unclear.[65]

C. Portfolio Investors Favor Their Home Country

Economic theory, which emphasizes the role of risk diversification in the investment choices of portfolio investors, predicts, without taxes, a full worldwide diversification of portfolio investments.[66] The problem for the theory, however, is that portfolio investment exhibits a substantial "home bias," that is, a large percentage of the debt and equity issued in any country is directly in the hands of that country's residents.[67]

Economists, to date, have been unable to explain the home-bias phenomenon. Indeed, given the difficulties of enforcing residence-country income taxes on FPI (discussed in Section VI), we might expect to see a bias in favor of foreign rather than domestic investments.

A large economic literature is devoted to efforts to explain the home bias,[68] but no explanation is yet regarded as convincing. Hedging explanations are to little avail, and neither transaction costs nor tax differentials have much explanatory power. In several countries, corporate-shareholder tax integration regimes favor domestic over foreign investment.[69] But these tax effects are far too small to explain the home-country bias seen in the data.[70] Intuitively, the most convincing explanation is grounded in information asymmetries; investors have better information about domestic than foreign securities.[71] But, whatever the reason, "aggregate demand for domestic equity is much less elastic than would be implied by standard models of portfolio choice."[72] This means that the economic impact of taxes on domestic portfolio investment income is less than might be expected.

D. Portfolio Capital Flees When the Milk Goes Sour

Unlike direct investments, portfolio investments are highly volatile. Portfolio investments move through the international capital markets quickly in response to changes in economic circumstances.[73] In the 1990's, for example, the UK's unplanned exit from the European Rate Mechanism in 1992, the Mexican Peso crisis, the Asian financial crisis, and the financial fallout associated with the demise of the Long Term Capital Management hedge funds all demonstrated the volatility of portfolio investments. The most dramatic instances of the volatility of portfolio capital during that decade involved the flight of capital from developing countries. The serious political and economic consequences that resulted often were not caused by specific policy decisions within the country, but rather resulted from flows of portfolio capital triggered by changes in market expectations and herd behavior.[74]

Institutional investors, especially from the United States, dominated the flow of portfolio equity to the developing world in the 1990's.[75] "Modern risk management techniques of portfolio managers, such as computerized portfolio insurance/programme trading strategies, value-at-risk and mark-to-market models, may exacerbate the movements of asset prices and increase the risk of [portfolio] contagion."[76] The five developing economies that received the largest flows per capita of portfolio capital from the United States as of 1997 were Mexico, Brazil, Chile, Hungary, and Malaysia.[77] Each experienced serious economic shocks due to the flight of portfolio investor capital during the 1990's.[78] A study of 20 emerging markets in the aftermath of the 1994 Mexican peso crisis found a connection between a country's financial and currency vulnerability and the composition of its capital inflows.[79] In particular, larger short-term foreign portfolio flows were correlated with greater disarray in the local financial markets.[80]

The pain of these shocks, however, was not limited to developing countries. Particularly in response to the Asian financial crisis and the demise of Long Term Capital Management, financial turmoil reached markets in Europe and the United States when portfolio equity churned as investments turned sour.[81] In response, debates emerged over the appropriate international economic policies in light of the risks posed by foreign portfolio flows. Nobel Prize-winning economists, world-renowned financiers, and central bankers have all de bated whether and how global portfolio capital flows should be constrained.[82] Numerous popular books [83] as well as major works of economic scholarship have addressed the subject. Jeffrey Sachs, for example, claims that, at a minimum, the international financial system needs the functional equivalent of the U.S. bankruptcy code and much more extensive banking regulation.[84] In the international tax context, portfolio capital movements renewed interest in the "Tobin Tax," named after James Tobin, the Nobel Prize-winning economist who first proposed the tax in 1971.[85] The Tobin Tax is an excise tax on capital transactions specifically designed to impose an additional bur den on fast-moving capital, including much of the world's current FPI Its burden would be far lower or nonexistent for slow-moving capital, which includes nearly all FDI.[86] The debate over policies appropriate to deal with global capital flows in international economic policymaking circles, however, has had almost no impact on the international income tax literature, which, as we have indicated, generally has ignored the question of whether FPI should be taxed differently from FDI.[87]

E. The Taxation of Portfolio Investment Does Not Affect the Location of Plant and Equipment

The empirical economic evidence demonstrates that corporate decisions about where to locate plant and equipment and headquarters activities, such as research and development, are quite sensitive to differences in the corporate-level taxes applicable to the income generated by these investments. But taxes on portfolio investment income generally do not affect the location of corporate investments in plant and equipment.[88]

Economic theory holds that effective marginal tax rates on FPI might influence the locational decisions of companies if a change in tax policy changes world interest rates. If, however, as most policy-makers believe, capital markets are sufficiently integrated that the world interest rate is unaffected by the domestic amount of saving in any one country, personal taxes generally will not affect the investment behavior of companies.[89] Along these lines, the European Commission's Working Paper on Taxation in the Internal Market (the "EC Working Paper") recently examined a set of simulated tax reforms in which either the domestic elements of various European corporation tax regimes, the international elements of those regimes, or the relationship between the corporation tax regime and the personal tax regime were harmonized across EC countries.[90] The Commission Staff concluded that "personal taxes have little effect on the impact of hypothetical policy scenarios to corporation tax."[91]

Changes in the marginal income tax rates for portfolio investors, to some extent, might affect the allocation of portfolio investments throughout the world. But in a classical corporate income tax system, taxes on portfolio investors generally will not influence the decisions of companies about where to locate their plant or equipment. Decisions about where to locate productive plant and equipment are made at the corporate level. So long as business decisionmakers cannot know the identity and tax position of their marginal shareholders, they will take only corporate-level taxes into account in making their business decisions.[92] As a practical matter, this seems to describe corporate behavior accurately, at least for publicly traded companies. In a classical corporate income tax system, while corporate-level taxes may vary depending on where investments are made, the residence country's taxation of a portfolio investor's dividends and capital gains typically does not vary based on the location of the corporation's investments.[93]

Our conclusion that taxes on the income from FPI do not influence the locational decisions of companies is true only if internationally mobile portfolio capital is available to a company.[94] This holds generally for large publicly traded multinational companies, which account for the bulk of FDI, but internationally mobile portfolio capital may not be available for small and medium-sized companies.[95] As a result, tax policy changes for FPI might affect these companies in a way that such changes would not affect larger multinationals. Small and medium-sized companies, however, are also less likely to base their foreign locational decisions on tax rates, and, in any event, are relatively unimportant in terms of the international allocation of productive plant and equipment.

Thus, the taxation of FPI—in sharp contrast to the taxation of FDI—has, at most, a small impact on where productive plant and equipment will be located.[96] It might affect the national origin of the owners of the company that owns the plant and equipment, and the nations from which the capital to finance the plant and equipment has been raised, but not the location of the plant and equipment itself.

IV. Evaluating The Taxation Of Foreign Portfolio Investment Income

Most analyses of international income tax policy assume that the fundamental goal of such policy should be to advance worldwide economic efficiency.[97] This norm in turn has been translated into "capital export neutrality" (CEN), which requires that a nation strive for a tax policy that is neutral about a resident's choice between domestic and foreign investments providing the same pretax rates of return.[98] CEN requires that a resident of any nation pay the same marginal rate of income taxation regardless of where she invests.[99] CEN also is indifferent about which country obtains the income tax revenue from the investment.[100] CEN often is advanced as the basis for the residence country's allowing a credit for income taxes imposed by the foreign country where the income is earned.

Businesses often advance policies based on a second kind of neutrality, capital import neutrality (CIN), which requires that all investments in a given country pay the same rate of income tax regardless of the residence of the investor.[101] CIN thus would subject income earned within a country to the same overall level of taxation, whether the income is earned by a resident or a foreigner. CIN often is advanced as a basis for taxation only by the country of source, with the residence country exempting foreign source income from tax.[102] The U.S. business community typically has opposed CEN and advanced CIN in connection with arguments to improve the "competitiveness" of U.S. multinationals doing business abroad.[103] It is now well known that it is impossible to achieve CEN and CIN simultaneously whenever countries' tax bases and tax rates differ.[104] As a result, U.S. international income tax policy (and that of other OECD nations) often is described as a "compromise" between CEN and CIN.[105] One problem with basing policy on this notion of compromise is that almost any policy can be described as meeting the compromise criterion.

Rather than endorsing CEN or CIN—or some compromise between them—as the basis for U.S. international income tax policy, we instead endorse the view—which one of us previously has advanced in detail elsewhere [106]—that U.S. international tax policy should be fashioned to advance the interests of the American people. By this we mean long-term U.S. well-being, not short-term advantage. Designing such policies requires U.S. policymakers to take into account the potential responses of other nations and to be mindful of the substantial advantages to this nation from U.S. participation and leadership in furthering cooperation in international tax policy among nations.

Not everyone is convinced, however, that the approach to policy that we advance here is the best normative approach to international tax policy; both CEN and CIN still have their adherents. Thus, before turning to the question of what tax policy for FPI would be most equitable and economically advantageous for Americans, we discuss in some detail why CEN and CIN have little to offer as a basis for establishing U.S. policy for taxing income from FPI, even for those who urge CEN or CIN as the basis for U.S. income tax policy for FDI.[107]

A. Capital Import Neutrality Is Not Relevant to the Taxation of Foreign Portfolio Income

Multinational corporations sometimes have advanced CIN as the basis for U.S. international tax policy, urging that the fundamental purpose of such policy should be to promote the "competitiveness" of U.S. multinationals doing business abroad.[108] The claim most often made is that the United States should impose no residual U.S. corporate-level tax when the tax in the country where the income is earned is below that which would have applied if the income had been earned domestically.[109] U.S. multinationals arguing for such a policy contend that the United States should enhance (or at least not inhibit) their ability to compete in foreign markets with multinational companies from other OECD countries. Whatever one thinks about advancing U.S. multinationals' competitiveness in foreign markets as a basis for the taxation of income from FDI, it has little or no relevance to the appropriate income taxation of FPI. Taxation of FPI, indeed taxation of investment income generally, may affect the ability of corporations to raise capital,[110] whether from foreigners or U.S. nationals, but has no effect on the ability of U.S. multinationals to compete against foreign corporations in doing business in a foreign country.

B. How Relevant Is Capital Export Neutrality to the Taxation of Foreign Portfolio Investment Income?

Tax policy grounded on CEN should produce a tax system where domestic and foreign investments that earn the same pretax return also yield identical after-tax returns. CEN is intended to prevent companies or individuals from forgoing investments with a higher pretax yield in favor of investments with a lower pretax yield but a higher post-tax return.[111] From a worldwide economic efficiency perspective, investment decisions made with reference to post-tax rather than pretax outcomes reduce productive efficiency and create deadweight economic losses.[112] Capital export neutrality therefore is principally concerned with preventing tax distortions of the decisions of U.S. and other firms about where to locate their real investment assets, their plant, and equipment.[113] Even in the context of direct investments, however, it is difficult to know how important such distortions in the location of investments are to the efficient functioning of the world economy. As the economist Michael Keen has re marked: "[W]e currently know almost nothing about the quantitative welfare implications of alternative tax treatments of cross-national direct investment."[114]

The most important recent attempt to assess the magnitude of such distortions in the current international tax system is the EC Working Paper.[115] That analysis demonstrates that the current international tax system does not come close to achieving CEN for direct investments. For example, the EC Working Paper shows that U.S. companies engaging in direct European investment through European subsidiaries face widely variant effective average tax rates in different European countries.[116]

The EC Working Paper analyzes investment by a U.S. parent company in various European countries (assuming wholly-owned subsidiaries) and computes the effective average tax rate (EATR) for these direct investments.[117] The EC Working Paper studied three categories of direct investment by U.S. firms in wholly-owned European subsidiaries: (1) investment financed with retained earnings, (2) investment financed with new equity, and (3) investment financed with debt.[118]

The paper shows that for such FDI the EATR varies from 25% for an investment in a subsidiary in Ireland, when the investment is financed by retained earnings, to 43.6% for an investment in a subsidiary in Portugal, when the investment is financed by issuing new equity.[119] Even within each of the three categories of financing, variation in the EATR is substantial. For investment financed by retained earnings, the highest EATR was 43.5% in Germany; the lowest EATR was 25% in Ireland.[120] For investment financed by new equity, the highest EATR was 43.6% in Portugal; the lowest EATR was 31.5% in Sweden.[121] For investment financed by debt, the highest EATR was 39.7% in Portugal; the lowest EATR was 31.5% in Sweden.[122] Nor does the current international tax regime achieve CEN for portfolio investors. Our own analysis shows disparate tax rates for FPI into different countries by U.S. investors. We calculated the total rate of taxation borne by a top-bracket U.S. individual portfolio investor investing in France, Germany, the United Kingdom, and the United States in 2000. These computations included both the corporate-level tax on earnings and all U.S. and foreign taxes on the share-holder. A U.S. investor, subject to the highest U.S. individual tax rate, investing in a U.S. company bore a total marginal tax burden of 58% on dividend payments, while the same U.S. investor paid a 40% tax on dividends paid by a French company, 58% on dividends paid by a German company, 45% on dividends paid by an Irish company, and 47%

on dividends paid by a U.K. company.[123] The total tax on dividends earned by U.S. portfolio investors in these European countries and in the United States varied by as much as 18 percentage points.

Both the EC Working Paper and our own calculations demonstrate that CEN does not exist for either FDI or FPI under the current international tax regime. Investments that earn similar pretax rates of return do not earn comparable post-tax rates of return. Thus, U.S. individuals and U.S. multinational companies may eschew investments with higher pretax yields in favor of investments with lower pretax yields but higher post-tax returns. The economist Michael Devereux has illustrated in detail the policies that would be necessary to move from the current income tax regime on foreign investment to CEN with respect to both FDI and FPI.[124] Devereux's work reveals that achieving CEN would require the U.S. government to make a series of difficult, politically infeasible, and undesirable tax policy changes.[125]

CEN will exist for portfolio investments only if post-tax rates of return on portfolio investments abroad are equal to those available domestically.[126] But, as Devereux demonstrates, these post-tax rates of return on portfolio investments depend in part on rates of corporate taxation at home and abroad. If both the foreign and domestic companies in which portfolio investments can be made are able to choose in which country to invest, the companies will, in principle, divide their investments (including the capital they raise via the portfolio investments they receive) between the foreign and domestic countries up to the point at which the post-corporate tax rate of return is equal on investments in the two countries.[127] Furthermore, if the post-corporate tax rate of return is higher in one country than in all others at all levels of investment, then all the corporate investments will flow to the country that provides the higher post-corporate tax rate of return.[128]

Thus, in an international capital market in which investors from both foreign and domestic countries invest in the corporations of both foreign and domestic countries, CEN for FPI will exist only if two conditions hold true simultaneously. First, corporate tax rates must be independent of the location in which the investment is made.[129] Second, any differences in the corporate tax rates faced by the domestic and foreign corporations must be offset by the personal taxes faced by all investors.[130]

Thus, to achieve CEN, U.S. companies must face the same corporate tax rate on investments made in the United States or abroad.[131] As the EC Working Paper shows, however, this condition does not hold.[132] Nor is it ever likely to hold absent a uniform worldwide tax base and a single worldwide tax rate. Moreover, if, for example, the corporate tax rate on companies resident in England were higher than that on companies in the United States, in order to achieve CEN for all U.S. portfolio investors investing into England, the United States would need to impose a lower personal tax rate for investments in British companies than for investments in similar U.S. companies.[133] Similarly, offsetting increases or reductions in U.S. taxes for U.S. portfolio investors would be necessary as a reaction to different corporate tax regimes in every other nation.[134] This is not an appealing or practical personal income tax regime.

Faced with the widespread failure to achieve locational neutrality for investments in plant and equipment, even within the countries of the European Union, the EC Working Paper-quite properly in our view-focuses its policy analysis and recommendations on the taxation of corporate income, principally the taxation of corporate direct investments.[135] As we have discussed, the taxation of FPI can be expected to have little or no impact on the location of productive plant and equipment, even if it does affect who owns the investment. Thus, there would be little point in striving to achieve CEN in fashioning policy for the income taxation of residents' FPI—even if the practical barriers to doing so were not so great.

While this conclusion seems indisputable from the perspective of a country with a classical corporate income tax system, integration of the corporate and individual income taxes may change the analysis. Integrated corporate and individual tax systems add an additional level of complexity in considering CEN for· FPI.[136] Several of the countries among the top 10 recipients of U.S. portfolio investments have integrated their corporate and shareholder income tax systems, at least to some extent.[137] While achieving such integration by excluding all or a portion of dividends from shareholder-level taxation has become more common in recent years, in most countries integration was accomplished through so-called "imputation credits," shareholder credits for all or a portion of the corporate income tax.[138]

This puts three tax variables at play (tax rules and rates at the corporate level, imputation credits available to shareholders, and the tax rules and rates at the personal level) in any effort to achieve CEN for FPI.[139] When two countries' integration regimes interact or when an integration regime interacts with a classical regime, the simplest way to achieve CEN for FPI would be to provide greater imputation credits to investors in companies resident in the higher-corporate-tax-rate country in order to offset the higher corporate tax.[140] Devereux's analysis implies that in each country in the world in which U.S. portfolio investors invest, a separate credit should be calculated to offset differences in the rate of corporate tax that exists relative to U.S. corporate taxes.

This means that to achieve CEN for FPI, in the absence of CEN for direct investment, the United States would have to tax some portfolio investments into certain foreign countries at a lower rate than the rate at which it taxes identical domestic portfolio investments. Moreover, the United States also would have to negotiate bilateral tax treaties perfectly calibrated to offset the effects of foreign corporate and withholding taxes, including those above the U.S. corporate tax rate. And the United States would have to modify the rules mandated by such treaties each time U.S. or foreign corporate tax rates changed.

If such bilateral tax treaties were not adopted, the United States would have two remaining options to achieve CEN. First, it might try to convince all foreign governments to exempt income from taxation at source. While some countries might exempt foreign investments in an effort to attract foreign capital, taxation by the source country is common and such an exemption would not be universally accepted. Alternatively, the United States might try to persuade all countries in the world to agree on a uniform corporate tax rate and also to treat foreign and domestic portfolio and direct investors identically with regard to integration credits.[141] Devereux points out that if corporate tax rates across all countries were equal, and all countries were willing to grant imputation relief at identical rates for both domestic and foreign investments of their resident investors, CEN would be achieved for FPI.[142] The world, of course, is not going to harmonize tax rates or integration systems to this extent in the foreseeable future; to date, the EU has failed even to harmonize its corporate income tax rates.

Furthermore, the kinds of bilateral adjustments necessary to achieve CEN for FPI in the presence of both classical and integrated tax regimes would conflict, at least in some cases, with the principle of nondiscrimination, that is, the requirement that foreigners and domestic residents be treated similarly.[143] To achieve CEN, European countries would have to adopt similar country-specific tax policies as described above for the United States.[144] Indeed, every country would have to tax its resident investors differently depending on the country where investments are made. But varying the level of domes tic taxation depending on the country where a resident invests would violate the free movement of capital requirement of the EU Treaty.[145] And this seems neither a desirable nor practical international tax policy.

Finally, we briefly assess CEN's role for taxing FPI in a dividend exclusion system, such as that proposed by President Bush in January 2003. The proposal would have exempted from individual income tax dividends paid to shareholders whenever dividends were paid out of fully taxed corporate earnings.[146] In determining whether dividends are eligible to be excluded from the recipients' income, the proposal would have treated foreign income taxes paid by the corporation-up to the foreign tax credit limit-as equivalent to U.S. income taxes.[147] Thus, assuming that the corporation cares whether it pays excludable or taxable dividends to its shareholders, the dividend exclusion proposal would have prevented dividend exclusion integration from changing the impact of current corporate-level taxes on companies' decisions about where to locate their productive investments. To the contrary, allowing excluded dividends to be paid only from corporate income subject to U.S. taxes, as a 1992 Treasury study of a dividend exclusion method of corporate-individual tax integration had recommended,[148] would have shifted incentives for corporate investment to ward domestic investment, again assuming that companies would prefer paying tax-free rather than taxable dividends. Many integration systems abroad have preferred domestic over foreign investments, causing them in some instances to run afoul of the EU prohibition of domestic legislation inhibiting the free movement of capital.[149]

Consistent with our earlier discussion, the Bush proposal conformed to the view that the important decisions about the location of productive investments are made at the corporate level. This view is also consistent with the analysis of the EC Working Paper,[150] which treats all corporate-level taxes as important to locational decisions, even if paid only to enable the company to pay dividends that are either excluded from shareholders' income or for which shareholders receive tax credits for corporate taxes paid.

On the other hand, the Bush proposal was unconcerned with achieving neutrality in the investment choices of portfolio investors. It provided no exclusion for dividends paid directly to U.S. portfolio shareholders by foreign companies out of income earned outside the United States. In this regard, the Bush plan would have introduced into the U.S. tax law a new preference for U.S. portfolio investors in favor of investments in domestic rather than foreign corporations.[151] We next turn to the question whether a preference for domestic portfolio investment is desirable as a policy matter.

But, before leaving CEN altogether, we emphasize that the foregoing analysis illustrates the changes in U.S. tax policy that would be necessary to achieve CEN for U.S. investors in the face of differences in the taxation of both direct and portfolio investments that exist in other countries throughout the OECD. And other countries would have to make similar adjustments to achieve CEN on their outbound portfolio investments. In other words, worldwide economic efficiency cannot be achieved for investments by U.S. persons in the absence of either uniform worldwide taxation or the kinds of offsetting adjustments described above.

A different view of CEN, however, might require only that U.S. income taxation itself not contribute to the distortion of the allocation of capital throughout the world, in effect, regarding any distortions that would remain as the responsibility of other nations. The idea is that at least U.S. tax law itself would not distort worldwide economic efficiency. For example, the limitation on the foreign tax credit could be justified on this view-contrary to the standard view of CEN—if the higher tax burden on foreign capital is simply regarded as a distortion introduced by the tax policies of other nations. This perspective would require far less of U.S. tax policy, only that the U.S. tax system itself be neutral as between domestic and any foreign investments with similar pretax rates of return.

We see little reason to take this view. The normative justification for CEN is to achieve worldwide economic efficiency. That one country–even one as big and important as the United States–can disavow responsibility for the distortions that prevail is unimportant. If achieving CEN is the desired goal, either the nation should strive to achieve genuine neutrality in its residents' investment decisions or it should strive to achieve multinational arrangements and agreements to enhance such neutrality. Short of that, it should abandon CEN as the normative basis for its policy and focus its efforts on something it can better control: enhancing the well-being of its own citizens and residents.

C. Resurrecting the Discredited Criterion of "National Neutrality": Enhancing National Well-Being

Four decades ago, in her classic analysis of international tax policy, the economist Peggy Musgrave demonstrated that when one views international tax policy from a national, rather than a worldwide, perspective–as we do here-that the country of the investor's residence will obtain the maximum benefit by equating pretax returns on domestic investments and after-tax returns on foreign investments.[152] In essence, this policy treats returns earned both in the United States and abroad on investments by U.S. persons as increasing the welfare of the

U.S. people, along with taxes paid to the U.S. government. From the U.S. national perspective, taxes paid to a foreign government are simply a cost of earning income.[153] This policy, which unfortunately came to be known as "national neutrality," allows only a deduction, not a credit, for foreign income taxes.[154] In essence, it ensures that the return to the U.S. fisc from investments abroad is as great as the return on domestic investments.

This idea of national neutrality never attracted many adherents. It implies investments abroad will be made only when the returns after imposition of foreign taxes are as great or greater than returns available before tax in the United States. Obviously, this would result in less investment abroad than that which would occur when a credit is allowed for foreign taxes. Today "national neutrality" seems completely out of favor,[155] principally we think, because it rarely has been examined separately in the context of FPI.

For direct investment, a policy of national neutrality is inappropriate. Given the levels of corporate income taxes prevalent in the world since World War I, allowing only a deduction for foreign income taxes would surely have inhibited U.S. investment abroad, resulting in little or no U.S. direct investment in the OECD countries where most U.S. direct investment is located today.[156] For investments in Europe, Japan, and Canada, allowing only a deduction for foreign income taxes often would have produced a combined tax rate on foreign investments of U.S. companies approaching 100% (taking into account both corporate and shareholder-level income taxes). It is simply not plausible that the standard of living of U.S. citizens and residents would be higher today had such investments abroad not been made.[157] It is not surprising, therefore, that no one today endorses a policy of "national neutrality" for international direct investments. The unilateral enactment by the United States of a foreign tax credit for income from direct investments and subsequent treaty negotiations to eliminate double taxation of such income through credits for foreign income taxes or exemption of foreign source income has clearly served U.S. national interests.[158] Indeed, no OECD country allows only a deduction for foreign income taxes on outbound direct investments. About one-half the OECD countries allow a foreign tax credit as in the United States; the other half exempt foreign earnings from domestic income taxation.[159]

Such uniformity of approach does not hold, however, for FPI. Belgium, for example, allows only a deduction for foreign income taxes paid by domestic residents on their portfolio investments abroad.[160] Indeed, in the context of a classical corporate income tax or the reduced tax rate system for both foreign and domestic dividends enacted in 2003, a deduction rather than a credit for foreign taxes on portfolio investments by U.S. residents and citizens merits serious consideration.

D. The Case for a Deduction Rather Than a Credit for Foreign Taxes on Portfolio Investments

An FTC regime (like an exemption of foreign source income) recognizes as primary the claim to taxes on international income of the country where the income is earned, the source country. By allowing a credit for foreign income taxes, the residence country asserts only a residual claim to tax revenues from the income and generally collects taxes only when the source country's tax rate is lower than that of the residence country.

Principles of international equity and interpersonal fairness, however, imply that FPI should be taxed by the country where the individual resides. Most analysts contend that in the division of revenues among countries, the source country's claim to tax international income stems, in large part, from the benefits it provides that allow that income to be earned.[161] These benefits include such things as legal and physical infrastructure, for example. The country of source also often provides benefits such as education to the company's workers, who are responsible for generating much of the business's revenues; This is one reason why revenues from taxing wages generally are allocated first to the country where the wages are earned. Source-based taxation of active business income-of direct investment–therefore is justified, "[a]s a matter of both principle and administrative convenience."[162] Governments that provide the infrastructure and institutional capital that enable foreigners to earn income by conducting business activities there merit at least a substantial share of the tax revenues from FDI if they want to claim it.

In contrast, a source country's claim to the tax revenues from FPI is more attenuated. For portfolio income, taxation at source generally is justified essentially on enforcement grounds. The claim is that taxation at source is essential to collect income taxes.[163] Enforcement aside, the claims of the residence country, which has funded the government services that provide for the well-being of the portfolio investor, seem to deserve priority in the inter-nation allocation of tax revenues from FPI The primary allocation of the taxation of portfolio income to the residence country by the "international tax compromise" reflects this priority. At most, source countries impose withholding taxes on such income-withholding taxes that routinely are reduced or eliminated bilaterally through tax treaties.

The fact that FDI almost always is made by corporations, while individuals account for the bulk of FPI, further supports the allocation of the income from the former to the source country and the income from the latter to the country where the investor resides. Corporate level income taxes typically are imposed at flat rates, while individual income taxes frequently are imposed at progressive rates, rates that increase as the individual's income increases. When an individual invests abroad, only the residence country has the ability to measure the person's worldwide income. Since the primary justification for imposing personalized income taxes is the idea that taxes should vary based on a person's ability to pay, it is essential that the residence country take into account all income, no matter where earned, in measuring its citizens' and residents' ability to pay.[164] No one believes that source country-imposed, gross basis withholding taxes are a good way to measure ability to pay.[165] They ignore deductions necessary to measure net income and, even if the residence country allows tax credits for the foreign withholding taxes, the tax imposed may be inconsistent with the residence country's judgments about appropriate taxation. For example, the FTC may be to no avail if the shareholder is taxexempt.[166]

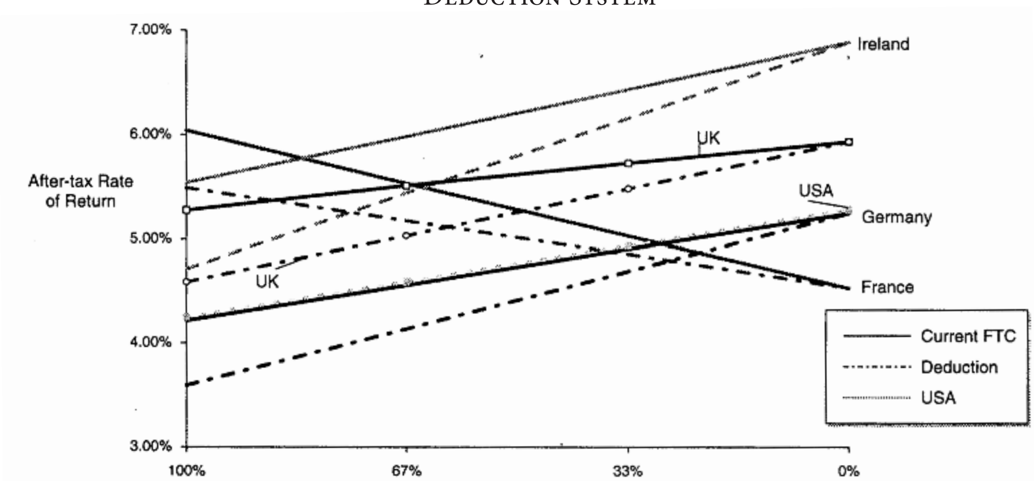
Source countries may levy withholding taxes on dividends to encourage corporations to reinvest the earnings there rather than repatriating them to the shareholders' residence. But such a policy has no relevance to portfolio investors, since they cannot control a company's decisions about paying dividends. Since it is common for source countries not to levy any tax on gains on the sale of shares by nonresidents, the nonresident portfolio investor is taxed only on distributed, not retained earnings. Moreover, unlike interest and royalties, the two other categories of income that might be subject to withholding taxes by source countries, dividends are not deductible in computing the corporate tax and thus already have been taxed once by the source country at the corporate rate. Other than historical practice, what claim does the source country have for taxing this income twice?[167] Substituting a deduction for the FTC properly recognizes as primary the residence country's claim to foreign portfolio income.

From the residence country's perspective, the important economic objections to substituting a deduction for the FTC with respect to income from FDI do not apply to FPI Taxation by the country of residence of portfolio income-even when that country allows a deduction for foreign income taxes-will not distort decisions of corporations about where to locate their real investments in plant or equipment.[168] Nor does such a policy inhibit free trade-the free movement across borders of goods and services.

Given the relatively small level of source-based taxation of FPI, moving from a credit to a deduction for foreign income taxes on portfolio investments would have only a small impact on investors' rates of return. Figure 3 below charts after-tax rates of return to U.S. FPI into four European countries, compared to after-tax rates of return to domestic FPI, when returns are divided in different ratios between capital gains and dividend distributions, assuming in each case a 10% pretax rate of return on equity investments.[169] Figure 3 demonstrates that substituting a deduction for the FTC would not increase the degree of disparity among the after-tax returns produced by identical investments in the most tax-favorable and least tax-favorable jurisdictions. Substituting a deduction changes only the countries and the dividend-to-capital gain ratios that are most tax-efficient. Thus, substituting a deduction for the foreign tax credit, in practice, would not create any greater deviations from CEN in the U.S. international tax system than the tax credit regime.

Figure 4

Rates Of Return Given National EATRs U.S. Outbound FPI Taxed At The Top Bracket Under Both A Foreign Tax Credit And A Deduction System



% of Earnings Distributed as Dividends

(Assuming remainder of corporate earnings kept as cash by corporation and realized as capital gains at end of year)

Under year 2000 tax rates and law, the largest disparity in post-tax rates of return between two identical investments by an investor subject to the top income tax rates, each with 10% pretax rates of return, was between investments in France, with a 6.04% after-tax return, and Germany, with a 4.22% after-tax return. This disparity, which occurs when 100% of corporate earnings are distributed as dividends, represents a difference of 1.82 percentage points. With a deduction for foreign income taxes, the difference in after-tax returns on identical investments with 100% of corporate earnings distributed as dividends grows a bit. The post-tax rate of return when the United States allows only a deduction for foreign withholding taxes for an investment in France would equal 5.43%, while the rate of return in Germany would be 3.59%. This represents a disparity of 1.90 percentage points, slightly bigger, but extremely close to a credit regime.[170] Replacing the FTC with a deduction for foreign taxes would shuffle the attractiveness of investments in various countries, decreasing in the process the income tax disadvantage U.S. nationals now sometimes face for domestic portfolio investments compared to FPI.[171] And shifting to a deduction would increase U.S. tax revenues,[172] perhaps by hundreds of millions of dollars annually, revenues that might be used to decrease U.S. taxes on capital income generally.[173]

A deduction, rather than a credit, could serve the national interest of the United States by improving internation equity and interpersonal fairness and removing tax disincentives to domestic portfolio investment, while increasing revenues. Indeed, a goal of U.S. international tax policy should be to eliminate source-based taxes on portfolio income altogether and focus taxing authorities internationally on collecting taxes on portfolio income exclusively in the country of residence. "U.S. tax treaty policy for many years has been to eliminate (or when that is not possible, to substantially reduce) source country withholding taxes on [portfolio] interest and royalties."[174] And source-based taxation of portfolio income is slowly disappearing. Since 1984, when the United States abolished its withholding tax on portfolio interest, most investments by U.S. taxpayers that generate portfolio interest income have become exempt from source-country taxation. Similarly, capital gains realized by U.S. shareholders on their sales of foreign shares now generally are taxed only by the United States. Only portfolio dividends continue to be subject to any significant income taxation at source, and even these source-based withholding taxes may be in decline.[175] A deduction, rather than a credit, coheres with an international tax policy that sees source-based taxation of portfolio income as being, at most, a necessary expedient for preventing tax evasion on portfolio dividends. We consider alternative ways successfully to prevent tax evasion on residence based taxes in Section VI.

1. Two Caveats to the Case for a Deduction Rather Than a Credit

We would make one exception to our proposal that a deduction be substituted for the credit now allowed for foreign income taxes on FPI. Corporations often invest, usually on a short-term basis, a certain level of funds as working capital for their ongoing business operations. Such working capital is a necessary adjunct to corporate direct investments abroad. Foreign corporations often invest such working capital abroad, even when the corporation is owned by one or more U.S. corporations or other U.S. shareholders. Income from such investments of working capital generally are treated as FPI. Since such income actually represents active business income of the corporation, we would continue to allow an FTC on portfolio income earned from corporate investments of working capital.[176]

Furthermore, the computations of the impact of moving from a credit to a deduction on an investor's rate of return presented above are based on a U.S. classical corporate income tax system. President Bush's January 2003 proposal to integrate the corporate and shareholder taxes through an exclusion from income for dividends would have moved the U.S. tax system with regard to FPI generally in a direction similar to that which would occur by substituting a deduction for the FTC in the current classical system. Under the Bush plan, the United States would have exempted from tax dividends paid by domestic companies on earnings abroad, but not dividends paid to U.S. shareholders by foreign companies from similar investments. In this scenario, some countries would likely retain withholding taxes at source on dividends, and elimination of such taxes would likely occur only through bilateral treaty negotiations. As with many integration systems, U.S. tax law then would systematically favor investment in domestic over foreign companies. If dividends from U.S. companies were excluded from shareholders' income, but not dividends from foreign earnings of foreign companies, the case for retaining the FTC for foreign withholding taxes imposed on dividends paid from foreign companies might seem stronger on both equity and economic efficiency grounds. Under a dividend exclusion, the normative background against which to compare taxes on dividends paid from FPI would be a zero rate of U.S. tax on most domestic dividends. It no longer would make sense to consider the FTC on taxes paid on dividends from FPI a loss to the U.S. Treasury, since dividends received on FPI invariably would face a higher rate of tax than comparable investments in the United States. The Bush proposal, however, was not enacted by Congress, which instead decided-at least on a temporary basis-simply to lower the tax rate on dividends, whether from domestic or most foreign investments.[177]

V. Should We Worry About The Response—Or Perhaps Even Retaliation—By Foreign Governments?

With direct investments, attempting to pursue U.S. national interests through a policy of national neutralityallowing a deduction rather than a credit for foreign taxes–would be folly. Not only would direct investments abroad by U.S. multinationals shrink toward nothing, but other countries might retaliate against the United States by allowing only a deduction rather than a credit or exemption for income from their companies' direct investments in the United States. This would deprive the United States of the advantages of both outbound and inbound direct investments, a consequence that surely could not be described as advancing the interests of U.S. residents and citizens.

But such dire consequences would not follow if the United States were to substitute a deduction for the FTC with respect to FPI As we have shown, the most likely scenario would be some shifting of portfolio equity investments by U.S. residents and citizens to U.S. companies with little or no effect on the location of real investments in plant and equipment throughout the world. In the case of FPI in the form of debt, most U.S. lenders are not taxed by the source country and the choice between a deduction and a credit is generally irrelevant. The question remains, however, how other countries likely would respond to a shift from a credit to a deduction with regard to outbound portfolio equity investments from their countries. We cannot be certain.

The economist Gary Hufbauer has suggested that if the United States were to abolish its FTC for outbound FPI and eliminate all of its withholding taxes on inbound FPI, market forces would lead other countries to drop their withholding taxes as well.[178] Hufbauer contends that residence-based taxation alone would result, and that this would produce a more efficient worldwide allocation of capital.[179] Hufbauer's essential premise is that U.S. portfolio investment is sufficiently large that it lowers the cost of capital in economies where it is present. He claims that without a FTC, U.S. investors would "withdraw funds from countries that imposed withholding taxes on [portfolio] income."[180]

Hufbauer cites Germany's 1989 attempt to institute a withholding tax on interest to support his prediction.[181] In that instance, German banks confronted a massive withdrawal of foreign-owned capital to jurisdictions such as Luxembourg and Switzerland, which impose no withholding tax on interest income. Eventually, pressure by German banks forced the German government to repeal its withholding tax.[182] Hufbauer suggests a similar dynamic would occur if the United States were to eliminate its FTC.[183]

To be sure, allowing only a deduction for foreign taxes on FPI would disfavor FPI whenever the foreign before-tax rates of return were equal to domestic pretax rates of return if the foreign jurisdiction had any source-based tax on income from portfolio investments. Those foreign jurisdictions with zero or lower source-based taxes would be favored by U.S. portfolio investors over countries with higher source-based taxes. Hufbauer predicts that competition for U.S. capital would lead source countries interested in U.S. portfolio investments to abolish any remaining source-based taxation of such investments. Hufbauer therefore expects withholding rates on dividends to disappear if the United States were to substitute a deduction for the FTC.[184] Under current U.S. tax law, zero source-based taxation would make domestic portfolio investments equally favorable on an after-tax basis as FPI with comparable (risk-adjusted) pretax rates of return.

We are more skeptical than Hufbauer about the magnitude of the shifts in portfolio investment flows that would be likely to accompany a U.S. shift to a deduction for foreign income taxes on FPI The current multinational allocation of FPI by U.S. investors persists despite substantial variance in after-tax rates by country. U.S. portfolio investors already experience significantly different effective tax rates in multiple geographies with imperceptible effects on portfolio allocations. For instance, the effective tax rate for U.S. investors on investments in France through U.S.-based mutual funds has been more than 20 percentage points lower than a similar investment in Germany.[185]

Nevertheless, Germany remains the fifth largest recipient of U.S. investment, with more U.S. FPI than France. Nor do we find the German case Hufbauer cites persuasive; the differences between the U.S. and German situations are quite substantial.[186] Thus, we would predict much smaller investment shifts than Hufbauer from replacing the FTC with a deduction for foreign withholding taxes. Indeed, some evidence suggests that portfolio managers' interest in diversification may be sufficiently high to make the percentage of their investments allocated to foreign jurisdictions quite inelastic. The UN Commission on Investment, Technology, and Related Financial Issues, for example, claims that between 1991 and 1999 investments in emerging markets in general decreased the return on global portfolios and increased their volatility.[187] UNCTAD's survey of fund managers revealed that despite this fact, fund managers reported that they "continued) to believe in the benefits of diversifying into emerging markets and d[id] not plan to discontinue investing in such markets."[188]

Thus, we do not expect major shifts in U.S. portfolio investments from this proposed change in tax policy, although some reshuffling among favored destinations for FPI might occur. It is impossible, however, given the available data, to be confident about the effects on portfolio investments from a policy shift from the FTC to a deduction for foreign taxes paid. In any event, the current trend is toward lower withholding taxes for portfolio dividends, the only form of FPI currently subject to any substantial source-based taxation. We expect that trend to continue and we agree with Hufbauer that it might well be accelerated if the United States were to shift from the FTC to a deduction for foreign taxes on income from FPI.

VI. Collecting Residence-Based Taxes On FPI Is The Key Concern

The major issue facing the United States, as well as all other capital-exporting nations, with regard to FPI is enforcement of residencebased income taxation on income earned abroad.[189] We argue here in favor of a policy of taxation of FPI by residence countries and suggest elimination of taxation of such income at source. In this connection, we suggest that the United States should consider replacing its credit for such income with a deduction for foreign taxes. The major difficulty for any regime of taxing FPI, however, is the widespread underreporting and evasion of income taxes. While shifting from the FTC to a deduction might increase the tax savings from evasion in some cases, underreporting of income from FPI is also beneficial when a credit is allowed for foreign withholding taxes. Relying on sourcebased withholding taxes as the principal enforcement mechanism is simply to accept the impracticality of enforcing residence-based taxes, clearly a second-best outcome. There is no other compelling policy justification for the imposition of withholding taxes at source.

We do not agree that enforcing residence-based taxes is impractical. Ultimately, therefore, the question becomes how to enforce residence-based taxation of FPI. Multilateral cooperation and coordination is the linchpin for success, but unilateral innovations also may help.

A. The Magnitude of Underreporting and Evasion of Taxes on Foreign Portfolio Investment

The extent of underreporting and tax evasion of FPI is, of course, unknown. If we knew what income was underreported, we would know enough to collect the tax. The best data available, however, suggests that tax evasion by foreign portfolio investors is commonplace.[190] Foreign investment earnings are substantially easier than domestic earnings for investors to underreport or to fail to report to their residence country's tax authority.[191]

In March 1994, for the first time in 50 years, Treasury conducted a comprehensive survey of outbound portfolio investments from the United States.[192] As a result of this survey, the Department of Commerce revised its 1993 estimates of portfolio interest income on foreign bonds earned by U.S. persons upward by $6.1 billion, from $17.2 billion to $23.3 billion,[193] and its estimate of portfolio dividends on stocks upward by $4.1 billion, from $6.8 billion to $10.9 billion.[194] The 1993 estimate of U.S. holdings of foreign stocks increased from $302.8 billion to $543.9 billion.[195] In 1997, a similar Treasury survey produced a reduction of more than $10 billion in the reported U.S. balance of payments deficit due to increased estimates of interest and dividends received by U.S. residents from foreign securities.[196] In combination, the magnitude of these adjustments suggests massive gaps in the tax reporting of interest, dividends, and capital gains from FPI.[197] As foreign investments have increased over time, the limited ability to tax foreign earnings has become an increasingly serious problem for tax administrators.

Bilateral action by the United States and its treaty partners through tax treaty renegotiations may help combat the underreporting problem. The OECD has suggested that countries intensify the exchange-of-information provisions in their tax treaties.[198] Tax treaties also could incorporate additional provisions encouraging coordinated tax enforcement and assistance in enforcing each country's tax laws by other signatories.

B. Current Multilateral Efforts to Improve Information Reporting

Jurisdictional limitations, tax competition, and administrative obstacles have limited the effectiveness of unilateral or bilateral approaches to address underreporting of income from FPI.[199] Thus, multilateral coordination has become necessary to achieve the effective international information exchanges required for residence-based taxation of FPI income.[200] The OECD's Forum on Harmful Tax Practices (the OECD Forum) represents one such effort.[201] Established in April 1998, the OECD Forum's purpose has been to examine various approaches that groups of countries might take to collect tax revenues from FPI that flows through offshore financial centers and tax havens and to control the growth of so-called "harmful preferential tax regimes" within the developed world.[202] Estimates suggest that the value of deposits in offshore financial centers and tax haven countries exceeds $5 trillion.[203] Since 2000, the OECD has successfully obtained commitments to share information internationally from a number of jurisdictions traditionally considered tax havens.[204] This success suggests that, at the very least, the threat of coordinated multilateral defensive measures may coerce tax havens into entering into information exchange agreements with OECD countries.

Since 1998, the OECD Forum also has worked to create multilateral norms of transparency of financial transactions, which, in combination with comprehensive information exchange, it believes may substantially reduce the evasion and underreporting of income from international investments.[205] The OECD Forum regards transparency as requiring publicized rates of taxation for enterprises and individuals in a given jurisdiction and the elimination of the ability to negotiate their rate of tax.[206] According to the OECD Forum, "([t]ransparency also requires financial accounts to be drawn up in accordance with generally accepted accounting standards and that such accounts either be audited or filed."[207] Governments also are required to have access to information identifying the beneficial ownership of all types of entities in the country and access to all types of bank information relevant to tax matters.[208] All the information one country gathers should be made available on request to any other national tax authority.[209] The only limitation is that the requesting authority must commit to use "the information obtained and provided . . . only for the purposes for which it was [specifically] sought."[210]

In 2000, the OECD Forum compiled a list of 47 jurisdictions that were classified as tax havens based on the factors the OECD had identified in 1998.[211] The OECD Forum began communicating with these states, which are not OECD members, to explore their potential cooperation in establishing international standards of transparency, fairness, and disclosure in tax practices.[212] The Forum promised to leave off its public list of uncooperative tax havens any jurisdiction that made a public commitment to "adopt a schedule of progressive changes to eliminate its harmful tax practices by 31 December 2005."[213]

In June 2000 the OECD announced that six jurisdictions, Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino, all tax havens, had committed to create mechanisms for international exchanges of information and to improve their practices by 2003 for criminal matters and by 2005 for civil matters.[214] By 2002 31 jurisdictions had made such commitments.[215] The OECD's success in obtaining commitments from these countries suggests that the threat of multilateral coordinated defensive measures by a number of large developed economies can successfully pressure offshore jurisdictions to enter into information exchange agreements.[216]

Another recent OECD report addressed how bank secrecy may be used to hide illegal activities and to escape domestic taxes.[217] The report recommended the elimination of anonymous accounts and a reexamination of the "domestic tax interest" requirement for information exchange.[218] The domestic tax interest requirement, which some countries have applied, provides that a treaty country cannot obtain bank information from a treaty partner unless the country with access to the information itself has an interest in obtaining that information for its own tax purposes.[219] The OECD report also recommended a reexamination of policies and practices that prevent exchange of information for criminal tax cases and initiatives to achieve access to bank information for civil tax cases.[220]

In 2003, the OECD published an updated version of the OECD Model Tax Convention, which includes a new Article 27 obligating "Contracting States [to] lend assistance to each other in the collection of revenue claims."[221] Article 27 requires contracting states to collect revenue claims for the other contracting state as if the revenue claim were a revenue claim of the state doing the administration and enforcement.[222] Under this article, tax authorities of contracting states would apply their administrative and enforcement mechanisms exactly as if they were collecting their own revenue claims, with one major caveat. The Commentary suggests that under ¶ 6 of Article 27 "no legal or administrative proceedings, such as a request for judicial review, shall be undertaken in the requested state with respect to matters of the existence, validity or amount of a tax claim."[223]

C. Will Information Exchange Agreements Prevent Underreporting and Evasion?

In the domestic context, the United States has successfully used information reporting in lieu of withholding to collect income taxes on domestic interest, dividends, and capital gains.[224] In the transnational context, the United States already exchanges tax information with other jurisdictions through U.S. income tax treaties, tax information exchange agreements (TIEAs), and mutual legal assistance treaties (MLATs).[225] Under most U.S. tax treaties and TIEAs, requests for assistance may be made for any civil or criminal tax investigation not barred by the statute of limitations, and information can be exchanged regarding any relevant person.[226] The amount of underreporting of FPI uncovered by the recent Treasury surveys makes clear, however, that current international information exchanges are inadequate to prevent evasion of income tax on foreign income.[227]

EU nations, however, are now using information reporting as a substitute for withholding with some success.[228] At an April 2000 summit, EU member states reached an agreement requiring source countries either to impose withholding taxes or to engage in information exchange with respect to the taxation of passive income.[229] A number of countries that had been unwilling to impose low-rate withholding taxes were willing to cooperate in extensive information reporting.[230] The success of information reporting within the EU offers hope that a similar regime might be negotiated among all the major developed economies.

The United States has not stood idly by awaiting the implementation of successful multilateral actions directed at enforcement of income taxes on FPI Since 1997, the Service has attempted to induce foreign financial intermediaries doing business in the United States to cooperate in revealing U.S. persons who earn portfolio income. The basic arrangement is that the United States will grant anonymity to foreign investors of foreign financial intermediaries in exchange for the intermediaries' cooperation in collecting tax owed by U.S. citizens and ensuring that only those foreigners entitled to reductions of U.S. withholding taxes by virtue of a treaty are receiving the treaty benefits.[231] With a major exception for bearer bonds, the goals of the qualified intermediary regime are to identify all U.S. persons receiving income from non-U.S. intermediaries and to curb "treaty shopping" abuses so that only genuine residents of treaty countries obtain treaty benefits. These know-your-customer rules require the foreign financial institution to identify U.S. customers who hold accounts and to withhold taxes due from foreigners.[232]

Obviously, the Service's efforts to enlist foreign financial intermediaries offer only a partial solution to the problem of underreporting. U.S. investors may move their money away from these institutions to others offshore that preserve their anonymity. But enlisting the aid of financial intermediaries is an innovative step toward greater enforcement, one that seems likely to take on greater importance in the years ahead. And perhaps unilateral actions such as these will spur additional multilateral coordination and cooperation.

When foreign portfolio income is earned outside the major developed countries, however, additional problems occur in obtaining effective information exchange and transparency.[233] Vito Tanzi has suggested that obstacles created by language differences, along with the resource burdens on information-providing countries of collecting and organizing the massive flow of information about individual investors, may limit the ability of international information exchange to prevent tax evasion on foreign portfolio income earned in tax havens and developing countries.[234]

More generally, Tanzi identifies three “fiscal termites” specifically related to portfolio investment that he regards as making income taxes increasingly difficult to collect: (1) the pressures arising from the growth of off-shore financial centers and tax havens and the falling transaction costs connected with using their services, (2) the increasing availability of derivatives and hedge funds as vehicles for portfolio investment, and (3) the general difficulty of taxing financial capital as the international capital market becomes more integrated and efficient.[235] Tanzi believes that these “termites,” combined with other difficulties related to the increasing mobility of labor and capital, will force the developed economies to become increasingly reliant on taxes that are little affected by these problems, for example, immobile factors of production or resources.[236]

Tanzi observes that hedge funds and new financial products may pose even more intractable problems than standard forms of FPI.[237] He contends that tax authorities may not be able to cope with these complex arrangements, even when they have all the requisite information available.[238] Tanzi points out that with hedge funds utilizing derivatives “the distinction between capital income and capital gains or losses becomes fluid when a contingent claim (gain or loss) can be created on a structure of certain cash flows (income).”[239] Derivative products made available through hedge funds also can easily manipulate the distinction between dividends and interest.[240] Thus, derivatives and hedge fund investments create significant challenges for the taxation of portfolio income generally, and foreign portfolio income in particular.[241] At least $1 trillion is currently estimated to be channeled through hedge funds, and hedge funds are growing in popularity as a vehicle for portfolio investments among wealthy investors.[242]

We do not completely share Tanzi’s pessimism in this regard, but it would be foolish not to acknowledge the difficulties new financial products pose for income tax systems generally. They challenge the notion of a sharp division among dividend, interest, and capital gain income that has been so fundamental to the taxation of both domestic and foreign portfolio income. Addressing the challenges that these innovations pose for income taxation, however, is well beyond the scope of this Article. They require substantive changes in classifications and taxation of income, raising a host of issues far beyond the question we address here of the efficacy of withholding taxes versus information reporting as a potential response to the underreporting of income taxes on FPI but failing to acknowledge the existence of these challenges would make us seem Pollyannas, which we are not. Recent OECD experience makes clear that the United States can play a constructive role in establishing information reporting regimes to better serve U.S. national interests. This may be done both through bilateral and multilateral negotiations and through diplomatic efforts by the world's largest economy.[243] It also now seems likely that Europe will press ahead to create international tax reporting standards through OECD and UN processes, regardless of whether the United States participates. Only by engaging information reporting issues at the multilateral level will the United States be able to ensure that agreements eventually reached by developed countries will be consistent with U.S. interests and our legal capacities to comply.

VII. Conclusion

We have demonstrated that the standard analysis of international tax policy, which either has lumped direct and portfolio investment together or has ignored portfolio income altogether, is inadequate. International portfolio income has now become sufficiently important in the world economy to warrant independent analysis.

Indeed, careful analysis has demonstrated that the standard normative criteria most widely used to evaluate international tax policies—CEN and CIN—are inapt for portfolio income. And, the principal concern of CEN—neutrality in business decisions concerning the location of real investment in plant and equipment—is not affected by the taxation of international portfolio income. Moreover, given the wide variation in both corporate and individual tax rates, as well as the variety of policies in integrated tax systems regarding the treatment of foreign shareholders, any attempt to achieve genuine CEN in the taxation of portfolio income would require impractical and undesirable case-by-case distinctions by resident countries for investments in specific foreign countries. Proponents of CEN should focus their attention on redressing the distorting tendencies in the current taxation of direct investments.

When one evaluates the taxation of international portfolio income from the perspective of national well-being—the welfare of U.S. citizens and residents and fairness in their taxation-the case for the current FTC weakens substantially. Indeed, a strong case can be made for replacing the FTC with a deduction for foreign withholding taxes. Ultimately, the goal should be to eliminate altogether source-based taxation of international portfolio income.

The key difficulty for residence-based taxation of international portfolio income results from the widespread underreporting and evasion that now occurs. Any solution to that problem necessarily will require both unilateral and multilateral actions. The good news is that the United States has already taken a major step forward in its information reporting requirements for qualified financial intermediaries, and recent actions in both the OECD and the EU offer promise of vastly improved multinational cooperation. The advent of new financial innovations and the persistence of financial tax havens and bank secrecy ensure, however, that there will be many opportunities for improvement for years to come.

Part 4

Europe

Chapter 9

Income Tax Discrimination and the Political and Economic Integration of Europe

Introduction

Whither Europe? That is the question newspapers and pundits asked repeatedly after the French and the Dutch rejected the proposed European Constitution in the summer of 2005. But that question was a perplexing one long before these summer setbacks. And, even if the new constitution is ultimately approved, the question will persist. Here, we explore one critical aspect of European integration, focusing on the tax aspects of European constitutional arrangements set out in the European treaties - arrangements that will remain unchanged under the new constitution if it is eventually ratified. Our principal conclusion is that the European Court of Justice (ECJ) is undermining the fiscal autonomy of member states by articulating an interpretation of income tax arrangements that is ultimately unstable. In particular, the court has invalidated a number of European Union (EU) member state tax provisions in a manner that unsettles member states' longstanding mechanisms for both avoiding international double taxation and protecting against international tax avoidance. The court's decisions also threaten the ability of member states to use tax incentives to stimulate their economies.

The actions of the ECJ must be understood within Europe's broader institutional context. The court's tax doctrine rests on its interpretation of the central freedoms guaranteed by Europe's governing treaties. With the Treaty of Rome in 1957, six countries-Belgium, France, (West) Germany, Italy, Luxembourg, and the Netherlands-came together to form a "common market" known as the European Economic Community.[1] In addition to "mak[ing] war unthinkable" in Western Europe,[2] the motivating idea of this treaty was to increase economic interdependence, primarily through increased trade between these member states. In 1973, the United Kingdom, Ireland, and Denmark joined; Greece entered in 1981, followed by Spain and Portugal in 1986. These twelve members agreed to the Single European Act of 1986, which defined an area committed to "the free movement of goods, persons, services and capital."[3] These are frequently labeled the "four freedoms," and they are now incorporated into the European Community (EC) Treaty and included in the proposed European Constitution.[4]

Subsequent treaties expanded the European experiment and established various institutions to advance its mission. In 1992, the Treaty of Maastricht created the EU—a political union cooperating in foreign policy, defense, and criminal law, in addition to economic relations.[5] The same year, a majority of member states adopted the Euro as the EU's currency and established a new European central bank to supply a common monetary policy throughout most of the Union. The monetary union agreement also imposed specific budgetary responsibilities on the member states. Through the Stability and Growth Pact, these countries agreed to limit their fiscal deficits to three percent of GDP— a limitation that has proved unenforceable.[6] Membership in the EU now stands at twenty-five, and twelve member states use the Euro as their common currency.[7]

The political and legal institutions that govern the EU do not fit easily into familiar categories. Some scholars describe the EU as a pooling of sovereignty.[8] Others regard it as a blend of international law, national constitutional law, and federalism. [9] In any event, the rights and obligations of the treaties apply to the member states and to the citizens of those states, as well as to the EU's governing institutions.[10]

There are four organizations that promulgate and enforce EU rules: (1) the European Parliament (Parliament), which is the only EU governing institution whose members are directly elected by the people;[11] (2) the European Council of Members (Council), which is composed of sitting ministers of member state governments who have the authority to bind their member states; (3) the European Commission (Commission), which has the exclusive power to draft and propose legislation and to implement EU policy; and (4) the ECJ (formerly the Court of Justice of the European Communities), which serves as the EU's constitutional court.

The unique institutional structure of the EU has limited the ability of legislative bodies to formulate member state income tax policy while permitting the ECJ to take a prominent role. In sum, neither the Parliament, the Council, nor the Commission has the authority to adopt Europe-wide income tax measures without a level of consensus that is typically not achievable except in technical and relatively uncontroversial matters. Although the treaties have increasingly involved the Parliament in legislation and have expanded its powers over time (as a way of narrowing Europe's democracy deficit), its authority remains limited. Most of Parliament's enactments must be approved by the Council before taking effect.[12]

Though the Council– considered the EU's "intergovernmental center of gravity"[13]–has the power to regulate commerce among member states and to decide other issues, its authority is also circumscribed. The finance ministers of the member states make up the Economic and Financial Affairs Council (ECOFIN), which has responsibility for tax matters,[14] but they cannot act on income tax issues without unanimous agreement. Consequently, any member state can veto any proposal.[15] In addition, before issuing "directives" or regulations on tax matters, the Council is required to consult with Parliament and the Economic and Social Committee, which is an advisory body consisting of 350 people who represent "various categories of economic and social activity."[16]

The Council is further constrained by the fact that it can act only on proposals of the Commission (although it can request that the Commission study specific issues). There are twenty-five commissioners, one from each member state. Rather than representing a particular country, each commissioner is responsible for a substantive area of EU legislation and regulation. The Commission is the moving force behind most policy initiatives and has often announced its tax policy goals in communications to the Council, the Parliament, and the Economic and Social Committee.[17] The Commission also represents the EU in international organizations including the Organization for Economic Cooperation and Development (OECD) and the World Trade Organization (WTO). Upon a recommendation of the Commission, the Council–subject to the unanimity and consultation requirements - may issue directives on tax matters. Needless to say, adopting directives is a slow and cumbersome process, subject to the veto of any member state, and, as a result, only a few income tax directives have been issued.[18]

However, the Commission does have an alternative to these labyrinthine procedures. The Commission–whose members are required to act independently of their member states' governments and to promote the EU's interests[19]–has the power to initiate enforcement actions against member states and often brings cases to the ECJ.

The ECJ has jurisdiction to resolve disputes between member states, between EU institutions and member states, and between the various EU institutions. Its twenty-five judges also hear cases involving issues of European law referred to it by the national courts of the member states. Judges are appointed by each of the member states for a renewable six-year term. The ECJ cases we shall discuss here are generally either (1) actions brought by the Commission against a member state claiming that the member state's law violates one or more of its obligations under the EC Treaty or (2) requests by national courts for an ECJ ruling interpreting European legal or treaty requirements in lawsuits involving private parties. Eight advocates general serve the court by issuing opinions on cases before the court itself acts. Much of the time the court follows the opinion issued by the advocate general. ECJ decisions are rendered by a majority vote, and neither the vote nor any dissenting opinions are published.[20] To date, the ECJ has decided more than one hundred cases involving income tax issues, with the vast majority striking down member states' tax provisions on the ground that they violate either one of the four freedoms guaranteed by the treaties or the treaties' bar against discrimination on the basis of nationality.

While the EU's basic separation of powers is familiar to Americans, its specific contours are not. Stripped of all political, social, and economic context, one would be hard pressed to predict whether these institutions would generally operate to expand supranational governance over the member states or to inhibit it. But—at least until the ratification setbacks of the summer of 2005—both European politics and the growing social and economic interdependence within the EU have promoted integration, with greater power and control moving toward the center. Removing barriers to trade, investment, work, and immigration within the EU, along with unifying most of its monetary system, has produced enormous momentum toward the political center.

The institution that has, so far at least, most spurred such centripetal force has been the ECJ. We agree generally with Alec Stone Sweet's conclusion that the ECJ has transformed the EU, enhancing its supranational power and "federalizing" its policy.[21] As he puts it: "Today, the ECJ has no rival as the most effective supranational judicial body in the history of the world, comparing favorably with the most powerful constitutional courts anywhere."[22] More than two decades ago Eric Stein famously summed up the ECJ's work: "Tucked away in the fairyland Duchy of Luxembourg and blessed, until recently, with benign neglect by the powers that be and the mass media, the Court of Justice of the European Communities has fashioned a constitutional framework for a federal-type structure in Europe."[23]

There is now emerging, however, a serious question about whether the ECJ can (or will) continue to move political and economic power away from the member states to the EU's governing institutions. Through its decisions in income tax cases, the ECJ is bumping headlong into the member states' retained power to tax and their veto power over any European tax legislation. Individual member states have held on fiercely to their sovereign right to impose income taxes even as they have integrated economically in their treaties through free trade and the free movement of workers, residents, goods, services, and capital (and through the monetary union). The ECJ has the power only to negate tax provisions of member states. No European institution has the power to mandate income tax rules–except with unanimous consent from the member states. However, by striking down specific income tax provisions of the member states as incompatible with the EU treaties– generally with little regard for the internal logic or consistency of member state tax systems or for the effects on their finances—the ECJ is eroding the member states' veto power over any European authority to conform or harmonize member state income taxes.

An irresistible force is now confronting an immovable object. The ultimate question is whether the current mixture of unification and separatism can endure. If not, what are the implications for the future of Europe? As we shall show in some detail, this is the fundamental issue raised by the income tax decisions of the ECJ. We begin by analyzing those decisions and identifying the negative legal and fiscal policy implications for member states. We then consider the potential responses of both the European Union and the United States.

I. Company Taxation In The European Court Of Justice

To an American reader, the description of ECJ cases that follows will sound somewhat familiar. It echoes to some degree cases decided by the Supreme Court under our own Constitution.[24] But, rather than tracing these doctrinal analogues, we shall instead examine these decisions through the lens of nondiscrimination—a concept developed principally through the ECJ's interpretations of the four freedoms. Since our concern here is not with a doctrinal analysis of the ECJ's decisions but with the implications of its jurisprudence for the economic and political future of Europe (and for the trading partners of Europe, including the United States), we are selective in our analysis of ECJ cases - confining our discussion largely to ECJ decisions involving corporate and shareholder income taxes. Empirical evidence now makes clear that companies' decisions about where to locate facilities are responsive to corporate income tax differences,[25] and it has become commonplace for nations to use corporate taxes as a means of competing for such facilities. We begin by showing how the ECJ has adopted a different and more expansive view of nondiscrimination than is demanded by international trade and income tax agreements.

A. Discrimination Against International Commerce Under International Trade and Tax Treaties

There are three principal ways in which a country might use its income tax to discriminate against international commerce. It could favor domestic products over foreign products, domestic producers over foreign producers, or domestic production over foreign production.[26]

Discrimination against foreign products (including services) is the domain of the multilateral treaties, such as the General Agreement on Tariffs and Trade (GATT) and its successors (enforced by the WTO), that govern international trade.[27] These agreements limit not only tariffs on imports, but also subsidies for exports, which are sometimes thought to favor domestic products over foreign products in foreign markets. Income tax incentives for exports are subject to these limits, as the United States has learned on several occasions.[28] Whether the GATT should be read to constrain other income tax provisions is more controversial.[29] If so, the agreements could inhibit a country from limiting income tax benefits, such as accelerated depreciation or investment tax credits, to machinery and equipment produced locally.

Income tax discrimination against foreign producers is the domain of the bilateral treaties that govern international tax relations.[30] These agreements typically prohibit a country in which income is produced (usually called the source country) from taxing foreign enterprises operating in that country more heavily than similarly situated domestic enterprises.[31] A source country could not therefore tax business income earned in that country by a foreign company at a rate higher than that applied to comparable income earned by a domestic company. Nor could a source country limit income tax benefits, such as accelerated depreciation or investment tax credits, to machinery and equipment owned by domestic companies.

Neither trade nor tax treaties prohibit discrimination against domestic companies' income from foreign production. Such discrimination will arise if a company's home country (the residence country) taxes the company's foreign income more heavily than its domestic income. Rather than treating a residence country's taxation of its enterprises' foreign income as a matter of discrimination, the tax treaties conceptualize the problem as international double taxation, which arises because both source and residence countries can assert taxing jurisdiction. Framing the issue this way has obscured the analysis of whether foreign production is being treated better or worse than domestic production, because the baseline of equivalent treatment often is not explicitly articulated.

There are two standard residence-country methods for reducing double taxation of foreign income under both national law and the bilateral tax treaties.[32] The first is to tax foreign income, but then to grant a tax credit for taxes paid on such income in the source country (a foreign tax credit). The most common rationale offered for this method is capital export neutrality, under which a company should pay the same marginal rate of taxation on its income from investment at home and abroad. The goal of this approach is to subject all of a taxpayer's business activity to the same overall level of taxation, regardless of the location of the investment. However, to avoid refunding taxes paid to another nation, the foreign tax credit is generally limited to the rate of tax in the residence country,[33] so investment abroad will bear a heavier tax burden than investment at home if the source country's tax rate is higher.

The second method for reducing international double taxation is for the residence country to exempt foreign income. The usual rationale offered here is capital import neutrality, which requires that all investments in a given country bear the same marginal rate of income taxation, regardless of the residence of the investor. This approach would subject all business activity within a specific country to the same overall level of taxation, whether the activity is conducted by a resident or a foreigner.[34]

Under the foreign tax credit (and capital export neutrality), a residence country should not treat foreign production any worse than domestic production, given the baseline of equal after-tax returns. On the other hand, under an exemption for foreign income (and capital import neutrality), a residence country may treat foreign production better than domestic production to achieve equal treatment with domestic production in the source country, given the same baseline.

Other than mandating relief of international double taxation by a credit or exemption, there is no provision in the international trade and tax treaties that explicitly precludes a residence country from discriminating against foreign production by its nationals, whatever the appropriate baseline. Suppose that a residence country that used a foreign tax credit to eliminate international double taxation also applied higher rates to foreign income than to domestic income. Although this result would not be consistent with the capital export neutrality rationale usually thought to underlie the credit, such a provision would not seem to violate any obligation of the treaties unless the higher rate effectively eliminated the benefit of the credit. Rather than taxing foreign income more heavily, the more common practice is to offer tax benefits for domestic income. An example of this form of discrimination in the U.S. tax code is the deduction for nine percent of "income attributable to domestic production activities."[35] For economic policy reasons, the United States has chosen in this provision to favor domestic over foreign production by U.S. taxpayers—a preference that is not precluded by the trade and tax treaties. Another example of this sort of preference is the common limitation of income tax incentives, such as accelerated depreciation or investment tax credits, to machinery and equipment used domestically.[36]

To recapitulate, trade and tax treaties forbid nations from adopting two of three discriminatory practices. Trade treaties constrain discrimination against foreign products or, correlatively, in favor of domestic exports. The nondiscrimination concept in the tax treaties prohibits source-country discrimination against foreign producers. However, neither the trade nor the tax treaties prevent a residence country from favoring domestic production over foreign production by its own taxpayers. In the next Section, we show that the ECJ's jurisprudence is consistent with international practice on the first two of these dimensions. On the third, however, the ECJ has gone further, limiting the ability of member states to favor domestic over foreign production by their own companies. After analyzing both the legal and fiscal policy implications of the ECJ decisions, we will consider comparable decisions of the U.S. Supreme Court invalidating state tax laws that discriminate against interstate commerce.

B. The Corporate Income Tax Decisions of the ECJ

As previously indicated, the principal legal basis for the ECJ corporate income tax decisions is the EC Treaty's guarantee of freedom of movement for goods, persons, services, and capital. The Treaty also provides for nondiscrimination based on nationality,[37] and precludes internal taxation of other member states' products in excess of taxation of domestic products,[38] as well as government subsidies ("state aid" in the language of the EC Treaty) incompatible with an internal market.[39]

Our goal in this Section is to show that the ECJ decisions can be understood to prohibit discrimination on all three of the dimensions described above, a much more robust approach than that found in international trade and tax law. We do not, therefore, classify the decisions in terms of the various treaty freedoms or rights.[40] Nor do we distinguish nationality discrimination from market restriction, a distinction sometimes deployed by the ECJ and its European commentators.[41] More recent analyses suggest a growing awareness that these various rights and obligations taken together constitute a general prohibition of discrimination against commerce among member states.[42] In the language of a recent advocate general's opinion, national laws "must not result in less favourable treatment being accorded to transnational situations than to purely national situations."[43] It is in that spirit that we organize the ECJ decisions in terms of discrimination against foreign products, producers, and production. Our discussion is selective, rather than exhaustive, because our goal is simply to show that the ECJ jurisprudence occupies all three categories.

The court has long invalidated member states' laws or regulations that effectively discriminate against foreign products. One celebrated example is *Rewe-Zentral AG v. Bundesmonopolverwaltung for Branntwein* (more commonly referred to as *Cassis de Dijon)*[44] in which Germany had refused importation of a French liqueur because it did not meet a requirement of minimum alcohol content applicable to both domestic and foreign products. The court annulled the German provision on the ground that it effectively restricted importation of goods produced in another member state.[45] An early decision invalidating an income tax provision because it discriminated against a foreign product or service is *Commission v. France,*[46] in which certain French business deductions for newspapers were conditioned on the newspaper having been printed within France. The court reasoned that the provision was likely to restrict imports of publications printed in other member states, therefore having an effect equivalent to a restriction on imports. Other provisions the ECJ has held to violate the EC Treaty by taxing imported products and services more heavily than their domestic counterparts include:

> Sweden imposed a fifteen percent tax on premiums paid by Swedish residents to foreign life insurance companies, but not on premiums paid to Swedish companies.[47]
>
> Germany imposed a tax on German lessees of equipment, such as airplanes, but only if the lessors were foreign.[48]
>
> Denmark imposed greater restrictions on business deductions for meetings at foreign tourist sites than for meetings at Danish tourist sites.[49]
>
> Sweden limited deductions by employers of premiums on employee pension insurance to insurance purchased from Swedish companies.[50]
>
> Finland taxed residents on their winnings from foreign lotteries, but not from Finnish lotteries.[51]

ECJ decisions sometimes fall into more than one category of discrimination in our framework because the three categories can overlap.

For example, the Danish case in the list above involved a Danish entity that organized a foreign business meeting for Danish clients,[52] so the decision involved both a foreign product and foreign production. We do not separately analyze such overlapping cases because our goal is simply to show that the ECJ jurisprudence operates on all three dimensions of discrimination.

In addition to restricting discrimination against products imported from other member states, the ECJ has long constrained heavier taxation by source countries of enterprises from other member states. An early example of this second category of discrimination arose because dividends paid by French corporations to French insurance companies benefited from a tax credit, whereas such dividends paid to non-French insurance companies operating in France did not.[53] The court reasoned that if France treated foreign companies operating in France on the same footing as French companies for the purpose of taxing their profits, it could not treat them differently with regard to a related tax advantage without giving rise to discrimination.

An important recent example of potential discrimination against foreign producers is found in *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*.[54] In that case, the ECJ considered a law under which German subsidiaries of nonGerman parent companies were denied deductions for interest paid to the foreign parent company when the subsidiary had a high debt-to-equity ratio, although such deductions were allowed for payments by German subsidiaries to German parent companies. The general purpose of such thin capitalization provisions, which are common in developed countries,[55] is to prevent tax avoidance. Without such provisions, local subsidiaries of foreign parents could disguise nondeductible dividends as deductible interest, thereby shifting a portion of the corporate tax base from the source country to a lower-tax foreign country. In spite of that purpose, the ECJ held that applying such provisions to foreign, but not domestic, parent companies violated the treaty freedoms. Other examples of source-country discrimination against incoming investment invalidated by the ECJ include:

The United Kingdom paid interest on U.K. tax refunds to U.K. companies but not on refunds to U.K. branches of non-U.K.

companies.[56]
Greece subjected Greek branches of foreign banks to a higher rate of tax than Greek banks.[57]
The United Kingdom imposed an "advance corporate tax" on dividends of U.K. subsidiaries of non-U.K. parent companies but not on U.K. subsidiaries of U.K parent companies.[58]

As indicated in the previous Section, countries are generally free under the international trade and tax treaties to favor domestic production over foreign production by their own companies. The ECJ, on the other hand, has invalidated many provisions of this type, particularly in recent years. An important case in this category is *Marks & Spencer plc v. Halsey*,[59] which involved a British retailer whose Belgian, French, and German subsidiaries had suffered substantial losses and were eventually closed or sold. The key issue before the court was whether the United Kingdom had to allow Marks & Spencer to offset the foreign losses against its U.K. domestic taxable income. The litigation stimulated a great deal of interest and commentary in Europe because disallowance of losses of foreign subsidiaries is a common feature of member state tax systems, so the potential revenue loss was enormous.[60]

Like many countries, the United Kingdom taxes U.K. corporations, including subsidiaries of U.K. parent companies, on domestic and foreign income (subject to a foreign tax credit). Foreign subsidiaries of U.K. companies are not generally subject to U.K. tax on their current income, but the U.K. parents are taxed on dividends received from foreign subsidiaries (also subject to a foreign tax credit). Under U.K. law, losses in domestic, but not foreign, subsidiaries can be used to offset income in U.K. parent companies. This system of "group relief" requires the subsidiary to "surrender" the loss to the parent, so it cannot be used twice.

Before *Marks & Spencer* was referred to the ECJ, two of Europe's leading international tax specialists, sitting as special commissioners of the U.K. Department of Inland Revenue, decided in favor of the government.[61] They held that the failure to extend loss offsets to foreign subsidiaries did not violate the EC Treaty because the income of foreign subsidiaries was not subject to U.K. taxation. Citing previous ECJ decisions, the commissioners concluded that the U.K. taxation of dividends to parent companies was not germane because parent and subsidiary were different taxpayers.

The ECJ Advocate General subsequently recommended that the U.K. provisions be struck down, interpreting the treaty freedoms to require no less favorable treatment for transnational than purely national investment situations.[62] From this perspective, he concluded that investment abroad was disadvantaged relative to investment at home under U.K. law. While the U.K. special commissioners focused on the symmetrical treatment of foreign income and losses, the Advocate General focused on the fact that a U.K. parent and a domestic subsidiary could not both use a loss surrendered by the latter. Accordingly, the Advocate General concluded that the United Kingdom could not prevent the use by a U.K. parent company of the loss of a foreign subsidiary unless the latter was able to deduct or carry forward the loss in the source country.

The ECJ reached the same result as the Advocate General, although without articulating any broad principles of interpretation. [63]In the court's view, the U.K. system of group relief was simply a tax advantage that could not be limited to domestic subsidiaries.[64] It is easy to formulate the outcome as necessary to avoid discrimination against foreign production: Losses of domestic subsidiaries are available to offset income of U.K. parent companies (on the condition that the subsidiaries cannot use the losses); therefore losses of foreign subsidiaries must be available to offset the income of such parent companies (on the same condition). It is also easy to see how this result applies to Marks & Spencer, because its subsidiaries had been liquidated or sold. On the other hand, the court failed to provide any helpful guidance on the meaning of the condition under other circumstances, particularly when the definition of losses and the provisions for deductibility differ across member states. We will not be surprised to see the question of foreign loss offsets return to the ECJ.

The foreign investment in *Marks & Spencer* through a foreign subsidiary is commonly called direct investment. Another form of foreign investment occurs when individuals in one country purchase shares in foreign companies. This is known as portfolio investment. The ECJ has invalidated a number of residence-country tax provisions that restrict outgoing investment in both categories, including:

The United Kingdom did not allow U.K. holding companies to consolidate losses unless their business consisted wholly or mainly of holding shares in U.K. subsidiaries.[65]

France permitted companies selling medical products to deduct research and development costs, but only if those costs were incurred in France.[66]

The Netherlands taxed dividends that Dutch shareholders received from foreign companies but not dividends they received from Dutch companies.[67]

Austria taxed dividends that Austrian shareholders received from foreign companies at a higher rate than dividends they received from Austrian companies.[68]

Finland provided shareholder credits for corporate taxes to Finnish holders of shares in domestic, but not foreign, corporations.[69]

As we explain below, the last three of these decisions, which concern outgoing portfolio investment, helped demolish a widespread European system for eliminating or mitigating the double taxation of corporate income.

II. Implications Of The ECJ Decisions

A. Legal Implications

It should be evident that the *ECJ* has adopted a much more robust concept of discrimination than that found in international tax and trade law, particularly with respect to outgoing investment. Indeed, a recent PricewaterhouseCoopers study concludes that the corporate tax systems of all twenty-five EU members contain provisions that violate the court's jurisprudence.[70]

Member state victories in corporate tax cases have been rare.[71] In principle, provisions that violate EC Treaty freedoms can be justified on certain grounds, such as the internal consistency of the member state's tax system (usually styled "cohesion" or "coherence" in ECJ opinions) and the prevention of tax avoidance. In the past, however, the court has rarely upheld provisions on these grounds, often stating that less intrusive means to such ends should be available (the principle of proportionality). [72] The ECJ also regularly rejects arguments by member states based on loss of revenue and erosion of the tax base,[73] although at least one recent advocate general's opinion suggests that financial consequences may be relevant.[74]

A robust prohibition of discrimination against commerce among member states may sound innocuous or even benign, given the goal of creating a single internal market in the EU. However, a requirement of nondiscrimination is too unidimensional an approach for many issues of income tax design. The ECJ decisions to date suggest potentially staggering constraints on countries' freedom to resolve what strike us as quintessentially legislative issues— constraints that are fundamentally inconsistent with the fiscal autonomy retained by the member states in their right to veto EU taxing provisions. In this Section, we explore the legal implications of the ECJ jurisprudence both retrospectively and prospectively. We begin by showing how the court undermined a longstanding system for avoiding double taxation of corporate income in many EU countries. We then speculate on whether EU member states are still free to encourage domestic investment with tax incentives and to eliminate international double taxation with foreign tax credits.

1. The Demise of Imputation

Until recently, many countries in the EU avoided double taxation of corporate income (once to the corporation and again to shareholders on receipt of a dividend) by providing a full or partial shareholder credit for corporate taxes previously paid with respect to income distributed as a dividend.[75] Full implementation of such a credit would result in corporate income ultimately being taxed only once, at the shareholder's tax rate, so the income is said to be imputed to shareholders.[76]

The other major policy option for integrating corporate and shareholder taxes is a full or partial shareholder exclusion of dividends.[77] Full implementation of an exclusion would result in corporate income ultimately being taxed only once, at the corporate tax rate. Largely as a result of the ECJ tax decisions, the shareholder credit option has now been abandoned in the EU,[78] in some cases even before the ECJ had decided whether it violated the EC Treaty freedoms. In order to understand this development, we need to explain two potential complications of imputation systems.

First, untaxed corporate income complicates imputation because a shareholder credit assumes that the corporation has paid the taxes to be credited on receipt of a dividend. Rather than requiring every corporation to report to every shareholder the amount of a varying tax credit on every distribution, the European approach to imputation had been to provide a standard credit and require the corporation to pay a compensatory tax on distributions if previously paid corporate taxes were less than the total amount of credits available to shareholders.

Second, international income also complicates imputation for both incoming and outgoing investment.[79] The key issue regarding incoming investment is whether the shareholder credit should be available to foreign investors. A source country typically imposes only flat-rate "withholding taxes" on dividends to foreign shareholders, because it has no way of knowing the rest of the shareholder's income situation. The traditional practice has been to reduce these withholding taxes to identical low levels in bilateral tax treaties. Corporate income would therefore be subject to primary taxation in the source country (due to the exemption or foreign tax credit in the residence country), while dividends then paid to the foreign investors would be subject to primary taxation in the residence country (due to reduction of withholding taxes in the source country). In this situation, imputation would achieve integration for domestic investors, while leaving for treaty negotiation the question of whether shareholder credits would be extended to foreign investors. Countries have differed in their willingness to enter into treaties that extend credits to foreign shareholders. The most common decision-not to extend such credits to foreign investors-creates the possibility of source-country favoritism of domestic investors, because the corporate tax on domestic income would be integrated when distributed to domestic, but not foreign, shareholders.

Regarding outgoing investment, the key issue is whether foreign taxes paid on corporate income earned abroad should reduce shareholder taxes when that income is distributed as a dividend. The tendency has been to ignore corporate-level foreign taxes when computing individual shareholder taxes on dividends out of foreign income. Distribution of foreign income to shareholders could therefore trigger a compensatory tax, leading to the possibility of residence-country bias against investment abroad. Domestic corporate income is taxed only once by the residence country when distributed to domestic shareholders under full imputation. Foreign corporate income is taxed in the source country and typically benefits from either an exemption or a foreign tax credit in the residence country, but such income typically is taxed again when distributed to shareholders as a dividend.

The potential for favoring domestic investors and domestic investment under imputation has long been known, and various solutions have been proposed in Commission studies over the years.[80] The unanimity requirement, however, always precluded adoption of any particular solution, and member states began to fear that their imputation systems would be found by the ECJ to violate the EC Treaty freedoms. After the court held in 2000 that an exemption for domestic dividends had to be extended to dividends from other member states,[81] the Commission forcefully argued that imputation also violated the EC Treaty freedoms.[82] Late in 2004, the ECJ eventually did strike down the Finnish imputation system because it failed to provide tax credits to Finnish shareholders for corporate taxes paid to other member states by companies established in those member states.[83]

The major European countries had, however, already begun abandoning their imputation systems in anticipation of a negative decision by the ECJ. Legislation effective in 2001 replaced the German imputation system with a shareholder exclusion for half of dividends received, whether from within Germany or from abroad, including from countries outside the EU. While some policy analysts had argued for this change on the basis of the developing ECJ jurisprudence, others had opposed the resulting partial double taxation of corporate income as economically harmful to Germany.[84] The United Kingdom had already eliminated much of its imputation system in legislation effective in 1999, which retained the form of a shareholder tax credit in order not to violate certain provisions of the U.K.-U.S. tax treaty.[85] Those treaty provisions have since been eliminated, so some observers now anticipate a more transparent version of the U.K. legislation that will eliminate the shareholder credit even as a matter of form.[86] Finally, France and Italy both adopted legislation in 2003 that replaced their imputation systems with a partial shareholder exclusion for dividends.[87] As of this writing, only a few of the EU member states still have imputation systems; most have adopted some form of dividend exclusion.[88]

The demise of the European imputation systems would have been remarkable enough if it had followed an unequivocal ECJ decision reflecting agreement that discrimination against international commerce was an inherent feature of such systems. However, many member states repealed longstanding legislation even before a final ECJ decision. Moreover, the Advocate General eventually indicated in *In re Manninen* that imputation might well conform with the treaty freedoms if certain modifications were made.[89]

We do not argue here that shareholder credits are necessarily superior to shareholder exclusions as a means of eliminating the double taxation of corporate income.[90] The choice turns largely on the tradeoff between progressivity and simplicity. A credit would apply the shareholder's marginal tax rate to corporate-source income, while an exclusion would avoid many of the complexities of imputation. That choice seems to us quintessentially legislative. Our point is that making nondiscrimination the sole criterion for the choice necessarily suppresses considerations of efficiency, fairness, and administrability that should inform difficult tax policy decisions. Nor do we deny the possibility that some countries might have used the specter of *ECJ* action as cover for repealing imputation for other reasons; even that possibility would demonstrate the reach of the court's jurisprudence.

2. The Future of Tax Incentives and International Double Taxation

Is the demise of imputation the harbinger of other profound consequences for member state business tax laws? We address this question by speculating on the potential effects of the *ECJ* decisions on two other typical features of corporate taxation: stimulation of domestic investment and elimination of international double taxation.

Inspired by the success of Silicon Valley, France recently announced the creation of sixty-seven *pôles de compétitivité,* regional sites where public and private research efforts would be combined to achieve excellence in a particular business domain.[91] The French government promised support of at least €1.5 billion over three years, including reductions in corporate taxation and social security contributions for participants.

Are the contemplated tax reductions for these sites, all of which are in France, consistent with the ECJ case law? In addition to the decisions noted above, consider that the court recently struck down French legislation limiting a research tax credit to research conducted in France.[92] As for the Commission, it has indicated that Europe needs additional spending for research, [93] but it has also formally requested that Spain modify its tax deduction for research and development, because research outside Spain is subject to limitations that do not apply to research done in Spain.[94] (Such formal requests are typically issued prior to instituting proceedings before the ECJ.) The strength of the Commission's negative view regarding tax benefits that are limited to a member state's territory is perhaps best illustrated by a noncorporate case it has filed in the ECJ seeking to invalidate a German income tax deduction for certain school expenses because the deduction was available only for schools in Germany.[95] The Commission reasoned that this restriction placed the provision of services by foreign schools at a disadvantage, making parents who would like their children to be educated in another member state worse off.

The Commission's position with respect to tax incentives for economic development is complicated by its role in enforcing treaty provisions that prohibit state aid to private enterprise that is incompatible with a single European market, while recognizing that some regional aid is appropriate.[96] Exercise of the Commission's discretion to reconcile these positions is, of course, subject to the ECJ's interpretation of the treaty freedoms.[97] With respect to taxation, the Commission has drawn a highly problematic distinction between provisions that are generally applicable and those that are exceptions, with only the latter constituting prohibited state aid.[98] Two recent examples of the Commission's use of state aid authority to invalidate tax incentives are its current investigation of Luxembourg's exemption for finance and holding companies (a benefit in effect since 1929) and its decision to condition preliminary approval of the *pôles de compétitivité* on an undertaking by France that corporate tax reductions would not exceed a de minimis amount (€100,000 per taxpayer per year).[99]

We offer no opinion on whether corporate tax incentives like those for the French *pôles de compétitivité* will eventually pass muster under either the state aid provisions or the treaty freedoms, but we think it is fair to conclude that the tax advantages involved are fundamentally inconsistent with the logic of the ECJ decisions that have invalidated tax provisions favoring domestic production. Indeed, we believe that member states may eventually find that their freedom to use a variety of tax measures to stimulate domestic economic development has been severely constrained by that jurisprudence.

We indicated earlier that there are two standard residence-country methods for reducing international double taxation in national laws and the bilateral tax treaties: exemption of foreign income and a foreign tax credit. Just as the ECJ decisions undermined the shareholder credit option for reducing economic double taxation of corporate income, some leading European analysts now argue that those decisions will also eliminate the foreign tax credit option for reducing international double taxation. We consider an indirect and a direct version of this argument.

As indicated in our discussion of *Marks & Spencer,* residence countries that have elected the foreign tax credit option do not generally tax the income of foreign subsidiaries of domestic corporations until it is repatriated as a dividend to the parent company. This deferral feature of international taxation creates a possibility for tax avoidance because earnings can be left to compound abroad in a safe investment in a low—or zero-tax jurisdiction. In response, many countries have adopted "controlled foreign corporation" (CFC) provisions that mandate current taxation to parent companies of passive investment income earned by foreign subsidiaries.[100] Parent companies are not generally taxed on undistributed earnings of domestic subsidiaries, so the ECJ has been asked to invalidate CFC regimes because they apply only to foreign subsidiaries.[101] Given the importance of these anti-avoidance provisions, the litigation has attracted widespread attention in Europe.[102] If the CFC provisions are invalidated, some analysts argue that a foreign tax credit regime cannot be maintained because taxation of foreign income will be undermined by indefinite deferral.[103]

A more direct form of the argument that the foreign tax credit method of reducing international double taxation is incompatible with the treaty freedoms is that it prevents a company resident in a high-tax country from benefiting from low taxes abroad.[104] This result is arguably the logical extension of the taxpayer's position in *Marks & Spencer* that a residence country cannot interfere with its companies' freedom to invest abroad.[105]

There is, however, a fundamental problem with this argument. Consider commerce between a high-tax country (High) and a low-tax country (Low), each with one company that engages only in domestic commerce *(*H_d and L_d*)* and one company that engages only in commerce in the foreign country *(*H_f and L_f As shown in the following matrix, nondiscrimination against foreign producers and foreign production (or capital import and capital export neutrality) in this simple example requires equivalent treatment of two companies in each country.

Figure 1.
Equality of Tax Treatment

	HIGH	LOW
Nondescrimination Against Foreign Producers Requires	$H_d = L_f$	$L_d = H_f$
Nondescrimination Against Foreign Production Requires	$H_d = H_f$	$L_d = L_f$

Given the overlap of source and residence jurisdiction, there are three companies potentially subject to taxation in each country: H_d, H_f and L_f in High; L_d, L_f, and H_f in Low. As long as the two countries have different tax rates and bases, however, there is no way to achieve the specified equality of tax results. Consider the purely domestic companies H_d and L_d. *As* shown in the matrix, each must bear the same burden as L_f and H_f, which means that H_d and L_d must also bear the same tax burden, implying equal taxes in both High and Low, which is impossible.

This result is often expressed as the impossibility of implementing both capital export and import neutrality. One of us has previously made this point in terms of an irreconcilable conflict between three simple principles in the context of U.S. taxation of international transactions:

Principle 1: People should pay equal taxes on their income

> regardless of the country that is the source of that income. In particular, U.S. taxpayers should be treated equally regardless of the source of their imcome.
> *Principle 2:* All investments in the United States should face the same burden regardless of whether a U.S. person or a foreign person makes the investment. In other words, U.S. and foreign-owned investments and businesses should be treated equally.
> *Principle 3:* Sovereign countries should be free to set their own tax rates and to vary them as their domestic economic situations demand.[106]

The essential difficulty is that the first two principles can hold simultaneously in two or more countries only if income is taxed identically (for example with the same rates and bases) in all such countries, which would rule out the third principle.

The conflicts underlying this impossibility result can produce irreconcilable claims of discrimination. Consider the case of H_f when High reduces international double taxation with a foreign tax credit. Unlike L_d, H_f will pay high taxes to High on its income in Low in order to achieve parity with H_d. As indicated above, H_f can describe its situation in terms of discrimination against international commerce by observing that it pays higher taxes than L_d solely because it is engaged in international commerce, whereas L_d is engaged in domestic commerce. On this view, the ECJ jurisprudence arguably requires High to replace its foreign tax credit with an exemption for foreign income in order to allow H_f to compete in Low on the same basis as L_d.[107] Carried to its logical extreme, this view of nondiscrimination would fully implement capital import neutrality by permitting only source-country taxation and eliminating residence-country jurisdiction over international income within the EU.[108]

On the other hand, a conceptually parallel argument could be made on behalf of L_f which, unlike L_d, is forced to pay high taxes to High in spite of its legal status as a Low company. [109] The idea here would be that High should not be able to interfere with a Low company's choice between domestic and foreign production by imposing high taxes on L_f when it engages in commerce outside its home country. On this view, companies would carry their home-country tax status and rates with them wherever they operated in the EU. Such a result would be consistent with ECJ decisions such as *Cassis de Dijon* requiring member states to accept products that satisfy a regulatory requirement in the exporting, but not the importing, member state.[110] As for the Commission, this approach would be consistent with its proposed experiment in "home state taxation," which will permit some smaller companies to compute their EU taxable income under the tax laws of their country of origin beginning in 2007.[111] This approach would also be consistent with the Commission's proposal that a service provider generally be subject to regulation only in its country of origin.[112] Carried to its logical extreme, this view of nondiscrimination would fully implement capital export neutrality by permitting only residence-country taxation and eliminating source-country jurisdiction in the EU.[113]

The problem with the argument that the foreign tax credit (and residence taxation) is discriminatory should now be apparent. There is simply no principled basis to prefer it over the opposite argument that exemption of foreign income (and source taxation) is discriminatory.[114] Putting the point more generally, prohibiting discrimination based on destination is ultimately inconsistent with prohibiting discrimination based on origin. This indeterminacy confirms the limits of nondiscrimination as a tool for resolving basic issues of international taxation. The core tax policy issue here is the division of the tax base between source and residence countries, the resolution of which has depended more on compromise and practice than on any overarching principle.[115] Regulating that division by reasoning from a principle of nondiscrimination ultimately produces an incoherent result.

So far, we have considered the logical implications of the ECJ's robust approach to nondiscrimination. Are there more modest approaches that the court might adopt that are less robust and not subject to our impossibility result? We will briefly consider two.

Our analysis, like the court's, has viewed the four freedoms as protecting taxpayers against higher taxation of transnational income than domestic income. A more limited approach would be to view the freedoms as only precluding a member state from taxing more heavily income that crosses its borders than income that does not.[116] The key difference between these two approaches is that the latter would not take into account the tax situation in the other state. The most rigorous version of this approach would determine whether a taxing provision was neutral with respect to income and outgoing investment on the assumption that both countries had the same tax system and rates.[117] In the conventional language of international taxation, member states would be required only to apply capital import neutrality to incoming investment and capital export neutrality to outgoing investment. Taxing foreign producers at a higher rate than domestic producers would be prohibited on this view, as would be an investment tax credit or other tax benefit available for domestic, but not foreign, production. However, distortions resulting from the interaction of national tax systems would not be eliminated, because one member state's action would be tested without regard to the tax situation in another member state.

While it might have been possible to argue for such an approach in the past, the ECJ decisions discussed above indicate that the court does not consider itself subject to any such limitations today, if it ever did.[118] Consider again the *Marks & Spencer* decision, in which the court held that whether residence-country limitations on offsets for foreign losses were discriminatory depended on the availability of deductions for such losses in source countries.[119] Or consider the *Manninen* decision, which struck down the Finnish imputation system because Finland did not provide tax credits to its residents for corporate taxes paid to a foreign country by a foreign corporation that then distributed dividends to Finnish shareholders. If the foreign tax were ignored, the Finnish legislation would not be discriminatory, because it would collect the same total amount of Finnish taxes (corporate and individual) on all corporate income distributed as dividends in Finland, whether the paying corporation was domestic or foreign. The successful claim of discrimination required the court to consider the taxes in both countries.[120] Such precedents have led some commentators to suggest that the ECJ decisions may now require member states to eliminate double taxation within the EU, a possibility that requires looking beyond the tax situation in a single country.[121]

A second approach related to nondiscrimination that would stop short of our impossibility result might be implied from the history of the double taxation and nondiscrimination provisions in the bilateral tax treaties developed under the aegis of the OECD.[122] As discussed above, the tax treaties conceptualize the essential problem presented by outgoing investment as double taxation, not discrimination. The traditional solution has been for the residence country to cede primary jurisdiction over business income to the source country through either an exemption or a foreign tax credit. Source countries have, arguably in return, made two concessions: First, the source country cannot discriminate against investment from the residence country. Second, under the more recent OECD and EU attempts to limit tax competition,[123] the source country cannot favor incoming investment over domestic investment. The latter concession provides some discipline against source countries simply taxing incoming investment at lower rates, which could be considered inconsistent with the expectations of the residence countries when they ceded taxing jurisdiction. Similarly, one might argue that the foregoing two concessions by source countries are premised on the residence country not discouraging outgoing investment.

Given the starting point of double taxation solved by exemption and credit systems, one could then imagine a "nondiscrimination" approach in which source countries (as under current tax treaty practice) agree to apply the same rates to incoming investment that they apply to domestic investment, while residence countries (if discrimination against foreign production were prohibited) would apply the same rates to outgoing investment that they apply to domestic investment. Some might characterize this solution (like the EU state-aid rules) as prohibiting only special tax rates that favor or penalize transnational investment, while allowing countries full control over their general tax rates. As indicated above, we think such a distinction is problematic.[124]

While we can imagine the OECD promoting this result,[125] there is little reason to think that the ECJ would consider the exemption and credit methods of avoiding double taxation as sacrosanct under the EC Treaty. Like the first limited approach discussed above, this solution would not in any event achieve locational neutrality, because there would still be different tax rates and different results under credit and exemption systems. Nations would retain some tax sovereignty because they could set rates, but they would no longer be able to use tax provisions (or presumably any other tool of public policy) to promote domestic investment. Even in the OECD context, it seems unlikely that countries such as the United States would be willing to abandon these tools.

Political compromise is another way to avoid the impossibility result, but that is not the institutional role of the court. Absent some broad legislative solution, which seems a long way off for Europe, the particular aspects of member states' tax laws that will be struck down will depend on the agenda of the ECJ. That agenda will in turn depend on which cases the Commission chooses to bring and which cases private parties consider worth the costs of litigation. The latter criterion suggests that the member states may well find themselves defending cases that are unwinnable and, at the same time, expensive to lose. Complete harmonization of member state tax bases and rates could eliminate the underlying conflicts, but such a resolution could come only from EU policymakers. Although the Commission is actively pursuing the possibility of base harmonization,[126] it currently opposes the policy of rate harmonization urged by some member states.[127] We will return to the possibility of base and rate harmonization below.

B. Fiscal Policy Implications

Not only does the ECJ's jurisprudence have troubling legal implications, it also raises a series of fiscal policy implications. One pattern emerging from the court's jurisprudence is that its decisions generally reduce taxes in the member states. Indeed, whenever the court decides a tax case brought by a private party (and referred to the ECJ by a national court), the best result a member state can achieve is to maintain the status quo. Private litigants simply will not pay the costs of litigating unless victory promises lower taxes. And while cases brought to the ECJ by the Commission might either raise or lower taxes, we believe that, to date at least, they have tended to reduce taxes.[128] The ECJ has been quite explicit in refusing to take the revenue costs to a member state into account in reaching its decisions,[129] although a November 2005 advocate general's opinion suggests that the retroactivity of decisions might be limited in exceptional cases if there is a "risk of serious economic repercussions" and "objective, significant uncertainty" about the EU law at issue.[130]

Moreover, the ECJ has routinely rejected the defense that offending provisions are essential to the cohesion or coherence of member states' taxing statutes.[131] To be sure, member states have sometimes responded with a tax increasing measure to offset the potential effect of an ECJ decision on their national treasuries. This, for example, describes some member states' responses to the ECJ's decisions that would have required them to extend their corporate integration benefits both to residents of other member states and to investments in other member states by their own residents. Likewise, Germany's response to the ECJ's thin-capitalization decision,[132] which struck down Germany's restrictions on the ability of companies to use interest deductions to strip taxable earnings out of Germany into lower-tax member states, was to extend these restrictions to domestic transactions. But specific responses such as these do not put the lie to the general proposition that ECJ decisions have tended to increase fiscal pressures on the member states.

ECJ decisions also are limiting the ability of member states to use tax policy to stimulate their own domestic economies. We now know that the member states' economies do not move in tandem; some enjoy boom times while others struggle economically.[133] But, as with revenue consequences, differences in economic circumstances are of no consequence under the ECJ's interpretations of the requirements of the treaties. One standard method for combating recessions, for example, is to increase depreciation allowances or to provide tax credits for new investments in plant and equipment. The United States often has used these techniques in efforts to stimulate its economy.[134] Economists frequently have argued that providing economic stimulus this way provides more bang for the buck than simply reducing corporate income tax rates, because benefits such as these apply only to new investments, while a corporate rate reduction reduces the tax burden on both old and new investments.[135] Nations typically make more rapid depreciation or investment tax credits available only to plant and equipment used domestically since the governments are attempting to stimulate their domestic economies. Similarly, it is common for nations-including the member states of the EU—to provide special tax breaks for research and development conducted domestically on the grounds that these expenditures provide special benefits to the domestic economy and that they stimulate the creation of high-paying jobs. Other tax benefits, such as for oil and gas exploration, also are sometimes limited to domestic business activities for national policy reasons.

But, as we have shown, the ECJ has held that the EC Treaty's promise of free movement of capital and free establishment - that is, of nondiscrimination against foreign production—may prohibit member states from taking any of these actions without extending equivalent benefits to foreign production within any other EU nation. This severely constricts the tax policy instruments available to member states. Extending tax breaks for investments or for research and development to such activities in other member states both increases the costs to a member state's treasury and simultaneously dilutes the economic stimulus of such measures to that member state. It is not surprising, therefore, that no nation has agreed to this expansive concept of nondiscrimination in any other tax or trade treaties.

The decisions of the ECJ, therefore, are putting significant fiscal pressure on the member states: They are limiting member states' ability to structure their own tax systems, including their ability to respond to their own domestic economic conditions by benefiting domestic savings or investment. ECJ decisions also are restricting member states' ability to prevent resident individuals or corporations from shifting assets or income to another member state with lower income tax rates.[136] This puts downward pressure on tax rates-especially for mobile capital-within the EU.

While the United Kingdom and Ireland seem to be the nations most vocal about the loss of control over their tax policy, this loss of fiscal flexibility should be of special concern for those member states that have adopted the Euro as their currency. These nations have explicitly ceded their control of monetary policy to the central European bank (which has made preventing inflation rather than stimulating economic growth its main concern). And they have pledged, through the Growth and Stability Pact, to control their deficits.[137] But now they find their ability to fashion their own fiscal policy, by controlling their own income taxes, to be substantially eroded by the decisions of the ECJ.

III. The Fork In The Road

This state of affairs does not seem stable. Movement may occur in either of two directions: toward greater harmonization of income taxes within the EU or toward a restructuring of the treaties and institutions of the EU to return greater fiscal autonomy to the member states. As Yogi Berra famously remarked, "When you get to a fork in the road, take it." The ECJ has now brought Europe to that fork.

A. The Path of Greater Harmonization

In some sense, the widespread agreement that Europe now needs a constitution, rather than simply continuing to rely on existing treaties as its fundamental governing law, implies greater unification of the member states. But in the arena we are considering here—income taxation—the proposed constitution would not change the structure of governance within the EU. There have, however, long been forces pushing in the direction of greater harmonization of income taxes within Europe. The Commission, for example, has long maintained that harmonization of the corporate income taxes of the member states is essential to the full realization of the "common market" promised by the European treaties. As early as 1961, the Commission established working groups to study tax harmonization, and shortly thereafter it established a "Program for the Harmonization of Direct Taxes."[138] The essential goal was to eliminate differences in taxation that affect the movement of capital and to coordinate the tax policies of member states as instruments of economic or social policies.[139] In the 1970s, the Commission pressed harmonization of member states' income tax rates and tax bases even more vigorously, having identified a harmonized corporate income tax as a potential source of financing for European institutions.[140]

To shorten a long story, the Commission's goal of harmonization was thwarted by the Council.[141] Some member states, notably France and Germany, have supported harmonization, and others, such as the Netherlands, have supported a minimum corporate income tax rate. Certain other members of the Council, however, have shown little interest in income tax harmonization measures other than those that limit opportunities for tax avoidance or evasion.[142] Needless to say, the unanimity voting rule in the Council has inhibited the Commission's ability to do more.[143]

The Commission seems to have accepted that there will be no harmonization of corporate tax rates among the member states– at least not in the foreseeable future–and has shifted its efforts to the goal of harmonizing the corporate tax base. The Commission now justifies this effort by emphasizing the simplification advantages of a uniform tax base to companies doing business in Europe, relying less on claims of potential benefits to the common market.

To some extent, this shift in argument became inevitable when the Commission abandoned its efforts to harmonize both the corporate income tax base and rates around a relatively narrow band of permissible variations. Corporate tax rates in the twenty-five EU countries currently extend over a considerable range. In 2005, Estonia had no income tax on undistributed corporate profits at all.[144] Cyprus and Ireland had relatively low rates (10% and 12.5% respectively), while Belgium, France, Germany, Italy, Luxembourg, and Spain all had rates in excess of 30%.[145] This variation in rates creates substantial incentives for where to locate capital within the EU. With harmonization of rates now off the table, it is difficult for the Commission (or anyone else) to contend that harmonizing the tax base will produce neutrality in corporate decision-making within Europe. Both the history and current state of corporate tax harmonization efforts within Europe imply that competition for capital investments will remain an important feature of member states' tax policies for some time to come. No one versed in tax policy can comprehend the logic of allowing this to continue while banning all other forms of investment incentives, such as accelerated depreciation or tax credits. But this is precisely where Europe stands today.

One cannot help but ask whether the Commission's ongoing efforts to harmonize corporate tax bases is—despite its protestations—simply a stalking horse for a subsequent push to conform rates. The Commission's ongoing complaints about the unanimity requirement and its continuing calls for qualified majority voting on tax matters lend credence to this view.[146] But the United Kingdom, the Netherlands, and certain other member states show no sign of any willingness to cede their veto power over taxation measures. For now at least, harmonization of corporate tax rates throughout Europe seems to be at a dead end.

Putting aside the stalking horse view of the Commission's effort to harmonize member states' corporate tax bases but not their rates, let us examine what such a measure would accomplish. The Commission now justifies its harmonized base proposal as a method of simplifying EU corporate taxes and reducing the costs of tax compliance for EU companies, [147] and these two benefits should follow. In addition, harmonization of corporate tax bases in a manner approved by the Commission might reduce the number of cases likely to come before the ECJ. Presumably a Commission-led harmonization effort would attempt to purge from the member states' tax laws provisions that the Commission views as contravening the European treaties. As indicated above, a PricewaterhouseCoopers study has concluded that the corporate tax laws of all twenty-five member states contain such provisions.[148]

The Commission would couple the harmonization of the corporate base with apportionment of corporate tax revenues to the member states through a formula similar to that used within the United States. Such formulary apportionment should reduce (or perhaps even eliminate) the amount of residence-based taxation in Europe and thereby decrease the number of cases involving discrimination against foreign production coming before the ECJ. The Commission is urging that all members must use the same formula, a requirement that the U.S. experience shows to be wise. Historically, the U.S. states used an equally weighted three-factor formula that allocated a share of corporate income to each state based on the amounts of property, wages, and sales in the state. However, many U.S. states now weigh sales more heavily in their formula than property or wages. Some have even adopted sales-only formulas that encourage companies to locate property and jobs in-state while taxing income from in-state sales of goods produced out of state. Thus, if the EU were to mimic the United States by harmonizing its corporate tax base[149] and allocating the revenues to the member states by formulary apportionment, the U.S. experience suggests that, without a prohibition on extra weighting of sales, formulary apportionment would make it easy for member states to favor domestic investment, something the Commission has been litigating to prevent.[150]

In the United States, Congress has the constitutional power to impose a uniform formula on the states by legislation, but it has never done so.[151] In the EU, on the other hand, short of unanimous agreement on a single formula by all of the member states, there is no legislative body with the power to compel a uniform formula. While it is certainly possible for the member states to agree unanimously to move not only to formulary apportionment, but also to a specific formula, this seems unlikely any time soon. Thus, even if the Commission succeeded in harmonizing the corporate tax base, it might fail to harmonize either tax rates or the formula for allocation of profits to the member states. If the member states then followed our states' example of fashioning formulas to provide themselves a competitive advantage, the Commission would likely return to the ECJ arguing that any formulas that favor domestic products, producers, or production violate the EC Treaty. Based on the ECJ decisions to date, we would expect the court to restrict member states' discretion over the formula, something that both our Supreme Court and our Congress have refused to do.

In sum, harmonization of member states' tax rates is not in the cards for the foreseeable future. And we fail to see how-without some relatively narrow band of permissible variation in rates - harmonization of the corporate tax base coupled with formulary apportionment will accomplish the mission of strengthening the internal market. Indeed, based on our nation's experience, it seems more likely that such a regime would simply be another way station along the current litigious road. Even if harmonization of tax rates could be achieved, it is not at all clear that the resulting uniformity would be desirable, given the differences in the member states' economies and in their preferences regarding the size of government and the use of tax incentives for economic or social programs.[152]

Concerned that the obstacles to harmonization now seem too great to overcome, the Commission has also been pursuing what it calls "soft law" avenues to greater coordination among member states. The Commission, for example, has proposed "Codes of Conduct," which are not legally binding on the member states, but allow them to pledge their cooperation.[153] And key Commission personnel have suggested that, if achieving unanimity is impossible, the search for "a negotiated solution adopted by consensus in a soft law format is the only available tool."[154] Any such consensus may involve fewer than the full twenty-five EU member states and, if so, would apply only to those who agree.[155] In the meantime, the Commission fully intends to continue challenging member state income tax rules before the ECJ.[156]

B. The Path of Greater Autonomy

The ECJ's tax decisions undoubtedly have produced headaches for the member states. As we have discussed, member states' claims that a provision is necessary to maintain the coherence of their income taxes have generally been rejected by the court. And the court has paid little heed to the negative impact of its decisions on the revenues of the member states. Over time, many member states have abandoned their shareholder-credit systems for integrating their corporate and individual income taxes. The ECJ has also curtailed member states' ability to provide tax incentives for domestic investment or for domestic research and development. ECJ decisions have also struck down (and threaten to strike down more) member state tax provisions designed to inhibit companies' ability to shift income to lower-tax member states. The court has, for example, invalidated member states' limitations on corporations' ability to strip earnings from higher—to lower-tax countries within the EU. And other member state limitations on domestic corporations' ability to locate income in lower-tax member states are in grave danger. ECJ precedents now threaten the extensive network of bilateral income tax treaties that has evolved since the 1920s, both within Europe and between EU member states and other nations. Indeed, the foreign tax credit mechanism for relieving double taxation–used for more than half a century in the United Kingdom and elsewhere—now seems vulnerable to an adverse ECJ judgment. Even the European Commissioner for Taxation has conceded that he is "not happy with the fact that EU tax policy is increasingly being made as a result of [ECJ] decisions," admitting that "recent developments in this area could lead to a situation where it will become almost impossible for member states to protect their tax bases.[157]

The likelihood, however, that the ECJ's tax decisions, coupled with its other intrusions on member state sovereignty, will drive member states to separate from the EU seems even more remote than the harmonization of member states' income tax rates. The European project has come too far and the economic and political transformation has been too great for anyone to predict that Europe is about to fall apart. Member states have many reasons to maintain their political and economic union even if many also wish to retain autonomy over their tax systems, especially over income taxation. Pulling Europe apart is one option, but not one that the member states or the people of Europe seem to desire.

On the other hand, the fiscal consequences of the ECJ's current path are becoming more and more difficult for the member states to swallow. They simply cannot afford to stand idly by and watch their corporate tax revenues shrink. Nor can they readily increase their own corporate tax rates. Competition for capital investments within Europe blocks this avenue as a practical matter. (In fact, corporate tax rates in Europe and the OECD have been declining in recent years.[158])

One potential response by the member states to the ECJ's erosion of their sovereign power to shape their own income taxes would be to restrict the authority of the ECJ over such matters.[159] A future revision of the treaties or a new constitution might limit the ability of the ECJ to strike down member states' income tax provisions. Such a limitation on the jurisdiction of the ECJ, however, would permit considerable mischief by the member states. As our review of the ECJ cases has shown, some member state tax provisions are potentially quite protectionist, and some have been adopted to serve precisely that purpose. The dilemma for the nations of Europe is to find a way to retain their autonomy over tax matters without undermining the internal market and, as a practical matter, severely restricting the four freedoms.

The basic difficulty is that while the nondiscrimination requirements of international income tax and trade treaties may be too narrow to accomplish European integration, the nondiscrimination requirement that has emerged through the decisions of the ECJ is too broad. It stifles the member states' essential ability to promote their own domestic economies. The ultimate question is whether there lies any viable middle ground between the limited nondiscrimination requirements of international tax and trade treaties and the unduly inhibiting version of nondiscrimination fashioned by the ECJ, which does not allow for compromise among inconsistent principles. One alternative might be a slowing of ECJ intervention with more attention to the effect on the member states' fisc and a greater focus on protectionism as a potential middle ground. The court's inquiry might, for example, be redirected to whether the intent of the provision was protectionist.[160] The court also might move to mitigate the adverse impact of its decisions on member state revenues by limiting the retroactive effect of its decisions.[161]

In the absence of some pullback from the ECJ's current jurisprudence, we expect greater resistance by the member states. Already, several national courts within Europe have shown a reluctance to certify questions to the ECJ. They would rather interpret the requirements of European law themselves, even though certification is mandatory under the treaties if the governing European rule is unclear. The courts of Ireland, Italy, and Spain have never submitted a tax case to the ECJ for decision. If other member states were to follow this practice, they would restrict somewhat the ECJ's power, in effect diminishing its jurisdiction. In addition, member states have considerable power to discourage their domestic companies from challenging member state tax laws in the ECJ. More intensive and intrusive tax audits of litigants are one possibility-unseemly, to be sure, but nevertheless possible. Or member states might respond to ECJ decisions by extending restrictions to domestic companies rather than eliminating the offending provisions altogether. This was Germany's response after the ECJ struck down its limitations on interest deductions for payments to thinly capitalized foreign corporations.[162] Member states could respond similarly to the *Marks & Spencer* decision by restricting the use of certain domestic losses. Indeed, extending restrictions to intrastate transactions is how U.S. states have sometimes responded to adverse U.S. Supreme Court decisions.[163]

Alternatively, the Council and Parliament might limit the Commission's ability to bring cases either directly by reducing its mandate or indirectly by restricting its finances or increasing its workload (but not its personnel) in the tax arena. When the United Kingdom assumed the revolving presidency of the Council in 2005, the press indicated that curbs on the ECJ's tax jurisdiction would be on the agenda.[164]

Another possibility would be greater restraint by the ECJ itself. The court might, for example, give greater weight to arguments based on the fiscal coherence of a member state's tax system.[165] There are signals that the court could be moving to a more cautious mode. One advocate general, for example, has suggested that revenue implications might be germane to the court when deciding whether to strike down tax legislation.[166] Another has suggested limiting the retroactive effect of court decisions.[167] And the court itself declined to hold that the benefits of an intra-European tax treaty must be extended to nationals of member states not a party to the treaty.[168] One knowledgeable European commentator has criticized this decision as a sign that the court may be softening its approach to European integration.[169] Alternatively, the court might fashion a less robust nondiscrimination requirement.[170]

Finally, the member states may simply divide, as they did with respect to monetary union, with some pursuing greater harmonization, while others insist on greater autonomy.[171] These possible responses illustrate the potential for member states to maintain their separatism in the face of ECJ decisions without pulling the EU apart. Essentially, this is a form of "muddling through.[172]

IV. The United States: Similarities And Differences

A. Comparable Decisions of the U.S. Supreme Court

Europeans may be tempted to look to decisions of the U.S. Supreme Court in the hopes of finding a way through Europe's conundrum. After all, the U.S. Supreme Court since the nineteenth century has decided many cases analogous to the ECJ cases we discuss here. The two U.S. constitutional provisions that explicitly address the taxing powers of the states—the Import-Export Clause[173] and the Duty of Tonnage provision[174]—have not been important, but three other provisions have frequently been invoked: the Commerce Clause,[175] the Privileges and Immunities Clause,[176] and the Equal Protection Clause.[177] Most of the cases have been decided under the Commerce Clause, and the Supreme Court explicitly requires that a state taxing provision must not "discriminate against interstate commerce" in order to be upheld under that Clause.[178] It therefore seems worthwhile to inquire whether the ECJ might benefit from the U.S. jurisprudence. Implementing a coherent nondiscrimination requirement, however, has not proved to be any easier for the U.S. courts.

Walter Hellerstein, the leading legal analyst of the U.S. decisions, claims correctly that it is futile to attempt to reconcile the Supreme Court's "hundreds of decisions delineating the scope of state tax power over interstate business,"[179] and we shall certainly not undertake that task here. Professor Hellerstein describes the incoherence of these decisions:

> [1] Two taxes that have a substantially similar impact on interstate commerce are accorded different constitutional treatment. [2] The Court, conceding that the "line is sometimes difficult to define with distinctness," nevertheless draws one that is discernable, if at all, only to itself. [3] The line drawn is then explained in terms that effectively assure the Court ample discretion to draw lines in the future as it deems appropriate, without providing any clear guidance whether a particular levy will fall on one side or the other.[180]

It would be foolhardy, therefore, for Europeans to expect the U.S. Supreme Court to supply a way out of the mire, even if our political arrangements were similar, which they are not. Most importantly, the United States employs a federal corporate income tax that supplies both a uniform national corporate tax base and a minimum national tax rate.[181] The United States also has relatively low state corporate tax rates,[182] a more unified national economy than the EU, and a federal legislature that can both overturn Supreme Court judgments and enact legislation limiting the Court's power to nullify state taxes.[183] Notwithstanding these critical differences, however, we shall look briefly at a handful of Supreme Court decisions, employing once again the analytical framework we used above for classifying the corporate tax decisions of the ECJ. As before, we begin with discrimination against out-of-state products (and services).

The Supreme Court has consistently struck down laws that discriminate against out-of-state products. According to the Court, the "paradigmatic example of a law discriminating against interstate commerce is the protective tariff or customs duty, which taxes goods imported from other States, but does not tax similar products produced in State."[184] Because the Court has frequently taken such a firm position against these taxes, states have adopted them with decreasing frequency, so the Court, at least in recent years, has rarely found itself in a position to invalidate them. One such decision struck down state sales tax exemptions in Hawaii for two kinds of locally produced liquors, where these exemptions were intended to encourage the growth of the infant industries that produced the liquors.[185] Similarly, the Court found an Ohio tax credit against the state's motor vehicle fuel sales tax to be discriminatory.[186] Under that provision, taxpayers could receive a credit for ethanol sold (as a component of gasohol) by fuel dealers, but only if the ethanol was produced either in Ohio or in a state that granted tax advantages similar to those granted to ethanol produced in Ohio.[187]

The Court has also invalidated as discriminatory tax provisions that favor in-state provision of services—a type of tax that states seem to enact with increasing frequency. For example, the Court rejected a New York law that attempted to encourage stock trading in New York by offering a fifty percent reduction on the stock transfer tax levied on in-state stock transactions by non-New York residents.[188] The statute also limited the total liability of any taxpayer to $350 for a single transaction involving a New York sale. The Court struck this statute down on the ground that it offered unconstitutionally preferential treatment to stock trading services provided in New York.

With respect to producers, the Court has made clear that the Commerce Clause prevents state tax laws from discriminating against those from out of state. In several of these cases, states have offered exemptions from state taxes to in-state producers, thereby discriminating against their out-of-state competitors. For example, West Virginia imposed a gross receipts tax on manufacturing corporations engaged in the business of selling tangible property in the state and allowed only local manufacturers exemptions from the tax.[189] Similarly, Washington imposed a "business and occupation" tax on companies for the privilege of engaging in economic activities in the state, including both manufacturing and wholesale sales.[190] The tax included a "multiple activities exemption" under which local businesses involved in both selling and manufacturing could exempt from the manufacturing tax the portion of their output subject to the wholesale tax.[191] The Court struck down this arrangement on the ground that both taxes "facially discriminated" against out-of-state companies attempting to do business in Washington.[192] A third example of a case invalidating discrimination against out-of-state producers involved a Massachusetts tax and subsidy program under which every milk producer doing business within the state had to make monthly "premium payments" of an amount pegged to fluctuations in the national price of milk.[193] The state then distributed the monthly collections to in-state dairy farmers, who received shares in direct proportion to their contribution to the state's total production of raw milk. While both in-state and out-of-state producers made payments under this program, only in-state producers received compensatory benefits from the fund, a net result the Court found discriminatory.

The U.S. Supreme Court also has struck down state taxes that discriminate against out-of-state production, but this type of case does not occur frequently.[194] One such example concerned a New York statute that required parent companies owning domestic international sales corporations (DISCs) to consolidate the assets and liabilities of the DISC with those of the parent company.[195] The state provided the parent companies with a credit that lowered the effective tax rate on DISC income to thirty percent of the otherwise applicable rate. This credit applied only to gross receipts from export products shipped from inside New York, and, crucially, the magnitude of the credit depended on the percentage of business the DISC carried out in New York. The Court found that this law discriminated against companies producing outside of New York because an increase in out-of-state DISC-related production reduced the in-state tax benefit. Another decision along somewhat similar lines struck down a tax on the "first use" within the state of any natural gas, but allowed a variety of exclusions and credits against the tax for companies that had already paid a "severance" tax on the extraction of oil and gas within Louisiana.[196] According to the Court, this tax arrangement discriminated against interstate commerce by encouraging companies "to invest in mineral exploration and development within Louisiana rather than . . . in other States."[197] On another occasion, the Court invalidated a North Carolina "intangible property tax" on the fair market value either of stock owned by state residents, or of stock "having a business, commercial or taxable situs in the State."[198] The state imposed the tax at a rate of 0.25%, but residents could calculate their tax liability by taking a taxable percentage deduction equal to the fraction of the issuing corporation's sales, payroll, and property located in North Carolina-the factors that determined the amount of corporate tax paid to the state. The Court found that this calculation discriminated against companies that located their production outside of the state.

To recapitulate, the Supreme Court has invalidated state tax laws favoring in-state products, producers, and production. On the other hand, its jurisprudence has not yet had the same reach as the decisions of the ECJ, particularly with respect to the third category.[199] The primary reason for this, we think, is not found in the differences between the two courts' approaches to nondiscrimination, but rather in the fact that state taxation of corporate "business income"[200] typically occurs through formulary apportionment. Under this system, the states determine their corporate tax revenues by allocating shares of the total corporate tax base to each state depending on that state's share of wages, property, and sales. Wages and property are factors of production, while sales relate to consumption. Three-factor formulary apportionment divides the state income tax base among source and consumption states, largely without regard to a company's residence. Residence-based taxation of corporate income is thus much less important to the U.S. states than it is to the EU member states. It is therefore not surprising that the U.S. Supreme Court has been less concerned than the ECJ with discrimination by states against out-of-state production by their residents.[201]

The great advantage of formulary apportionment is that it avoids the thorny problem (which haunts tax administrations throughout the world) of having to determine related-company transfer prices to measure each state's income. But there is a rub. Economists regard formulary allocation of income taxes as essentially imposing burdens on the elements of the formula.[202] The U.S. states have found that the wage element of the formula increases the tax burden on locating jobs within the state and that the property element burdens the location of capital within the state. Consequently, over time states have moved toward weighing most heavily the sales element of the formula.[203] Iowa was the first state to eliminate completely the property and wage aspects of the formula and to use only sales in its formula.[204] In *Moorman Manufacturing Co. v. Bair,*[205] the U.S. Supreme Court upheld the constitutional validity of Iowa's sales-only formula for allocating corporate profits. For many years, Iowa had been the only state to use a sales-only formula for apportioning corporate income, but five additional states have now moved to a sales-only formula, and more than half of the states weigh sales more heavily than the property or wage factors.[206] Under the U.S. Constitution, Congress has the power to require the states to adopt uniform formulas, but, so far at least, it has declined to act.

Dissenting in *Moorman,* Justice Powell described his view of what was at stake: "Iowa's use of a single-factor sales-apportionment formula—though facially neutral—operates as a tariff on goods manufactured in other States and as a subsidy to Iowa manufacturers selling their goods outside of Iowa."[207] However, a majority of the Court upheld Iowa's sales-only formula by refusing to accept the three-part formula as the appropriate baseline for assessing nondiscrimination. In other words, a sales-only formula does not favor in-state production if one ignores other states' three-part formulas or if one assumes that all states have moved to a sales-only formula. This result provides American states a means of favoring in-state production that does not exist in the EU.

An important case currently before the Supreme Court may provide some insight into whether its approach to discrimination will move closer to that of the ECJ regarding outgoing investments. In *Cuno v. DaimlerChrysler, Inc.,*[208] the Sixth Circuit Court of Appeals allowed an abatement from local property taxes but invalidated an Ohio investment tax credit for new investments in Ohio. Both benefits were intended to encourage a company to locate a manufacturing facility in Ohio. The appellate court struck down the investment tax credit on the ground that this incentive favored in-state over out-of-state investment,[209] Even though nearly all of the fifty states provide incentives for local investments, relatively few of these have been challenged, and the Supreme Court has not yet squarely confronted the question of their validity.[210] If affirmed by the Supreme Court, the *Cuno* decision would invalidate a wide variety of tax incentives enacted to favor in-state investments and would move the United States further down the path taken by the ECJ with respect to this type of discrimination—and further into the labyrinth of impossibility we have described.[211]

While some, including Professor Hellerstein,[212] have argued that *Cuno* can readily be distinguished from *Moorman,* we disagree. The Ohio investment credit is simply a less expensive method of favoring in-state over out-of-state investments.[213] Rather than using a sales-only formula to avoid taxing any property located in the state, the credit is directed only at new investments. While it is not our main subject here, we think the U.S. Supreme Court should uphold Ohio's investment credit incentive and avoid stepping further into the conundrum that exists under the ECJ's decisions.[214] In taking this position, however, we should make clear that we need not endorse local tax incentives to do so. The Commerce Clause gives Congress the power to determine the extent to which such incentives should be allowed. Legislation has been introduced in Congress that would permit investment tax credits of the sort struck down by the Sixth Circuit in *Cuno* and would generally authorize states to provide tax incentives that otherwise might be held to be unconstitutionally discriminatory.[215] These bills also attempt not to overturn the remainder of the Supreme Court's Commerce Clause jurisprudence-admittedly a difficult task,[216] But Congress, not the Court, is the most appropriate body to decide whether to permit states to provide incentives for local investments, and if Congress speaks, it will almost certainly respond affirmatively.

B. Implications of the ECJ Decisionsfor the United States

We began our discussion of the Supreme Court decisions in the previous Section by asking if they could help resolve the conundrum created by the ECJ. Let us now turn the question around and ask what, if anything, the jurisprudence of the ECJ implies for the United States. We will examine implications for U.S. judicial decisions, tax treaty provisions, WTO constraints on taxation, European bilateral tax treaties, and the level of corporate taxation in the EU.

The first issue is whether the ECJ's view of the European requirements of nondiscrimination might find its way into the jurisprudence of U.S. courts. There are two contexts in which this might occur: first, in the Supreme Court's interpretations of the nondiscrimination requirements of the Commerce Clause of the U.S. Constitution in cases concerning state taxation of interstate commerce; and second, in judicial interpretations of the nondiscrimination requirements of U.S. bilateral income tax treaties.

Commentators have frequently remarked—sometimes unfavorably—

that in recent years the Supreme Court of the United States has paid attention to practices and judicial opinions from abroad in interpreting the U.S. Constitution.[217] It would therefore be no surprise for the ECJ's nondiscrimination jurisprudence, over time, to influence the Supreme Court's decisions involving the constitutionality of U.S. state tax provisions. While, as we have made clear, these cases arise in an institutional and political context quite different from Europe's, they often involve similar issues: the legality of measures by state governments that may discriminate against the free interstate movement of goods, services, labor, or capital.

Our discussion of both the legal and fiscal policy implications of the ECJ's corporate tax decisions and of the U.S. Supreme Court's struggle with similar issues makes clear that we would not regard importation of ECJ jurisprudence by the U.S. Supreme Court as a positive development. We have emphasized the differences between the European and U.S. political structures and contexts, including the existence of a U.S. federal income tax.[218] Most importantly, Europe has no legislative body with authority comparable to our Congress's to act concerning these issues. Moreover, the ECJ's nondiscrimination jurisprudence is, in our view, a quest for an unattainable goal in the absence of harmonized income taxes—the simultaneous achievement of neutrality based on both origin and destination. For that reason, among others, it is inherently unstable. Despite the serious shortcomings of U.S. Supreme Court decisions in this context, looking to the ECJ for help does not seem wise.

In the quite different context of federal courts interpreting the nondiscrimination clauses of bilateral U.S. income tax treaties, we think it is unlikely that the ECJ's cases will have any noticeable impact on the decisions of U.S. courts.[219] Recall that U.S. obligations under the tax treaties' nondiscrimination clauses extend only to inbound investments—in this case, investments in the United States-by individuals or companies who are neither citizens nor residents of the United States. Both the U.S. Department of the Treasury and U.S. courts have taken a more limited view of the scope of this obligation than is implied by the ECJ's view of the nondiscrimination requirements of the EC Treaty. The United States, for example, has long insisted that its thin-capitalization rules,[220] which were intended principally to limit the ability of U.S. subsidiaries of foreign parents to strip earning out of the United States, are not discriminatory on the ground that they affect all entities exempt from U.S. taxation, not just foreigners.[221] The ECJ, in contrast, struck down similar German restrictions on interest deductions.[222] Additional examples exist. The ECJ, for example, has invalidated "exit taxes" that apply to taxpayers leaving one member state for another, while the United States allows such taxes.[223] It seems unlikely that the ECJ decisions concerning discrimination against inbound investors will, without more, affect U.S. courts' determinations of what constitutes discrimination under U.S. bilateral income tax treaties.

A more likely course is that the ECJ cases finding discrimination against inbound investments will affect interpretations by the OECD of the nondiscrimination clause of its model treaties.[224] Both ECJ interpretations of EC Treaty requirements and U.S. and OECD interpretations of the nondiscrimination requirements of income tax treaties require that the source country not treat a branch or subsidiary of a foreign company doing business in the source country (a "permanent establishment" in the language of the treaties) less favorably than it treats a domestic branch or subsidiary doing business in that country. The main distinction is that the ECJ's nondiscrimination requirements also apply to foreign portfolio investors, while the income tax treaty rules do not. The ECJ's cases finding discrimination in cases involving services supplied by a foreigner also go beyond the income tax treaties' nondiscrimination requirements. Over time, the OECD model income tax treaty (and the OECD's interpretations thereof) could move closer to the ECJ's case law when inbound investments are at issue. Although the United States has always published its own model income tax treaty, which differs in some respects from the OECD model, the United States has also always been heavily influenced by the OECD model and its interpretations. We would not be surprised, therefore, if the U.S. model treaty also moved toward a more comprehensive view of discrimination regarding inbound investments.[225]

Neither the OECD's model income tax treaty nor any U.S. bilateral income tax treaty limits the taxation rights of the home country regarding outbound investments, other than those articles requiring that double taxation be addressed either through a credit for foreign taxes or an exemption for foreign income.[226] Although the OECD has announced that it is reexamining the scope of nondiscrimination in the tax treaties,[227] which conceivably could lead to a rule that applied to outgoing investment, we find it inconceivable that the United States would agree to expand its income tax treaties to mimic the ECJ's jurisprudence in this context. The United States is simply not going to negotiate away its ability to provide incentives for domestic investments or other activities, such as research and development or domestic exploration for energy resources.

A third forum in which the ECJ's nondiscrimination jurisprudence might affect U.S. tax policy is the WTO. GATT (and its successors), which the WTO is charged with enforcing, prohibits subsidies for exports. As we have indicated, this has led the WTO (and its predecessors) to strike down certain U.S. income tax provisions on the ground that they provided benefits to domestic exporters not available to foreign producers. In 2004, Congress responded by substituting a special deduction available only to domestic manufacturing activities.[228] Under WTO rules, as currently interpreted, this kind of subsidy is valid because it is available for the domestic manufacture of goods, whether exported or not. The ECJ, on the other hand, would likely strike down such a provision as discrimination against foreign production—a violation of the free movement of capital or the free establishment guarantee of the EC Treaty. It is conceivable—but unlikely—that the WTO might also someday extend its reasoning regarding export subsidies to this type of subsidy on the ground that it inhibits the free movement of goods and services. This would be a major expansion of constraints on national legislation by the WTO, which, for both the legal and fiscal policy reasons we have discussed here, would be greatly resisted by many WTO members, including the United States. We do not expect the WTO to go this far in the absence of explicit authorization in a new treaty—authorization that surely will not be forthcoming.

With regard to the extensive network of bilateral income tax treaties now in force throughout the world, the ECJ jurisprudence poses another fundamental question: Can the bilateral nature of these treaties be sustained when an EU member state is one of the parties?[229] In a number of tax cases, the ECJ has made clear that, along with their other taxing powers, member states must exercise their rights to enter into tax treaties in a manner that is consistent with EU law.[230] When the ECJ has found that a bilateral treaty violates one of the four freedoms, it has typically required the member state at fault to extend treaty benefits unilaterally to residents of other member states.[231] Whether member states will be able to maintain treaties on a bilateral basis at all, however, has been called into question by the ECJ's decision in the so-called *Open-Skies* cases.[232] In those cases, the ECJ held that clauses in bilateral air transport agreements between the United States and various member states, which limited benefits to nationals of the contracting member state, violated the freedom of establishment requirement of the EC Treaty. This created a dilemma since it is not possible for a European member state to extend the treaty benefits granted to it by the United States unilaterally to nationals of other member states. Nor could any member state force the United States to allow all EU nationals to enjoy the treaty benefits. Ultimately, the bilateral air transport treaties were saved when the United States agreed to new language allowing ownership and control by EU nationals of other member states. As a result, British nationals, for example, may now own and control a French airline and take advantage of the French-U.S. treaty.[233]

Bilateral income tax treaties between EU member states and the United States now routinely contain "limitations on benefits" clauses, which are intended to limit the treaties' benefits to tax residents of the contracting state.[234] The treaty between the United States and the Netherlands, for example, allows its reduced withholding tax rates on dividends, interest, and royalties to companies only if "more than 30 percent of the aggregate vote and value . . . is owned, directly or indirectly, by qualified persons resident in the Netherlands."[235] While their purposes are generally the same, the details of these limitations clauses vary, depending on when the treaty was negotiated and sometimes on specific bilateral considerations.[236] The ECJ's *Open-Skies* decisions suggest that these clauses may have to be renegotiated to permit benefits to nationals of other member states.

The *Open-Skies* cases, along with certain tax cases,[237] raise the more fundamental question of whether any EU country will be able to enter into a treaty with a non-EU country that treats its own nationals more favorably than nationals of any other EU member state. The crucial issue for the United States would then be whether the ECJ has imposed a type of most-favored-nation rule that, in essence, overrides the bilateral nature of the tax treaty. An opinion by the Advocate General in a recent ECJ case involving claims by a German resident for a wealth tax exemption the same as that granted by the Netherlands in a bilateral treaty to residents of Belgium suggested that—at least for bilateral treaties between EU member states—one member state could not grant benefits to nationals of another member state without making similar benefits available to nationals of all member states.[238] In allowing the German complainant benefits equivalent to those available to any Belgian national under the treaty, the Advocate General stated:

> [A]ccepting reciprocal obligations to another member state which limit the freedom of movement of the nationals of European non-member countries is contrary to Community law. The fact must not be overlooked that national provisions, which include validly concluded and ratified international treaties, must not infringe the fundamental freedoms of the European legal system. . . .
>
> . . . I am aware of the dangers which the foregoing considerations imply for the equilibrium and reciprocity which prevail in the system of double-taxation treaties, *but those difficulties must not become obstacles to the establishment of the single market.* . . . [T]he States in question have a duty to seek other formulae which, whilst achieving the objective sought, do not, in breach of Community law, prejudice the citizens of other Member States.[239]

The ECJ reached a different conclusion.[240] It upheld the Netherlands law allowing a wealth tax exemption only to its own residents on the ground that "the situation of a resident and that of a non-resident are as a rule not comparable."[241] And—citing arguments by a number of member states that a contrary holding would entail "danger" and "legal uncertainty" for bilateral tax treaties - the court also found that the more favorable treatment granted by the Netherlands to a resident of Belgium under the bilateral treaty did not violate EC law.[242] The court, however, did not override a prior precedent holding that a member state must extend bilateral income tax treaty benefits to a permanent establishment owned by nationals of a member state not a party to the treaty.[243] Instead, its emphasis in the wealth tax case was on the reciprocal rights and obligations that are an "inherent consequence of bilateral double taxation conventions."[244]

Given their conflicting conclusions, it is difficult to know what to make of the ECJ's cases involving bilateral tax treaties. The court's language suggests that the results will depend on whether the court concludes that the resident and nonresident are "in similar circumstances," which seems quite fact specific. The court's decision in the Netherlands wealth tax case suggests that it does not intend to impose a general most-favored-nation requirement on bilateral tax treaties, and it appears, for now at least, that the court will not lightly undermine even intra-European bilateral tax treaties.[245] The great divergence between the opinions of the Advocate General and the court in this regard deserves emphasis, and the court's decision has been strongly criticized by some advocates of European integration.[246] The resulting uncertainty regarding bilateral tax treaties also makes it unclear whether the ECJ will uphold limitations on benefits clauses.

At a minimum, the United States must take into account potential interventions of the ECJ when negotiating bilateral tax treaties with EU member states. For the longer term, the United States should begin considering what kind of treaty it would be willing to negotiate with Europe as a whole.[247] In the airline context, the United States went to considerable lengths to avoid a multilateral European treaty, principally to continue pressure on the British to expand landing rights at London's Heathrow Airport. In the income tax context, given the wide variations in both tax rates and tax administrative capabilities among the twenty-five EU Member states, the United States should also move slowly, if at all, toward a one-size-fits-all European treaty. But over time that may be exactly what the ECJ's jurisprudence will demand.

Finally—and perhaps most importantly—United States policymakers must begin to address how our nation should respond if, over time, the effect of the ECJ's corporate tax jurisprudence is to dismantle corporate income taxes in Europe. The European retreat from shareholder-credit corporate tax integration has already had some impact on U.S. treaty negotiations with certain European partners and may have influenced the U.S. decision to pursue a dividend exclusion (or lower shareholder tax rate for dividends) rather than shareholder credits, although a 1992 Treasury Report recommending this course undoubtedly played a more important role.[248]

As we have discussed, one thread of the ECJ's corporate tax decisions has struck down member state provisions designed to limit taxpayers' ability to shift income from high—to low-tax member states. Here we have emphasized the court's nullification in the *Lankhorst-Hohorst* case of Germany's provision inhibiting earnings stripping by excessive interest deductions and the *Marks* & *Spencer* case, which requires the United Kingdom to allow foreign losses to offset domestic earnings. But a variety of other limitations are also in jeopardy. Many commentators believe, for example, that the ECJ is likely to find that widely used provisions limiting the ability of companies to use "controlled foreign corporations" to shift mobile income from higher—to lower-tax member states violate the free movement of capital or the freedom of establishment articles of the EC Treaty.[249] Decisions like these threaten to make collecting corporate income taxes in Europe far more difficult.

There are a number of potential responses by the United States if Europe becomes a place where corporate income can easily escape tax.[250] Some policymakers, concerned with the potential for U.S. corporations to shift manufacturing and other investments to Europe—policymakers principally interested in maintaining capital export neutrality—will urge provisions imposing greater U.S. income taxes on such investments. Other policymakers, concerned with maintaining the competitiveness of U.S. corporations doing business in Europe vis-à-vis European corporations operating there—policymakers principally interested in capital import neutrality—will not only resist any efforts to tighten U.S. taxes on foreign investments, but will also urge reductions in U.S. corporate income taxes in an effort to make investments in the United States more attractive.[251] Thus, the ECJ decisions raise the possibility of a United States-European race to the bottom in corporate income taxation. Should this occur, either government spending would have to be reduced or the lost revenues would have to be replaced by other taxes.

Conclusion

In an effort to advance economic and political integration in the EU, the European Court of Justice has decided numerous cases striking down provisions of member states' corporate income taxes. These decisions have been intended to promote the four freedoms guaranteed by the European treaties—the free movement of goods, services, labor, and capital—and to eliminate discrimination based on nationality. In the process, the court has developed a jurisprudence of nondiscrimination that goes beyond such requirements in international trade or tax treaties.

We have shown here that the ECJ's nondiscrimination jurisprudence reveals an impossible quest: to eliminate discrimination based on both the origin and destination of economic activity. We have also shown that this quest necessarily must fail in the absence of harmonized corporate income tax bases and rates among EU member states. This implies that the court will find it necessary somewhere along the way to retreat, creating not only legal uncertainty, but ultimately doctrinal incoherence.

At the same time, the ECJ's jurisprudence is restricting member states' flexibility over their own fiscal policies in a manner that conflicts sharply with the member states' retention of the power to veto any European income tax legislation. The constraints that the ECJ's view of nondiscrimination places on member states' abilities to use incentives to stimulate their own domestic economies makes it difficult for member states to use tax policy as a way to respond to recessions. This problem is most pressing for those member states that have joined the monetary union and have thereby given up their ability to use national monetary policy to combat recession.

We cannot predict where the dilemmas we have identified will lead. Europe, we think, has only two options: greater harmonization through coordination of income tax bases and rates, or greater restraint by the ECJ, either through its own decision-making or externally imposed by the member states. The resistance of a number of important member states to European harmonization is firm, and any harmonization of tax rates seems a long way off. So, in the near term at least, we expect the ECJ to become more restrained. Failing that, difficulties for the member states in fashioning their own tax policies will grow.

While it is tempting, from this side of the Atlantic, simply to watch these European developments with detachment, the United States' political and economic relationships with Europe are too extensive for our nation to remain unaffected. At a minimum, we would expect the ECJ's nondiscrimination jurisprudence concerning inbound investments to influence and ultimately enlarge the OECD and U.S. interpretations of related nondiscrimination provisions in income tax treaties. More fundamentally, the ECJ decisions render the future of bilateral treaties between the United States and EU member states uncertain. And if the U.S. Supreme Court were to become convinced that the ECJ's interpretations are appropriate for the United States, the Court might impose new constraints on the flexibility of our states to enact tax incentives promoting local investments.

Ultimately, if the ECJ continues along its current path, the ongoing ability of both EU member states and the United States to rely on corporate income taxes as an important source of government revenues could be threatened. Some would welcome such a development; others would abhor it. But none can deny that diminishing corporate revenues would put significant financial pressure on countries already strapped to finance government expenditures—expenditures that seem destined to grow as all our populations age.

Finally, nothing we have said here should be taken as reflecting opposition to greater federalization of Europe. We emphasize two points: First, the U.S. experience amply demonstrates that successful federalization does not demand the limitations on member states' taxing autonomy that the ECJ appears to be imposing. In particular, it is unnecessary to restrict member states' ability to use tax incentives to stimulate their domestic economies. Second, as we have shown, the tax decisions of the ECJ, spurred by the tax policy objectives of the European Commission, conflict directly with the member states' retention of veto power over issues of direct taxation. The draft European Constitution does not change this unanimity requirement, undoubtedly reflecting the view of at least some member states that retention of taxing authority is a crucial aspect of their sovereignty. To be sure, greater federalization may require giving up this autonomy. If that is to occur, however, we believe that such change should come through democratic processes, with the critical decisions made by elected representatives rather than by appointed judges. This will require new European constitutional arrangements. When Europe reconsiders its constitutional arrangements, concerns like those we have expressed here will undoubtedly also emerge in legal contexts other than taxation.[252]

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Michael J. Graetz
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NOTES

Introduction

1 President John F. Kennedy, Annual Message to the Congress on the State of the Union (Jan. 11, 1962).

2 U.S. Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals 19-22 (2015).

3 Michael Graetz, 100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States (2008); Michael Graetz, *The Tax Reform Road Not Taken—Yet*, 67 Nat'l Tax J. 419 (2014).

4 *Id.* at 15-16; *see also* OECD, BEPS Action 4: Interest Deductions and Other Financial Payments, Public Discussion Draft (Dec. 18, 2014), http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf.

5 *E.g.*, H. Comm. on Ways & Means, Tax Reform Act of 2014, Discussion Draft § 4001 (Feb. 21, 2014) (Dave Camp, Chairman, H. Comm. on Ways & Means); H. Comm. on Ways & Means, Tax Reform Act of 2014, Discussion Draft, Section-by-Section Summary, at 142 (Feb. 26, 2014) (H. Comm. on Ways & Means Majority Tax Staff).

6 *See* Gabriel Zucman, The Hidden Wealth of Nations: The Scourge of Tax Havens (2015) (claiming that the U.S. loses at least $35 billion annually).

7 Mihir A. Desai & James R. Hines, Jr., *Evaluating International Tax Reform*, 56 Nat'l Tax J. 487 (2003).

Chapter 1

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1 U.S. Const. amend. XVI.

2 *See* Revenue Act of 1913, ch. 16, 38 Stat. 114.

3 *See* Revenue Act of 1918, ch. 18. §§ 222(a)(1), 238(a), 240(c), 40 Stat. 1057, 1073, 1080–82 (1919) (§ 222(a)(1) provided a foreign tax credit for individuals, § 238(a) provided a similar credit for domestic corporations, and § 240(c) described creditable taxes). The British had previously allowed foreign tax credits for taxes paid within the British Common wealth. *See* Thomas S. Adams, *Interstate and International Double Taxation*, *in* Lectures on Taxation 101, 102 (Roswell Magill ed., 1932) [hereinafter Adams, *Double Taxation*]. The Revenue Act of 1918 also adopted the so-called indirect foreign tax credit, which allows U.S. companies a tax credit for foreign taxes paid by their controlled foreign subsidiaries. *See infra* note 100 and accompanying text.

4 For example, this allowed an American company, subject to a U.S. corporate tax rate of 35%, with $1,000 of foreign source income, a $350 maximum foreign tax credit against its U.S. tax liability. *See* Revenue Act of 1921, ch. 136, §§ 222(a)(5), 238(a), 42 Stat. 227, 249, 258. This limitation was intended to ensure that U.S. companies and individuals could not use foreign taxes to reduce or eliminate U.S. taxes on U.S. source income. *See* discussion *infra* Section III.B.

5 *Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.562 M.178 1928 II (1928) [hereinafter 1928 Report].

6 Some early nineteenth century double taxation treaties are on record, such as a Dutch measure dating from 1819 exempting foreign ships from the Dutch business-license tax on condition of reciprocity. *See* Mitchell B. Carroll, *Double*

Taxation Relief, Discussion of Conventions Drafted at the International Conference of experts, 1927 and Other Measures 1 (Dep't of Commerce Trade Information Bulletin No. 523), 1927. But the modern treaty era began with the Prussian-Austrian double taxation treaty of 1899. This treaty's brief regional importance was primarily because it served as a model for several postwar treaties entered into in the early 1920s by central European successor states to the Austro-Hungarian Empire. Like many other early treaties, the Austro-Prussian treaty only applied to nationals of the two countries. In general terms, it followed a domicile-based principle of direct taxation. *See id*. at 2.

7 *See generally* Adam Vital, The Strange Career of the Model Double Taxation Treaty: A Brief Historical outline (1995) (unpublished manuscript on file with authors).

8 *See* Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex. L. Rev. 1301, 1303 (1996).

9 *See, e.g.*, *Colloquium on NAFTA and Taxation*, 49 Tax L. Rev. 525, 525–820 (1994) (discussing whether the adopt ion of NAFTA necessitates a change in tax laws).

10 Between 1970 and 1990, the percentage of United States receipts of foreign income derived from portfolio investment grew from 25% to more than half. *See* Avi-Yonah, *supra* note 8, at 1315.

11 A particularly outspoken official on the subject of "racing to the bottom" is European Community Tax Commissioner Christiane Scrivener. *See, e.g.*, *EC Tax Commissioner Outlines Priority Issues*, BNA Daily Tax Rep., Mar. 7, 1990, at G–8. For a critique of the "race to the bottom" scenario, see Alvin K. Klevorick, *The Race to the Bottom in a Federal System: Lessons from the World of Trade Policy*, 14 Yale L. & Pol'y Rev. 177 (1996).

12 *See, e.g.*, Gary F. Hufbauer, U.S. Taxation of International Income: Blue Print for Reform (1992).

13 *See* Hugh Ault et al., Comparative Income Taxation: a Structural Analysis 380–85, 402–25 (1997) (discussing use of a foreign source income exemption in the United Kingdom, Canada, Germany, the Netherlands, Australia, and France).

14 *See* National Commission on Economic Growth and Tax Reform, Unleashing America's Potential: a Pro-Growth, Pro-Family Tax System for the Twenty-First Century, *reprinted in* 70 Tax Notes 413 (1996) [hereinafter Kemp Commission Report].

15 For a discussion of the experience of Australia, Canada, France, Germany, New Zealand, and the United Kingdom with tax system integration, see U.S. Treasury Dep't, Report of the Department of the Treasury on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once 159–84 app. (1992).

16 *See* Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practice*, 47 Tax L. Rev. 565, 565–66 (1992).

17 *See* U.S. Treasury Dep't, *supra* note 15, at 159–84.

18 *See* Avi-Yonah, *supra* note 8, at 1356–59. *See generally* Commission of the European Communities, Report of the Committee on Independent Experts on Company Taxation (1992) [hereinafter Ruding Committee Report].

19 *See, e.g.*, Avi-Yonah, *supra* note 8, at 1352–53 (proposing taxation of individuals by country of residence and taxation of corporations on a source of income basis); Ruding Committee Report, *supra* note 18; Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 Cornell L. Rev. 18, 63–86 (1993) (discussing alternative approaches for enhancing the stability of International income taxation); Paul R. McDaniel, *Formulary Taxation in the North American Free Trade Zone*, 49 Tax L. Rev. 691, 702–38 (1994) (suggesting a treaty-based formulary system to resolve many of the potential tax-induced distortions to free trade caused by NAFTA).

20 *See, e.g.*, Kemp Commission Report, *supra* note 14, at 449 (reprinting the Kemp Commission's recommendation that Congress consider a "territorial tax system").

21 *See, e.g.*, Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and its Economic Premises*, *in* Taxation in the Global Economy 11, 12 (Assaf Razin & Joel Slemrod eds., 1990); Green, *supra* note 19, at 86 (urging the United States to move from source-based income taxation to a residence-based system).

22 *See, e.g.*, Avi-Yonah, *supra* note 8, at 1303–05 (calling for a "new consensus ... to remedy the [1920s compromise's] major weaknesses and ensure its continued viability"); McDaniel, *supra* note 19, at 693–94; Julie Roin, *Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems*, 81 Va. L. Rev. 1753, 1757–59 (1995) (arguing that Congress' response to the "source" versus "residence" debate has been "an unprincipled grab for undeserved tax revenue" rather than "considered reevaluation of ...previously accepted but obviously shaky policy").

23 Earlier efforts to set forth the history of International tax policy include Alan G. Choate et al., *Federal Tax Policy for Foreign Income and Foreign Taxpayers—History, Analysis and Prospects*, 44 Temp. L.Q. 441 (1971), and William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909–1989: How a Tilted Playing Field Developed*, 43 Tax Notes 1379 (1989). Such scholarship, however, has typically devoted little attention to the formative period of 1918–1928, and has rarely scratched below the surface of standard legislative history. In contrast, this article draws extensively on published and unpublished writings of key actors (especially Thomas Sewall Adams), minutes of League of Nations meetings, and other archival material. To our knowledge, these materials have not previously been used to relate the early history of U.S. international tax policy.

24 *See, e.g.*, Ault, *supra* note 16, at 567–68; Avi-Yonah, *supra* note 8, at 1305–06 (claiming that the 1923 Report underlies modern discussions of jurisdiction to tax).

25 *See* Staff of Joint Comm. on Taxation, 102d Cong., Factors Affecting the International Competitiveness of the United States 5 (Comm. Print 1991).

26 *See id*. at 248; Robert Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. Miami L. Rev. (forthcoming 1997).

27 Whatever one thinks about the demands of a written constitution, the views of yesteryear do not and should not limit the discretion of today's tax policymaker s. The nation's tax laws can be changed whenever the President and the Congress agree; changes in tax treaty policies demand only that the President and the Senate concur. Like Bork, however, we do brush aside many of the difficulties of ascertaining "original intent," by looking to T.S. Adams for illumination of the "principles" or "core values" he sought to implement. *See* Robert H. Bork, *The Constitution, Original Intent, and Economic Rights*, 23 San Diego L. Rev. 823, 826 (1986). We accept Boris Bittker's characterization of this as something of a "fuzzy target." *See* Boris I. Bittker, *Interpreting the Constitution: Is the Intent of the Framers Controlling? If Not, What Is?*, 19 Harv. J.L. & Pub. Pol'y 9, 36 (1995).

28 *See* 4 Joseph Dorfman, The Economic Mind in American Civilization 211 (1959). For a discussion of Ely's role in the early development of "law and economics" theory, see Herbert Hovenkamp, *The First Great Law and Economics Movement*, 42 Stan. L. Rev. 993, 1021–25 (1990).

29 Much of the material in this section is taken from Dorfman, *supra* note 28, at 214–221; T.S. Adams, 1873–1933 (A.E. Holcomb ed., 1933); W. Elliott Brownlee, *Social Investigation and Political Learning in the Financing of World War I*, *in* The State and Social Investigation in Britain and the United States 323 (Michael J. Lacey & Mary O. Furner eds., 1993).

30 For a discussion of the shortcomings of the pre-Wisconsin income taxes and an overview of the spread of state income taxation after Wisconsin's successful

experiment, see ALZADA COMSTOCK, STATE TAXATION OF PERSONAL INCOME 16–18 (1921). Comstock observes, "It would hardly be an exaggeration to say that the success of state income taxes in the last few years of their history has been due largely to the adaptation and use of the plan of centralized and specialized administration which was first used by Wisconsin in 1911." *Id.* at 56. In addition to the innovations of its administrative machinery, the Wisconsin tax was also particularly influential in its taxation of business income. *See* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION: CASES AND MATERIALS 629 (5th ed. 1988) (labeling the Wisconsin tax "the father of twentieth-century corporate income taxation"). Adams describes and defends the Wisconsin income tax in T.S. Adams, *The Significance of the Wisconsin Income Tax*, 28 POL. SCI. Q. 569 (1913) [hereinafter Adams, *Wisconsin Income Tax*].

31 *See* DORFMAN, *supra* note 28, at 215.

32 *See* Benjamin G. Rader, *Federal Taxation in the 1920s: A Reexamination*, 33 THE HISTORIAN 415, 421 (1971).

33 Roy G. Blakey, *The Revenue Act of 1921*, 12 AM. ECON. REV. 75, 90 (1922).

34 *See id.*; *see also* Brownlee, *supra* note 29, at 363.

35 *See* JEROLD L. WALTMAN, POLITICAL ORIGINS OF THE U.S. INCOME TAX 83 (1985).

36 *Id.*

37 *See, e.g.*, *Internal Revenue Hearings Before the Committee on Finance of the United States Senate on H.R. 8245*, 67th Cong. (1921) (Confidential Print for Use of Members of the Senate), *reprinted in* 95A INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 1979).

38 *See* Carlton Fox, Memoranda Concerning Whose Ideas Formed the Basis of the 1921 Revenue Revision, *reprinted in* 95 INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 979).

39 *Internal Revenue: Hearings Before the Committee on Finance of the United States Senate on H.R. 8245*, 67th Cong. 256 (1921) (statement of Senator LaFollette), *reprinted in* 95A INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950: LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS (Bernard D. Reams, Jr. ed., 1979) [hereinafter *1921 Hearings*.]

40 JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 91 (1985).

41 *See* SIDNEY RATNER, TAXATION AND DEMOCRACY IN AMERICA 14 (1967) (noting that Adams was "[o]ne of the greatest of American tax experts"); *see also* Brownlee, *supra* note 29, at 350–53 (noting Adams' "experience in legislative consultation, implementing radical forms of progressive taxation, and conducting economic investigations").

42 *See* Fred R. Fairchild, *Adams, Thomas Sewall*, in 11 DICTIONARY OF AMERICAN BIOGRAPHY 10 (Harris E. Starr ed., 1944).

43 For an appreciation of Pechman's achievements, see Stuart E. Eizenstat, Joe Pechman: *A Passion for Fairness*, WASH. POST, Sept. 2, 1989, at A25.

44 *See* T.S. ADAMS, *supra* note 29.

45 *See id.* at 13–14.

46 *Id.* at 6–7.

47 *Id.* at 7–9.

48 For examples of other leaders in the history of government regulation in America, see generally THOMAS K. MCCRAW, PROPHETS OF REGULATION (1984). We borrow McCraw's label "prophet" here also to express the "unusual combination...of both

theorizing about regulation and actually doing it." *Id*. at vii–viii.

49 *Ninth Session*, 15 Nat'l Tax Ass'n Proc. 329, 330–31 (1922).

50 David F. Bradford, U.S. Treasury Tax Policy Staff, Blueprints for Basic Tax Reform 89–90 (2d ed. 1984); *see also* The President's Tax Proposals To The Congress For Fairness, Growth, And Simplicity 383 (May 1985) ("The long standing position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions.").

51 U.S. Treasury Dep't, *Selected Tax Policy Implications of Global Electronic Commerce*, *reprinted in* BNA Daily Tax Report, Nov. 22, 1996, at L–8.

52 *Report on Double Taxation Submitted to the Financial Committee by Professors Bivens, Einavai, Seligman, and Sir Josiah Stamp*, at 18, League of Nations Doc. E.F.S.73 F.19 (1923) [hereinafter 1923 Report].

53 *Id*. at 40.

54 *Id*. at 51.

55 *See, e.g.*, Adams, *Double Taxation, supra* note 3, at 125 ("I see little hope or validity, in this tangled maze, in sweeping economic or juristic theories about the proper or natural jurisdiction [pertaining to certain taxes]."); *see also infra* Section V.A.

56 International Chamber of Commerce, Resolutions Unanimously Adopted by the Committee on Double Taxation 3 (Nov. 24, 1923) (available in T.S. Adams Papers, Yale University, Box 12, 1923–1924 folder) [hereinafter American Suggestions].

57 Letter from T.S. Adams to Edward E. Rhodes, Vice President, Mutual Benefit Life Insurance Company, 1 (Jan. 5, 1923) (available in T.S. Adams Papers, Yale University, Box 28, Jan.-June 1923 folder).

58 Thomas S. Adams, *The Taxation of Business*, 11 Nat'l Tax Ass'n Proc. 185, 186 (1917) [hereinafter Adams, *Taxation of Business*].

59 *Id*. at 187.

60 T.S. Adams, *Federal Taxes Upon Income and Excess Profits*, 3 Am. Econ. Rev. 19, 20 (1918).

61 *See* Thomas S. Adams, *Fundamental Problems of Federal Income Taxation*, 35 Q.J. Econ. 527, 542 (1921) [hereinafter Adams, *Fundamental Problems*] ("If the members of a partnership engaged in business in Detroit all live in Canada, and the partnership competes with business concerns the owners of which live in Detroit, our people will not consent to exempt the Canadians while the owners who live in the United States are taxed on their entire income or expenditures .... ").

62 *Id*.

63 *Id*. at 542–43.

64 Edwin R.A. Seligman, *Untitled Response to Speech by T.S. Adams, Taxes Upon Income and Excess Profits—Discussion*, 8 Am. Econ. Rev. 42, 43 (Supp. 1918).

65 Thomas S. Adams, *International and Interstate Aspects of Double Taxation*, 22 Nat'l Tax Ass'n Proc. 193, 197 (1929) [hereinafter Adams, *Aspects of Double Taxation*].

66 Adams, *Double Taxation, supra* note 3, at 120.

67 Adams argued:

[T]axes upon business have great fiscal virtue.... They are relatively inexpensive to collect and comparatively productive in yield. A given rate of taxation laid upon the business unit will usually yield a very much larger revenue than the same rate of taxation laid upon the individual owners of the business.

Adams, *Taxation of Business, supra* note 58, at 187.

68 *See, e.g., infra* notes 115–23 and accompanying text.

69 *See, e.g., infra* notes 111–13 and accompanying text.

70 *See infra* Section III.B.

71 Adams not only introduced the foreign tax credit into the U.S. law; he also attempted to impose it on International law in his work with the International Chamber of Commerce and the League of Nations. *See infra* notes 193, 254 and accompanying text. The FTC structure was also implicit in the Anglo-American Draft I-b of 1928. *See infra* notes 259–61 and accompanying text.

72

[T]he jurisdiction of domicile should usually grant an exemption only through the tax credit, by which the taxpayer is exempted at domicile only when he has proved payment of the tax in some other jurisdiction.... [T]he state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure that the person or property pays at least one tax.

Adams, *Double Taxation, supra* note 3, at 112–13.

73 *See* T.S. Adams, A Suggested Amendment to Sir Percy Thompson's Proposal Regarding a Deduction or Credit (undated) (unpublished memorandum, available in T.S. Adams Papers, Yale University, Box 17, folder containing undated League of Nations materials) [hereinafter Adams, Suggested Amendment] ("To prevent tax evasion, the relief in question can best be granted through a deduction or credit.... If the taxpayer evaded taxation abroad he would be caught at home.").

74 *See* Adams, *Double Taxation, supra* note 3, at 125–26 ("It is the opinion of many persons familiar with the subject, and my own, that in International and interstate trade there is probably as much evasion as double or multiple taxation.").

75 *Id*. at 126–27. For a more complete statement of Adams' views about progressive income taxation, see T.S. Adams, *Effect of Income and Inheritance Taxes on the Distribution of Wealth*, 5 Am. Econ. Rev. 234, 234–35 (1915) [hereinafter Adams, Distribution of Wealth]. Adams conceded that the income tax should not be levied on the poor, but argued that its burdens should be widely borne by all those capable of supporting themselves financially. He felt that a more narrow tax base would promote class conflict, public extravagance, and needless administrative complexity. He further argued that "the upper limit of enforceable rates is about 10 per cent." *Id*. at 235. Adams seems to have underestimated the enforceability of higher rates, although his calls for low rates and widening the tax base foreshadowed subsequent income tax debates.

76 *Id*.

77 *See* Committee on Double Taxation of the International Chamber of Commerce, Report Submitted by the American Section 2 (June 27, 1922) (available in T.S. Adams Papers, Yale University, Box 12, 1921–1923 folder) [hereinafter American Section Report] ("The American Committee [on Double Taxation] sees no sound reason why a progressive income tax should be reduced merely because [income] is earned or derived from more than one country.").

78 Adams discussed some the administrative challenges in an argument against providing personal exemptions to foreigners taxed in the United States:

We have to follow it into the foreign country. Maybe the foreign country has no income tax, although it has some tax which is somewhat similar. We have no test of the veracity of the foreign citizen. We cannot tell whether he has 10 children or 4 children, or whether he is unmarried or living with his wife. It also means, if you want to administer it with any care and accuracy, that we have to convert the foreign income into dollars in this country.

1921 Hearings, supra note 39, at 63.

79 Adams' preference for making residence the custodian of progressivity may have been reflected in his tentative attraction to the normal/super distinction proposed

by the International Chamber, though Adams ultimately rejected this model as incompatible with the U.S. tax system. *See infra* note 187. As an alternative, Adams urged the International Chamber to advocate the adopt ion of American-style FTCs, which, Adams noted, would also protect the progressive rate structures of residence nations. *See* American Section Report, *supra* note 77, at 1–2.

80 *See, e.g.*, Mitchell B. Carroll, *Proposed and Applied Methods of Preventing Double Taxation*, *in* Department of Com. Special Circular NO. 122, at 29 (available in T.S. Adams Papers, Yale University, Box 13) (observing that under American law "the principle of origin [source] prevails"). Adams' pro-source position is also manifest in the allocation rules of the 1921 Act, which were aggressive in taxing U.S.-source income. Note, for instance, the contrasting treatments of dividends and interest in the 1921 Act and the 1923 League Report: Adams allocates dividends and interest to the payor's nation (source), while Seligman allocates to the payee (residence). *See infra* note 149 and text accompanying note 221. The "foreign trader" provision of the 1921 Act—which would have shifted a large class of U.S. taxpayers to a purely source-based taxation—further underscores Adams' preference for source. *See infra* Section III.C.

81 *See* Edwin R.A. Seligman, Double Taxation And International Fiscal Cooperation 133–34 n.10 (1928).

82 *See, e.g.*, Staff Of Joint Committee On Taxation, *supra* note 25, at 88; H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 Colum. J. Transnat'l L. 359, 372 (1981); *supra* text accompanying notes 50–51.

83 *See* Choate et al., *supra* note 23, at 460 n.96.

84 Revenue Act of 1918, ch. 18, 40 Stat. 1057 (1919).

85 *See* Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 Tax Notes 581, 583 (1990). The reasoning behind the International tax aspects of the 1913 Act is difficult to discern from the historical sources. Some scholars have concluded that "it is quite likely that Congress gave little or no thought to the effect of the Revenue Act of 1913 on the foreign income of U.S. persons or the U.S. income of foreign persons." Choate et al., *supra* note 23, at 481. The decision in 1913 to tax the worldwide income of taxpayers may have simply followed the earlier decision to tax worldwide income in the 1909 federal excise tax on corporate income. *See* Corporation Excise Tax of 1909, ch. 6, § 38, 36 Stat. 11, 112–17.

86 *See, e.g.*, Frisch, *supra* note 85, at 583 (describing and criticizing the "national neutrality" viewpoint).

87 For example, if taxpayer *A*, a resident of country *X*, has revenue of 100 from sources in *X*, and costs of 80, its tax in *X* might be .3 x 20, or 6. If taxpayer *B*, also a resident of X, has revenue of 100 from sources in country *Y*, costs of 80, and must pay a tax in country *Y* of 4, then its tax in country *X* would be (100–84) x .3, or 4.80. In this way, *A* and *B* have both been taxed in country *X* at a rate of 30% on their net earnings, but *A* enjoys a higher after tax return ($14) on the domestic investment than *B* ($11.20) on the foreign investment.

88 *1921 Hearings, supra* note 39, at 64.

89 *See* Staff Of Joint Committee On Taxation, *supra* note 25, at 239–40.

90 *See* Frisch, *supra* note 85, at 583–84. *See generally* Joel Slemrod, *Free Trade Taxation and Protectionist Taxation* 1–28 (Nat'l Bureau of Econ. Research, Working Paper No. 4902, 1994) (comparing International tax policy to International trade policy).

91 For examples, see the papers collected in The Effects Of Taxation On Multinational Corporations (Martin Feldstein et al. eds., 1995).

92 *See* Brownlee, *supra* note 29, at 363.

93 *See* Randolph E. Paul, Taxation In The United States 124, 130 (1954). Herbert Hoover, Commerce Secretary under Presidents Harding and Coolidge,

"assigned no small credit [to the tariff] for American prosperity." JOSEPH BRANDES, HERBERT HOOVER AND ECONOMIC DIPLOMACY 30 (1962). Treasury Secretary Andrew Mellon, the other premier architect of U.S. economic policy during the 1920s, also favored protective tariffs. *See* PHILIP H. LOVE, ANDREW W. MELLON 252–53 (1929).

American trade and fiscal policy during the period covered by this Article had a clear mercantilist cast. President Harding declared, "We must protect American business at home and we must aid and protect it abroad." BRANDES, *supra*, at 15 (quoting Warren G. Harding, *Less Government in Business and More Business in Government, in* THE WORLD'S WORK 25–27 (1920)). After sweeping into power in the 1920 elections, Republicans promptly raised tariffs (even before enacting tax cuts), reflecting a prevalent belief, in the words of one contemporary critic, "that the tariff is the panacea for economic ills." Blakey, *supra* note 33, at 76. This mentality culminated in the famous Smoot-Hawley tariff of 1931, which enacted the highest tariffs in American history. This pro-tariff policy ultimately proved incompatible with U.S. insistence on repayment of war debts and resulted in financial collapse in Europe and exacerbation of the depression in the United States. *See* PAUL, *supra*, at 148.

94 The phrase appears in Ault & Bradford, *supra* note 21, at 11.

95 *See* WITTE, *supra* note 40, at 83–86.

96 *See* Fairchild, *supra* note 42, at 10. For a discussion of U.S. taxation during World War I, see W. ELLIOTT BROWNLEE, FEDERAL TAXATION IN AMERICA 48–66 (1996).

97 See *Proposed Revenue Act of 1918: Hearings Before the Comm. on Ways and Means*, 65th Cong., 3d Sess. 648, 649–650 (1918) (statement of Phanor J. Eder, Secretary, Mercantile Bank of the Americas); *see also* Clyde J. Crobaugh, *International Comity in Taxation*, 31 J. POL. ECON. 262, 262 (1923) (observing that problem of International double taxation had recently "assumed great importance" due to wartime tax increases and growing magnitude of International business transactions).

98 *See* WITTE, *supra* note 40, at 84–85.

99 Thomas Sewall Adams, *The New Revenue Act*, 108 THE NATION 316, 316 (1919).

100 The FTC was available unconditionally to U.S. citizens, but only available to resident aliens who were citizens of nations granting similar benefits to Americans residing abroad. *Compare* Revenue Act of 1918, ch. 18, § 222(a)(1), 40 Stat. 1057, 1073 (1919) (credit for citizens) *with* Revenue Act of 1918, ch. 18, § 222(a)(3), 40 Stat. 1057, 1073 (1919) (credit for resident aliens). The FTC was not available at all to non-resident aliens.

The 1918 Act also originated the so-called "indirect" or "deemed paid" foreign tax credit, which allows domestic corporations credits for foreign taxes paid by foreign subsidiaries when dividends are distributed to the parent. *See* Revenue Act of 1918, § 240(c). Subsidiaries incorporated in foreign countries are not considered U.S. residents and therefore are not subject to U.S. taxes on their income earned abroad. The dividends paid to a U.S. parent, however, are income to the parent and the indirect FTC was considered necessary to relieve double taxation on that income.

101 *See* SELIGMAN, *supra* note 81, at 135.

102 Adams, *Aspects of Double Taxation*, *supra* note 65, at 198.

103 *See* Adams, *Double Taxation*, *supra* note 3, at 102. For a discussion of other similarly limited unilateral relief measures that were in existence prior to the U.S. FTC, see JOHN G. HERNDON, JR., RELIEF FROM INTERNATIONAL INCOME TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROCITY FOR THE PREVENTION OF DOUBLE INCOME TAXATION 10–14 (1932) (describing legislation intended to alleviate some burdens of double taxation in the Nether lands (providing that foreign ships would be exempt from licensing taxes only if their countries granted a reciprocal exemption to Dutch ships), Belgium (taxing all income of

Belgians, but providing for a lower tax rate on foreign income than on domestic income), Norway (providing foreigners exemption from taxation in Norway if their countries provided a reciprocal exemption for Norwegians), and Switzerland (noting that the Center of Thuryan exempts residents' foreign income from local taxation if it has already been taxed abroad)). A few nations also protected residents from double taxation by taxing only domestic-source income. *See* T.C. Jen, Double Taxation 4 (1924) (describing income taxes of Australia, New South Wales, and South Africa) (unpublished manuscript, available in T.S. Adams Papers, Yale University, Box 29, May-Aug. 1924 folder).

Among the American states, New York was shortly to implement a new income tax that provided a credit to residents for taxes paid to another state, but only if the other state also had an income tax and provided a similar exemption for New Yorkers. *See* Edwin R.A. Seligman, *The New York Income Tax*, 34 Pol. Sci. Q. 521, 534 n.1 (Supp. Aug. 1918-July 1919).

Interestingly, given Adams' association with the state, Wisconsin also provided a tax credit to prevent double taxation, though double taxation of a different kind: Wisconsin permitted taxpayers to offset their personal property taxes against income taxes. *See* W. Elliott Brownlee, Progressivism And Economic Growth: The Wisconsin Income Tax, 1911–1929, at 62 (1974).

104 Adams, *Aspects of Double Taxation*, *supra* note 65, at 198.

105 *See id*. The FTC was part of the Revenue Act of 1918, misleadingly named because the law was enacted in 1919. Originally drafted in a special session of Congress during the summer of 1918, the Act was passed by the House in late September; however, the Senate could not complete its deliberations until after the Armistice on November. Peace necessitated a certain amount of redrafting, which prevented final Senate action until February, 1919. *See* Witte, *supra* note 40, at 85.

106 *See* Adams, *Aspects of Double Taxation, supra* note 65, at 197. During the limited discussion of the measure, Congressmen focused on the great burden of double taxation, but also depicted the FTC "as a method to encourage foreign trade and to prevent revenue loss through incorporation of foreign subsidiaries or expatriation." Roswell Magill & William C. Schaab, *American Taxation of Income Earned Abroad*, 13 Tax L. Rev. 115, 118 (1958).

107 Adams, *Aspects of Double Taxation, supra* note 65, at 197. Before turning his attention to the International arena, Adams concerned himself with the problem of double taxation within the United States. In his first published article on taxation, a monograph on the Maryland tax system, Adams identified the double taxation of debt as the "worst defect" of the state's property tax and argued that reform was necessary in order to "satisfy our innate ideas of justice." Thomas Sewall Adams, *Taxation in Maryland*, 18 Johns Hopkins U. Stud. Hist. & Pol. Sci. 13, 44–45 (1900) [hereinafter Adams, *Taxation in Maryland*].

108 To be precise, the problem at issue was not double taxation per se; Adams did not devote much attention, for instance, to the double taxation inherent in the classical model of corporate taxation or to the double taxation represented by the joint application of federal and state income taxes. Rather, Adams was vexed by the concurrent taxation of the same income by different nations. Seligman had long ago distinguished between just and unjust double taxation: double taxation "is not always wrong; it is unjust only when one taxpayer is assessed twice while another in substantially the same class is assessed but once." Edwin R.A. Seligman, Essays In Taxation 98 (1900). Adams' focus on international double taxation grew out of a similar sense that what is wrong in double taxation is discrimination: the person who chooses to live in one country and earn money in another is singled out for a double dose of taxes.

109 After completion of the 1928 model treaties, Adams joined the newly-formed permanent Fiscal Committee of the League of Nations. In this capacity, he focused on the problem of apportionment of International business income, but died before this project produced any concrete results. For a discussion of the history of the

apportionment project, see Mitchell B. Carroll, *International Tax Law: Benefits for American Investors and Enterprises Abroad*, 2 Int'l Law 692, 702–07 (1968).

110 Adams, *Aspects of Double Taxation, supra* note 65, at 197.

111 *Id*.

112 *Id*. at 197–98.

113 Some would argue that a government is justified in discriminating against those who do business abroad —in particular, that there may be something unpatriotic in sending one's capital abroad. During hearings on the 1921 Act, for instance, as we have pointed out, Senator Curtis voiced this objection. *See supra* text accompanying note 88. But this was plainly not Adams' position. Nor was it the prevailing view of the post-war American government. *See infra* note 118.

114 *See* Adams, *Distribution of Wealth, supra* note 75, at 235 ("To enforce a progressive income tax the cooperation of the taxpayer must be secured. But to secure his cooperation the rates must be fair and reasonable."); *see also infra* note 310 and accompanying text.

115 *See* Brandes, *supra* note 93, at 12 ("Throughout Hoover's term as Secretary [1921–1928] the Department of Commerce spared no effort in acting on the policy that exports were a key to business stability and thus to American prosperity.").

116 *See infra* text accompanying notes 118–23.

117 Magill & Schaab, *supra* note 106, at 118.

118 In the 1920s, the locus of this support was Herbert Hoover's Department of Commerce. For a description of the Department's aggressive efforts to assist American business abroad, *see* Brandes, *supra* note 93, at 10–15. In this vein, the Department took an active interest in the International tax issues on which Adams worked, maintaining a vigilant eye on both the FTC, *see infra* note 148 and accompanying text, and the work of the League of Nations. With respect to the League, for instance, the Department of Commerce played a role in the decision to send Adams to London and Geneva as the U.S. representative on the Committee of Experts, *see Adams Choice Here for Parley Abroad to Ease Trade Tax*, N.Y. J. Com., Dec. 28, 1926 (reproduced from National Archives), and dispatched its own foreign tax officer to act as Adams' assistant at the meetings. *See* Herndon, *supra* note 103, at 65. All of this suggests the importance of export-promotion to Adams' work on International tax.

While the Department of Commerce's preference was perhaps for exporting goods, and not capital, the International balance of payments was such that export of goods after World War I depended upon the export of capital, *see infra* notes 124–28 and accompanying text, and, in any case, the United States was perceived to have a surplus of financial capital, *see* Brandes, *supra* note 93, at 160, 163. Moreover, Europe's high tariff barriers made the export of finished goods rather difficult; American firms thus found it increasingly profitable to invest in manufacturing subsidiaries abroad, the sales of which were free from tariffs, rather than selling wholly American-made goods. *See* Frank A. Southard, Jr., American Industry In Europe 115–19 (1931). In sum, there was little sense in systematically treating the export of capital less favorably than the export of goods, and, in fact, the Department of Commerce generally encouraged investment abroad. *See* Brandes, *supra* note 93, at 163. However, the United States government did sometimes act to discourage American firms from building manufacturing facilities abroad, fearing U.S. job losses. *See* Mira Wilkins, The Maturing Of Multinational Enterprise: American Business Abroad 1914 To 1970, at 95, 162 (1974). Moreover, the government also encouraged American bankers to require that loans abroad be used to purchase American-made goods when available. *See* Brandes, *supra* note 93, at 157, 160.

While the American government leaned overall towards encouragement of the export of capital, the import of capital seems to have been somewhat less of a priority, understandably so, given the dearth of capital in post-war Europe.

Indeed, much of the meager post-war investment by European firms in the United States was funded with U.S. capital. *See* SOUTHARD, *supra*, at 200.

119 Such relief was also consistent with the Department of Commerce's desire to maintain comparatively low taxes for U.S. businesses selling U.S. products abroad in order to offset relatively high domestic labor costs, thus reducing the incentive for firms to move operations (and jobs) overseas. *See* BRANDES, *supra* note 93, at 168 (discussing the Department of Commerce's advice to firms considering moving overseas to take advantage of lower labor costs).

120 Mitchell B. Carroll, The Double Taxation Conference 28–29 (Sept. 3, 1927) (unpublished manuscript, available in T.S. Adams Papers, Yale University, Box 16, Sept. 1927 folder). Congress also tended to view the FTC as an export-enhancing device, an attribute of the FTC that was discussed when it was originally adopted in 1918, *see* Magill & Schaab, *supra* note 106, at 188, and that helped preserve the FTC against an assault by the House Ways and Means Committee in 1933, *see id*. at 120.

121 *See infra* note 156 and accompanying text.

122 Adams, *Aspects of Double Taxation, supra* note 65, at 194. Adams' associate, John Herndon, further observed that such concern over American businesses being left out of favorable foreign tax treaties was one of the major reasons the United States decided to participate in the model treaty effort in the first place. *See* HERNDON, *supra* note 103, at 64–65.

123 T.S. Adams, *Draft Convention Proposed by Professor Adams*, League of Nations Doc. D.T.120, at 2 (1927) (available in T.S. Adams Papers, Yale University, Box 16, Apr. 1927 folder) [hereinafter Adams, *Draft Convention*].

124 *See* BRANDES, *supra* note 93, at 171.

125 For a general discussion of the history of the war debts in the 1920s, see *id*. at 170–80. American allies objected vociferously to U.S. insistence on full repayment, tagging the United States with the label "Uncle Shylock." *Id*. at 170. After the war, the United States gave a brief respite to its allies, but ultimately applied economic sanctions in order to force its debtors to enter into repayment agreements, which most did between 1923 and 1926. *See id.* at 173–79.

Ultimately, the debt issue was about more than just inter-allied relations: U.S. insistence on debt repayment forced the Allies to press Germany for war reparations, which amounted to $33 billion. *See* id. at 180. The American government perceived that the rebuilding of Germany was vital to the future prospects for peace in Europe, *see id*. at 182, and, in 1924, in order to relieve the financial pressures imposed by reparations, advanced a substantial loan to Germany and encouraged private American investment in the German recovery, *see id*. at 183.

126 American interest in exporting to Europe did not abate even during wartime. For instance, in April of 1918, Congress passed the Webb-Pomerene bill, which permitted U.S. businesses to join together for exporting purposes notwithstanding antitrust laws. The purpose of this bill was to give American exporters greater leverage in negotiating with cartels of European buyers. *See* WILKINS, *supra* note 118, at 49–50.

Historically, Europe was the greatest market for American exports, taking 64% of total U.S. exports in 1914. *See* SIDNEY RATNER ET AL., THE EVOLUTION OF THE AMERICAN ECONOMY 386–87 (1979). Prior to World War I, the United States had been a net exporter of goods and services for four decades, but a net importer of capital. *See id*. at 385. Although the book value of U.S. investments abroad increased from $94 billion to $478 billion between 1897 and 1914, *see* WILKINS, *supra* note 118, at 17–18, it took World War I to transform the United States into a net exporter of capital, *see id.* at 30. Exports of capital would need to remain high to fund the continued purchase of American goods in Europe, on which the American economy had increasingly come to rely. The total value of American exports had more than doubled between 1914 and 1916 alone. *See* Harry N. Scheiber, *World War I as Entrepreneurial Opportunity: Willard Straight and the American International*

Corporation, 84 Pol. Sci. Q. 486, 497 (1969).

During the postwar era, it was a commonplace observation that American capital would need to be sent abroad in order to maintain and expand the sale of American goods in other countries: "The American banker and American salesman must go abroad." *Id*. at 509 (quoting Henry A. Wise Wood, *Planning the Future America*, 72 Annals Am. Acad. Pol. & Soc. Sci. 22 (1917)). Indeed , even during wartime, the authorization of loans to European nations was largely motivated by the desire to sup- port American exports. *See* Scheiber, *supra*, at 494.

127 *See* Paul P. Abrahams, *American Bankers and the Economic Tactics of Peace: 1919*, 56 J. Am. Hist. 572, 573, 583 (1969).

128 Observing these imperatives, incoming Commerce Secretary Herbert Hoover urged greater investment in Europe in a speech to the American Bankers' Association, arguing that such investments would raise "the capacity of foreign people to purchase American goods and to repay obligations to the United States." Brandes, *supra* note 93, at 152 (quoting Herbert Hoover, speech to the American Banker's Association (Dec. 10, 1920)). Hoover set out important qualifications and also insisted that loans be extended through *private* channels and that they be carefully tailored to achieve productive purposes. *See id*.

Connecting these imperatives with International tax policy, George May, an American businessman who worked with Adams in the International Chamber of Commerce's double taxation initiative, argued that the United States was compelled to relieve double taxation because "[o]ur own country could hardly maintain its policies of restriction of imports through high tariffs, exportation of surplus food products, collection of foreign government debts and the building up of a merchant marine, without making foreign investments to balance the International account." George O. May, *Double Taxation*, 5 Foreign Affairs 69, 69 (1926).

129 *See* Abrahams, *supra* note 127, at 576–78.

130 For a full description and history of the Edge Act, *see id*. at 577–83. Abrahams argues that the Edge Act was a response to the tension between U.S. trade and fiscal policies after World War I: "As the Americans saw it, the problem was to keep responsibility for the war-debt payments in Europe and at the same time give the Europeans enough financial breathing space to reconstruct their economy, restore the trade network, and earn enough dollars to pay their debts and buy American exports." *Id*. at 575.

131 *See* Witte, *supra* note 40, at 85.

132 *See id*. at 85–86.

133 Foreign businesses doing business in the United States were taxed on their net income from U.S. sources. *See, e.g.*, Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 1, 112–17 (taxing income of foreign corporations from "business transacted and capital invested within the United States"); *see also* Revenue Act of 1918, ch. 18, § 213(c), 40 Stat. 1057, 1065–66 (1919) (providing for taxes on profits from the manufacture and disposition of goods within the United States by nonresident alien individuals).

In order to facilitate collection of taxes from nonresident aliens, the 1918 Act required American payors of fixed or determinable annual or periodic income to withhold a percentage of the income. *See* Revenue Act of 1918, § 221. Such withholding taxes have become another fixture of U.S. International tax policy, although today, unlike under the 1918 and 1921 Acts, these "withholding taxes" are in fact final taxes, not subject to offsetting deductions and credits.

134 Revenue Act of 1918, ch. 18, § 222(a)(1), 40 Stat. 1057, 1073 (1919).

135 *See infra* note 138 and accompanying text.

136 *See* Witte, *supra* note 40, at 88 (observing that maximum rates on individuals fell from wartime high of 77% to 24% by the end of the 1920s).

137 *See 1921 Hearings, supra* note 39, at 74.

138 *Id*. at 73–74.

139 *See id*. at 74. The final version of the FTC limitation appears in the Revenue Act of 1921, ch. 136, § 222(a)(5), 42 Stat. 227, 249.

140 *See* May, *supra* note 128, at 75.

141 The 1921 Act marked the beginning of tax legislation limiting foreign tax credits. For example, in 1932 Congress, as part of a general revenue increase, revised the limitation so that taxpayers were required to use the lesser of an overall or per-country limitation. *See* Revenue Act of 1932, ch. 209, § 131(b), 47 Stat. 169, 211. In 1954, the overall limitation was repealed, leaving only a per-country limitation. *See* Internal Revenue Code Act of 1954, ch. 736, § 904, 68A Stat. 3, 287–88 (codified at I.R.C. § 904 (1958)). In 1960, taxpayers were given the option of using an overall or per country limitation. *See* Act of Sept. 14, 1960, Pub. L. No. 86–780, § (a), 74 Stat. 1010, 1010 (codified at I.R.C. § 904(b) (1964)) (amended 1976). In 1976, the per-country limitation was repealed, and the law had come full circle to the position of the 1921 Act. *See* Tax Reform Act of 1976, Pub. L. No. 94–455, sec. 1031, § 904, 90 Stat. 1610, 1620–24 (codified as amended at I.R.C. § 904 (1994)). In 1986, a system that categorizes various income into so-called baskets assumed primacy. *See* Tax Reform Act of 1986, Pub. L. No. 99–514, sec. 1201, § 904(d), 100 Stat. 2085, 2520–28 (codified as amended at I.R.C. § 904 (1994)). Other "refinements" have also occurred; principally in an effort to ensure that the credit limitation operates to protect U.S. taxation of U.S. source income, as the 1921 Act had originally intended . *See*, *e.g.*, Treas. Reg. § 1.861–8 (as amended in 1995) (prescribing rules for the allocation and apportionment of a taxpayer's deductions in an effort to provide guidance as to the determination of the taxpayer's taxable income from specific sources and activities).

142 *See 1921 Hearings, supra* note 39, at 6, 67.

143 *See id*. The Attorney General's opinion is reported at 32 Op. Att'y Gen. 336 (1920).

144 *1921 Hearings, supra* note 39, at 6.

145 *See* Revenue Act of 1921, ch. 136, § 217(e), 42 Stat. 227, 243–45. More specifically, Congress empowered the Commissioner to develop "processes or formulas of general apportionment" with respect to income derived from sources "partly within and partly without the United States," a category of income expressly including income arising from the manufacture of goods in one country and the sale in another. *Id*. This preference for formulary apportionment may reflect a longstanding interest of Adams. Indeed, this method of apportionment had been pioneered by Adams' Wisconsin income tax, and would become the norm in state taxation. *See* Hellerstein & Hellerstein, *supra* note 30, at 628–31. Nonetheless, § 217(e) offered a different mechanism for the allocation of income arising from the purchase of goods in one country and the resale in another; in such cases, the "source" of the income would be "the country in which [the goods were] sold." Revenue Act of 1921 § 217(e). In interpreting this ambiguous standard, courts ultimately looked to commercial law principles relating to passage of title. *See* Choate et al., *supra* note 23, at 450.

This issue remains both important and difficult today. *See, e.g.*, Treasury Sales Source Report To Congress (1992). The Clinton Administration proposed in its budget for fiscal year 1998 a revision to the sales source rules that would allocate income from products manufactured in the U.S. and sold abroad based on "actual economic activity." The President's Budget for Fiscal Year 1998, submitted to Congress Feb. 6, 1997, *Analytical Perspectives*, at 52.

146 *See 1921 Hearings, supra* note 39, at 66–67.

147 *See id*.

148 *Id*. at 68.

149 *See* Revenue Act of 1921, ch. 136, § 217(a), 42 Stat. 227, 243–44. As with interest, the 1921 Act sourced dividends based on the residence of the payor. Rental and royalty income from tangible property was sourced to where the property was

situated, while income from intellectual property was sourced to where used. *See id*. These source rules have largely remained intact to the present day. *See* I.R.C. §§ 861(a)(4), 862(a)(4) (1994).

150 *See 1921 Hearings, supra* note 39, at 67.

151 *See* Revenue Act of 1921, § 217, 42 Stat. 243–45.

152 *See infra* notes 251–55 and accompanying text.

153 Unlike most countries, the U.S. taxes U.S. residents and non-resident citizens alike, so the FTC was also a backstop for citizenship-based taxation. To avoid cumbersome repetition of the phrase "residents and citizens," however, we have lumped together the United States' citizenship-based and residence-based tax jurisdiction under the term "residence-based."

154 The residence backstop, for instance, discouraged Americans from investing in tax-exempt bonds issued by foreign governments—a tax dodge that was a particular bogey-man for Adams and the Treasury Department in the 1920s. *See infra* note 307.

155 Businesses in high-income-tax jurisdictions had less of a temptation to reincorporate abroad because their foreign taxes could more fully offset American taxes through the FTC. Thus, the foreign-source income of such businesses was more-or-less effectively exempt from American taxes. By contrast, American businesses in a nation such as China, which did not have an income tax, were fully liable to the United States for their foreign-source income. Given that nations without an income tax might still levy a range of sales taxes, property taxes, and registration fees, American businesses in such nations might still regard themselves as facing substantial taxation.

156 *See 1921 Hearings, supra* note 39, at 7.

157 *See* I.R.C. § 482 (1986).

158 *See 1921 Hearings, supra* note 39, at 80.

159 *Id*. at 6.

160 *Id*.

161 *See id*. at 7.

162 Further legislation dealing with this problem was adopted in 1937 and the Code today contains a complex array of provisions addressing the treatment of such passive income. *See, e.g.*, I.R.C. §§ 871(a)(1), 881(a), 904(d)(2)(a) (1994). For further discussion of the treatment of passive income in international tax, *see, for example*, Avi-Yonah, *supra* note 8, at 1305–10.

163 *1921 Hearings, supra* note 39, at 7.

164 In part, Adams probably felt comfortable making the foreign trader proposal because of the other reforms contained in the 1921 Act. The trader provision created a risk that American firms with trader subsidiaries would juggle their accounting so as to shift as much income possible to the subsidiaries, which were free from U.S. residence-based taxes. However, the Internal Revenue Bureau's new authority to look through corporate accounting practices to the substance of transactions (the proto-Arm's Length Standard authority) provided hope that such tax avoidance could be effectively countered. The language of the proposed Arm's Length standard provision expressly covered foreign trade corporations. *See id*. at 80; *see also supra* note 157 and accompanying text.

165 *See* Magill & Schaab, *supra* note 106, at 123.

166 S. Rep. No. 67–275, at 9 (1921), *reprinted in* 95A Internal Revenue Acts Of The United States 1909–1950: Legislative Histories, Laws, And Administrative Documents (Bernard D. Reams, Jr. ed., 1979).

167 *See* Magill & Schaab, *supra* note 106, at 123. Joining Senator LaFollette, Senator Simmons argued that the provision "came from sources 'profoundly interested in advancing the interests of consolidated, coordinated, combined, and predatory

wealth.'" Roy G. Blakey, *The Revenue Act of 1921*, 12 Am. Econ. Rev. 75, 96 (1922) (quoting 61 Cong. Rec. 8994 (1921))

168 U.S. residence-based taxation disadvantaged a U.S. corporation in competition with a company resident in a low-tax jurisdiction for business in that jurisdiction, but it did not disadvantage a U.S. company in competition with companies from a third country that itself did not exempt foreign source income.

169 *See* Magill & Schaab, *supra* note 106, at 124.

170 *See* Revenue Act of 1921, ch. 136, § 262, 42 Stat. 227, 271. Notwithstanding Senator LaFollette's belief that rejection of the "foreign trader" proposal would help keep American capital at home, Congress seems to have been well aware that the LaFollette Amendment would simply encourage American firms to incorporate subsidiaries abroad—capital would continue to flow overseas, but through a corporate form shielding the returns from current U.S. residence-based taxation. Accordingly, the Conference Committee introduced a number of measures into the 1921 Act that provided competitive advantages to American firms with foreign subsidiaries. For example, Congress made clear that interest and dividend income paid by corporations that derived 80% of their gross income from foreign sources would be treated as foreign-source income. *See* Revenue Act of 1921 § 217(a)(1)-(2). We have not been able to ascertain what role, if any, Adams played in the development of these provisions. Note that they respond to one of the concerns the "foreign trader" provision was intended to address (competitiveness of American firms abroad), while acquiescing to the incorporation of American business enterprises abroad. Though the "foreign trader" provision was not originally intended to promote trade and investment in any particular region, its transformation into the Possessions Corporation provision pointed to a later theme in U.S. International tax policy: the provision of tax benefits to encourage economic development in favored regions. Thus, in 1939 Congress implemented a new law quite similar in structure to the Possessions Corporation provision, but designed to benefit Western Hemisphere Trade Corporations. *See* Terence M. Flynn, *Western Hemisphere Trade Corporations: Quo Vadis?*, 12 Tax L. Rev. 413, 414 (1957). In 1922, Congress passed the China Trade Act (CTA), which provided relief to China Trade Corporations, albeit through a complicated structure dissimilar to that governing Possessions Corporations. *See id*. Notwithstanding the dissimilar relief mechanism, the CTA grew in part out of concerns similar to those motivating the "foreign trader" proposal: In China, as in the Philippines, the FTC was inadequate to place American firms on an equal tax footing with important foreign competitors. *See generally* Jennifer Hunt, China Trade Act (1995) (unpublished manuscript, on file with authors). Indeed, the House Ways and Means Committee held hearings on the China problem prior to its hearings on the 1921 Act. Adams did not testify on the subject in 1920 or later, and appears never to have articulated a position on the CTA, or, more generally, on such regionally-focused tax relief measures.

171 *See* Frisch, *supra* note 85, at 584; *see also* Avi-Yonah, *supra* note 8, at 1312 n.42; Ault & Bradford, *supra* note 21, at 39 (pointing out that capital import neutrality "obtains when there is no tax-based difference in circumstances at firms operating within a given country associated with the nationality of the firm's owners").

172 *See* Ault et al., *supra* note 13, at 402–08.

173 *See* Hufbauer, *supra* note 12, at 57–60 (discussing the implications of a policy of capital import neutrality on International competitiveness).

174 *See* Ault & Bradford, *supra* note 21, at 24–28.

175 *See id*.

176 *See* I.R.C. § 902 (1994). This is the modern version of § 240(c) of the Revenue Act of 1918.

177 *See, e.g.*, James R. Hines, Jr., *Tax Policy and The Activities Of Multinational Corporations* 31 (Nat'l Bureau of Econ. Research, Working Paper No. 5589, 1996) (stating that firms have incentives "to reduce their tax liabilities through selective

repatriations").

178 AULT ET AL., *supra* note 13, at 381.

179 Adams, *Taxation of Business, supra* note 58, at 193.

180 *See* Fairchild, *supra* note 42, at 10.

181 *See* Ault, *supra* note 16, at 567–68 (stating the "ultimate result" of the League of Nations work on bilateral tax treaties was the OECD Model Treaty); *see also* Rosenbloom & Langbein, *supra* note 82, at 365–66 (observing that the League's choice of "'classification and assignment'" as the basic structure for bilateral tax agreements is used today in "virtually all tax treaties"). Although the role of the International Chamber has been neglected somewhat in recent scholarship, older accounts of the history of the tax treaty movement usually begin with the Chamber. *See, e.g.*, HERNDON, *supra* note 103, at 19–40; Carroll, *supra* note 109, at 696 (noting the International Chamber's appeal to the League of Nations at the close of World War I to prevent double taxation).

182 The Chamber materials may be particularly instructive about Adams' approach to International treaty–making, because he was involved with the Chamber's effort almost from its outset. On the other hand, by the time Adams joined the League's double taxation project, the League had already produced a draft treaty and was invested in a particular approach to the double taxation problem. Thus, Adams' role within the League was somewhat more limited than his role in the Chamber's effort.

183 HERNDON, *supra* note 103, at 20 (quoting *Organizational Meeting of the International Chamber of Commerce* Res. 11 (June 28, 1919) INT'L CHAMBER OF COMMERCE). Several American delegates were apparently quite active in fashioning this resolution. See Memorandum No. 2: A Statement Upon the Attention That Has Been Given to the Subject of Double Taxation in International Chamber Circles to Date 5 (undated and unsigned, but probably prepared for Adams in 1922 by John O'Connor, an official of the U.S. Chamber of Commerce and secretary of the double taxation committee) (available in T.S. Adams Papers, Yale University, Box 12, 1921–23 folder) [hereinafter 1922 Chamber Memo].

184 HERNDON, *supra* note 103, at 20 (quoting Resolution Number 11).

185 These resolutions were drafted by a committee comprised of representatives from the national chambers of Commerce of Belgium, France, Great Britain, Italy, the Netherlands, and the United States. *See id.* at 21.

Between the 1920 and 1921 International Chamber meetings, the 1920 International Financial Conference in Brussels had taken up the call for International action to prevent double taxation. The Financial Conference was particularly concerned with the effect of double taxation on the ability of investors to make foreign investments, and specifically requested the League of Nations to take up the issue. *See id.* at 41–42.

186 *Id.* at 21–22. The distinction between progressive and non-progressive elements of an income tax may be less clear today than in 1921. The early American income taxes included both a "normal" tax, a flat tax applicable to all taxpayers, and a graduated surtax on high incomes. *See* WITTE, *supra* note 40, at 76–86. Under the 1921 resolutions, then, the United States would only levy its surtaxes on citizens—irrespective of residence or source of income—and its normal tax on domestic-source income. Schedular taxes, levies of varying rates—commonly used by European nations—on specific sources of income, were treated as "normal" taxes under this scheme.

187 In preparation for the 1921 meeting, the U.S. Chamber of Commerce consulted with Adams about the resolutions. Adams found the normal/super tax distinction to be "equitable and fundamentally in accord with sound theory," but suggested a number of modifications: 1) "where collected" should not be the basis for allocating income because it is easily manipulable; 2) source rules must be carefully worked out prior to submitting a plan to national legislature s; 3) because the surtaxes were so much heavier and more important in America than the normal taxes, it was

inappropriate not to take source into account in figuring the surtaxes, particularly with respect to American corporations doing most of their business abroad ; and 4) super taxes should be levied not just on citizens, but also on resident aliens. *See* 1922 Chamber Memo, *supra* note 183, at 9–10. Adams' first three suggestions seem to flow out of problems with the U.S. domestic legislation, which Adams was also working on in 1921. Note that, as usual, Adams assumes source should be the ultimate basis of jurisdiction for the most important taxes.

188 *See* OECD Committee on Fiscal Affairs, Model Tax Convention on Income and Capital, art. 24, cl. 5, Sept. 1, 1992, *reprinted in* 1 Tax Treaties (CC H) ¶ 191 [hereinafter OECD Model Treaty.] For additional examples of nondiscrimination provisions in international tax treaties, *see* Kees Van Raad, Nondiscrimination In International Tax Law 76–123 (1986) (studying nondiscrimination clauses under United States, Nether lands, and OECD Model Convention tax treaties).

189 *See* Alvin C. Warren, Jr., *Alternatives for International Corporate Tax Reform*, 49 Tax L. Rev. 599, 600 (1994).

190 *See* 1922 Chamber Memo, *supra* note 183, at 12. The members of the U.S. Committee were: Thomas S. Adams; Robert Grant, Jr. (Higginson & Co., London) ; W.F. Gephart (Vice President, First Nat'l Bank in St. Louis); Jerome D. Greene (Lee, Higginson & Co., New York) ; and John J. O'Connor (Manager, Finance Dep't, U.S. Chamber of Commerce). *See id.*

191 *See* Minutes of the Meeting of the Committee on Double Taxation of the International Chamber of Commerce 4 (Mar. 1, 1922) (available in T.S. Adams Papers, Yale University, Box 12, 1921–1923 folder).

192 The U.S. Committee could not produce a list of concrete examples of double taxation and concluded that American companies, in fact, were subject to double taxation only quite rarely. See American Section of the International Chamber of Commerce Double Taxation Committee, Memorandum to Accompany Minutes of Meeting on Double Taxation (May 23, 1922) (available in T.S. Adams Papers, Yale University, Box 12, 1921–1923 folder) [hereinafter American Section Memo]. In this regard, members of the Committee noted that the foreign tax credit was a "lifesaver" for American firms. See id. The Committee also noted that other nations routinely failed to enforce certain taxes against foreign companies, and that many taxes that were enforced were easy to evade by use of certain organizational structures. *See id.*

193 The Committee preferred the tax credit over an exemption for reasons of progressivity and for concerns over some income escaping taxation altogether. *See* American Section Report, *supra* note 77, at 1–3. The shipping tax suggestion represented a very narrow, incremental reform. *See id.* at 2–3. The U.S. Committee conceded that theory did not dictate the registry/effective control rule, but argued that "[i]t is more important to secure the adopt ion of one uniform rule than to insist that an exactly correct theoretical rule be developed." *Id.* at 3.

194 These resolutions included the foreign tax credit, but not the shipping or sales apportionment suggestions of the U.S. Committee. For a list of the resolutions with a point-by-point summary of the American and British responses, see Committee on Double Taxation of the International Chamber of Commerce, Observations of the American and British National Committees with Regard to Resolutions Presented at the Rome Congress by the International Chamber's Select Committee on Double Taxation (Aug. 29, 1923) (available in T.S. Adams Papers, Yale University, Box 12, 1923–1924 folder) [hereinafter Observations].

195 *See* Herndon, *supra* note 103, at 25–26. "Perhaps the most significant aspect of the League's work [on double taxation in the 1920s] was its ultimate choice of 'classification and assignment' as the basic structure for a model bilateral agreement. This structure is used today in virtually all tax treaties." Rosenbloom & Langbein, *supra* note 82, at 366 (footnote omitted). The choice was perhaps "significant," but by no means innovative. The Rome Resolutions and the source rules of the American Revenue Act of 1921 employed classification and assignment before the structure

made its first appearance in a League report in 1923. For additional discussion of the 1923 Report, see *infra* notes 215–28 and accompanying text. The International Chamber was in close contact with the League on the double taxation issue throughout the 1920s, and the League was no doubt well aware of the structure of the Rome Resolutions. *See* Herndon, *supra* note 103, at 24–25.

196 *See* Herndon, *supra* note 103, at 24–25.

197 *Id.* at 28.

198 *Id.* The Rome Resolutions also envisioned a credit mechanism which would allow nations of residence to levy taxes on worldwide income at whatever rate or rates they choose, but only after an offset for taxes paid abroad on foreign-source income. *See id.*

199 *See id.*

200 *See* American Suggestions, *supra* note 56, at 1–2.

201 The American Committee entertains grave doubt whether real progress is likely to be made by an attempt to adopt abstract principles . . . . [T]here are, not one, but many principles or bases of taxation which are theoretically valid. . . . [D]ouble taxation can be . . . reduced to a minimum not by discussions of abstract principles, but by adopting . . . 'a few definite proposals of a comparatively restricted scope . . . .'

Id. at 1 (citations omitted).

202 *See id.* at 3. The American Committee arrived at this decision both as a matter of "principle" and "administrative convenience." *Id.*

203 Notwithstanding its genera l approval of the Rome Resolutions, the American Committee proposed technical modifications of some provisions and, for political reasons, suggested the complete removal of a provision creating an International board of appeal for tax issues. *See id.* at 5 ("The American Committee regretfully expresses its belief that there is no hope that the American federal or state governments would in any way permit their decision of actual tax cases to be affected by an International organization . . . ."). This sentiment has contemporary echoes in current debates over U.S. submission to the jurisdiction of International trade tribunals. *See, e.g.*, David E. Sanger, *U.S. Rejects Role for World Court in Trade Dispute*, N.Y. Times, Feb. 21, 1997, at A1.

204 *See* Observations, *supra* note 194, at 2–3.

205 *See* May, *supra* note 128, at 74.

206 *See* Vital, *supra* note 7, at 6.

207 *See* Herndon, *supra* note 103, at 28–29.

208 *See* International Chamber of Commerce, Resolutions Unanimously Adopted by the Committee on Double Taxation 1–2 (Nov. 24, 1923) (available in T.S. Adams Papers, Yale University, Box 12, 1923–1924 folder).

209 *See* Annual Report of the American Committee on Double Taxation (c. 1924) (available in T.S. Adams Papers, Yale University, Box 12, 1923–1924 folder). For a discussion of the Italian position, see Herndon, *supra* note 103, at 33–34.

210 *See infra* note 215.

211 *See* Herndon, *supra* note 103, at 57. Belgium, Czechoslovakia, France, Great Britain, Italy, Nether lands, and Switzerland were the original countries represented. *See id.* at 58.

212 *See* Report and Resolutions Submitted by the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations, League of Nations Doc. No. C.115 M.55 1925 II (1925) [hereinafter 1925 Report]. For further discussion of the 1925 Report, see *infra* notes 229–35 and accompanying text.

213 *See* Herndon, *supra* note 103, at 36–37 (quoting resolutions of 1925 Brussels Congress of the International Chamber of Commerce). Adams' position on the 1925

Report is discussed *infra* note 236 and accompanying text.

214 For a discussion of the post–1925 work of the International Chamber on double taxation, see HERNDON, *supra* note 103, at 38–40.

215 Seligman and Stamp initiated a correspondence on the project in the fall of 1921, before it was even clear who the other members of committee would be. *See* Letter from Stamp to Seligman (Oct. 31, 1921) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder). The two exchanged five lengthy "notes" which essentially became the first, and less important, half of the 1923 Report, dealing with the "burdens and barriers" caused by double taxation. All of these notes are contained in E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder. In the last of these notes, Seligman proposed the personal/impersonal distinction and the allocational mechanism of economic allegiance which, as we will see, became the foundation for the second part of the 1923 Report, recommending solutions for the problem of double taxation. *See* E.R.A. Seligman, Note on Sir Josiah Stamp's Note Transmitted on June 1st, 1922, at 6–8 (June 22, 1922) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder).

Professor Bruins did not weigh in with substantive comments until March 8, 1923, and then largely endorsed the approach sketched out by Seligman's note. *See* G.W.J. Bruins, Some Observations (March 8, 1923) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder). Senator Einaudi appears never to have contributed substantive comment s before the 1923 Report was drafted.

The economists met in Geneva in March, 1923, to hash out the details of the Report. Einaudi was unable to attend the meeting. *See* SELIGMAN, *supra* note 81, at 140. After the meeting, Seligman had exclusive responsibility for editing the manuscript. *See* Letter from Leon Dufour to E.R.A. Seligman (April 11, 1923) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder). Einaudi was given the opportunity to comment on this draft, but given the pressure of publishing deadlines, was told that his comments could not be incorporated into the text; he simply had the choice of signing on or not signing on to the draft. *See* Letter from Seligman to Einaudi (April 4, 1923) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder). Einaudi opted to sign on, although he had made virtually no input into the 1923 Report. *See* Letter from Einaudi to Seligman (April 7, 1923) (E.R.A. Seligman Papers, Columbia University, Box 44, League of Nations folder).

In sum, the relative contributions of each of "the four economists" to the 1923 Report may be ranked, in descending order of importance: Seligman, Stamp, Bruins, and Einaudi. Significantly, Einaudi, the least important, was the only one of the economists from a net debtor nation (Italy). Seligman later expressed regret about this, fearing that the Report had been somewhat unbalanced in its presentation. *See* SELIGMAN, *supra* note 81, at 140.

216 For a discussion of Seligman's contributions to tax theory, *see* HAROLD M. GROVES, TAX PHILOSOPHERS 39–47 (1974); Hovenkamp , *supra* note 28, at 1004–09. Seligman (1861–1939) was a "foremost early proponent of the net income tax in the United States." GROVES, *supra*, at 42. Like Adams, Seligman was an active member of both the National Tax Association and the American Economic Association. His influential text, Essays in Taxation, went through ten editions—"setting something of a record" for tax treatises. *Id.* at 40. Moreover, perhaps because this and his other books read so much like legal treatises, *see* Hovenkamp, *supra* note 28, at 1009, Seligman was said to be "[t]he Progressive Era economist with the greatest explicit influence on judicial policymaking." *Id.* at 1004.

217 As an example, Seligman's book on double taxation devotes twenty-six pages to the history of thinking about the subject (beginning in the thirteenth century!) and thirty pages to an abstract taxonomy of taxes, but contains hardly a word about the allocation of business income among source nations. *See* SELIGMAN, *supra* note 81, at 32–57, 58–87. In contrast, Adams called the apportionment of business income "the most important technical problem in this field," Adams, *Double Taxation,*

supra note 3, at 121, and devoted much attention to the issue. In 1929, he obtained a grant from the Rockefeller Foundation to study the subject, a project on which he was still working at the time of his death in 1933. *See* Carroll, *supra* note 109, at 702.

218 *See* 1923 Report, *supra* note 52, at 18–25. "The problem consists in ascertaining where the true economic interests of the individual are found. It is only after an analysis of the constituent elements of this economic allegiance that we shall be able to determine where a person ought to be taxed or how the division ought to be made as between the various sovereignties that impose the tax." *Id*. at 20. Seligman developed the concept of economic allegiance in his early, path-breaking text Essays in Taxation, in which he optimistically argued that "all modern governments" are shifting to economic allegiance as the basis of tax jurisdiction. *See* SELIGMAN, *supra* note 108, at 110–11.

219 *See* 1923 Report, *supra* note 52, at 40. The 1923 Report leveled the following attack on existing practices:

[I]f we recognised facts and were not prevented by historical accidents and administrative cowardice or frailty from taxing every man in one sum upon his total resources instead of getting at him piecemeal, the "origin" idea would be far less instinctive. It leads direct to the consequence that countries creditor on balance should bear the main cost of relieving double taxation, and countries debtor on balance should contribute nothing to that cost. Although countries hold so instinctively to this origin principle in theory (and actually apply it when the foreigner has made investments already and is helpless), they drop the principle at once as soon as the practical question of new investment arises. Can origin, then, be so sacred a principle?

During the past year or so loans have been sought, for example, in the British money market by numerous foreign borrowers; Australia, New Zealand, France, Brazil have each recently issued their securities yielding fixed rates of return. One and all are distinguished by a common feature, namely, the exemption of the yield from all taxation, present or future, of the borrowing country.

Id.

220 *See id*. at 45–46. The 1923 Report represents something of a repudiation of the American foreign tax credit: as a progressive tax on worldwide income, the American income tax, under the reasoning of Seligman and the other League economists, should not have deferred in any sense to foreign source-based levies. Seligman's support for exclusively residence-based taxation in the context of progressive levies on worldwide income, which is comparable to the International Chamber's 1921 treatment of "super taxes," rested on two distinct concerns. First, he wished to distinguish between taxes levied solely on the theory of "ability to pay" from other taxes. Seligman regarded "ability-to-pay" taxes as substantially different in kind and distinctly personal in nature; in these characteristics, Seligman found important implications for jurisdiction: "[I]f the tax is a purely personal one, much may be said for the content ion that the country of domicile should have the right to impose the tax. The person is taxable as such where he is; the tax adheres to, or inheres in, the person." SELIGMAN, *supra* note 81, at 110. In contrast, he viewed other taxes as resting, at least in part, on a benefit theory—the taxpayer was being charged for the value of specific services rendered by the government. Jurisdiction for such taxes might more logically rest on the relative contributions of various nations to the production or consumption of the wealth being taxed. *See id*. In contrast, Adams regarded the notions of benefit and ability to pay as not easily separable. *See* text accompanying notes 54–64.

In addition to this argument, Seligman also rested his position on the inability of theory to produce clean allocations of business income. *See* 1923 Report, *supra* note 52, at 45 ("[I]t is almost impossible in economic theory to get a direct assignment of a quantitative character of finally resultant income amongst all the national agents who may be said to have had a finger in the pie."). Seligman's principle of economic allegiance was designed to weigh the competing claims of residence and source, but was of little value when there was more than one claim, as when a product was manufactured in one country and sold in another. In the absence of any clear theoretical solution to the source problem, the 1923 Report considered the possibility of an arbitrary division between treaty partners: for example, when a product is made in one country and sold in the other, each nation is entitled to tax one half of the profits. *See id.* at 51. The 1923 Report held "out no hopes of this proving to be a smooth and practicable arrangement. It can only be approximate and not an instrument of that degree of sensitiveness and accuracy which developed communities expect." *Id.*

Seligman ultimately wished to safeguard the ability of nations to levy progressive taxes on the worldwide income of residents—an understandable goal, and one that was largely shared by Adams with respect to taxation of individuals—but transformed this principle into an absolute preference for residence-based taxation. Alternatively, progressive rates might be protected through an American-style FTC: worldwide income is assessed at progressive rates set by the nation of residence, but source nations pocket a share of the ultimate tax liability. Seligman, however, rejected the FTC as being too much generosity to ask of creditor nations. *See id.* at 41–42. But the approach he endorsed placed an equally great burden on debtor nations. In the end, Seligman simply seems to favor residence-based taxation, though not for the world-wealth maximization reasons often used to justify residence-based taxation today.

221 *See id.* at 39. Thus, interest and dividends going from an entity in one country to an individual in another could not be taxed at all in the source nation. The source nation was not entitled to levy a global income tax on foreigners and could not levy specialized withholding taxes on interest and dividends. The aversion of the 1923 Report to withholding taxes has been an enduring feature of International treaty making. One of the main functions of contemporary tax treaties has been to reduce such taxes. *See* Ault, *supra* note 16, at 568–69. This tendency has been subject to criticism as it builds into the tax treat y network an assumption of classical corporate taxation, i.e., separate taxation of income at the corporate and the shareholder level. *See id.* If dividends were allocated to source, rather than residence, nations would be in a better position to implement integration with respect to foreign shareholders in a way that is consistent with the treatment of domestic shareholders.

Other allocation rules in the 1923 Report were less controversial and generally reflect the substance of the American rules from the 1921 Act, such as the allocation of the income from real estate to the nation where the real estate was located.

222 Ault, *supra* note 16, at 567; *see also* Avi-Yonah, *supra* note 8, at 1305–10.

223 *See* 1923 Report, *supra* note 52, at 47–48. The 1923 Report considered the exemption of non-residents as having three points in its favor: 1) exemption accorded with the common practice of many nations in issuing tax-exempt securities to foreigners; 2) exemption also accorded with the "true economic interests" of developing countries; and 3) exemption permitted escape from the theoretical difficulties of division and classification. *See id.* at 48. The primary problem the economists saw with the exemption of non-residents was that it systematically disadvantaged debtor nations. *See id.* The economists did recognize that such an exemption might thus have difficulty gaining widespread acceptance. *See id.* at 50. They saw no solution to this problem, although they did express some optimism:

[A]s semi-developed countries become more industrialised, with the resulting attenuation of the distinctions between debtor and creditor countries, the principle of personal faculty at the place of residence will become more widely understood and appreciated and the disparity between the two principles will become less obvious, so that we may look forward to an ultimate development of national ideas on uniform lines toward [the exemption of non-residents], if not as a more logical and theoretically defensible economic view of the principles of income taxation, at least as the most practicable solution of the difficulties of double taxation.

Id. at 51. In sharp contrast, the exemption of foreign source income was rejected out of hand as being too much to ask of creditor nations. *See id.* at 41–42.

224 The 1923 Report contained a brief "addendum" on apportionment, which failed to make any specific recommendation beyond noting that the experiences of the American states might prove instructive on the problem. *See id.* at 52–53. More generally, contemporaries found the Report to be "exasperatingly dull and difficult." Letter from Lockhart to A. Holcomb 1 (July 16, 1923) (available in T.S. Adams Papers, Yale University, Box 14) (quoting with approval commentary by the London Economist on the 1923 Report). Another reader found the prescriptive section of the Report to be "inconclusive." *See* Carroll, *supra* note 80, at 23, 25.

225 *See* Seligman, *supra* note 81, at 141.

226 Rosenbloom & Langbein, *supra* note 82, at 366.

227 For an exhaustive description of these treaties, see Herndon, *supra* note 103, at 10–18, 69–145.

228 *See* Carroll, *supra* note 80, at 29.

229 *See* Carroll, *supra* note 109, at 697–98.

230 *See supra* text accompanying note 213.

231 Participants included representatives from Belgium, France, the United Kingdom, Italy, the Netherlands, Switzerland, and Czechoslovakia. *See* Carroll, *supra* note 109, at 697–98.

232 For a reprint of excerpts of the 1925 Report, see Seligman, *supra* note 81, at 179–82.

233 *See id.* at 60–61.

234 The Technical Experts justified source-based taxation on the grounds that: New countries which need foreign capital for their general development desire to have a share in the taxes levied on income arising in their territory, and they are unwilling to leave them to the countries, often already very rich, which have provided the capital. Moreover, from a technical point of view, the collection of [source taxes], which does not involve the declaration by the taxpayer of his total income, is, generally speaking, easier and surer than in the case of the [personal taxes]. 1925 Report, *supra* note 212, at 15.

235 *Id.*

236 T.S. Adams, Untitled Comment Regarding the 1925 Report of the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations 1–2 (July 5, 1925) (unpublished comment, available in T.S. Adams Papers, Yale University, Box 13, 1924–1925 folder).

237 Seligman, *supra* note 81, at 150.

238 *See* Herndon, *supra* note 103, at 60.

239 The new representatives came from Germany, Poland, Japan, Venezuela, Argentina, and the United States. *See id.* at 61.

240 In 1928, for instance, Adams was among the four most vocal delegates, speaking more than thirty times during the proceedings. *See id.* at 176.

241 *See id.* at 63–64.

242 *See id.*

243 Mitchell Carroll, who assisted Adams at the 1927 and 1928 meetings as chief of the foreign tax section of the United States Chamber of Commerce, recalled four decades later that the American involvement was motivated by a desire to reduce foreign taxes on American business so as to reduce the costs of the FTC. *See* Carroll, *supra* note 109, at 693–94.

244 The Experts drafted separate treaties covering income taxation, succession duties, administrative cooperation, and judicial cooperation. This Article only deals with the income tax treaty, which was the primary focus of the Committee's work. Between the 1927 and 1928 meetings, representatives from fourteen

additional governments were added to the Committee's membership, including delegates from the Soviet Union and many of the nations carved out of the former Austro-Hungarian Empire. For a complete list of attendees, see HERNDON, *supra* note 103, at 175.

The drafting work of 1926–1928 culminated in the adopt ion of three different model income tax treaties, denominated Draft Conventions No. I–a, I–b, and I–c. Unlike Draft Convention No. I–a, neither I–b nor I–c maintained the distinction between impersonal and personal taxes. Draft Convention No. I–b assigned priority of taxation to the state of domicile, while Draft Convention No. I–c incorporated elements of both I–a and I–b. *See* 1928 Report, *supra* note 5.

245 Post-war France levied taxes on eight specific categories of income with rates ranging from 6% to 18%, depending on the category and size of the income, as well as a global income tax with graduated rates ranging from 1.2% to 30%. *See* HERNDON, *supra* note 103, at 63. Everyone agreed that the schedular taxes were impersonal and the global tax was personal. *See id*.

246 A number of alternatives presented themselves. For instance, the American "normal" tax might be treated as impersonal, though levied on the global income of residents and citizens and the full amount of American-source income of nonresident aliens. *See* Carroll, *supra* note 120, at 13–14. Alternatively, the income tax as a whole might be treated as impersonal when levied on nonresident aliens—this was the view favored by Adams. *See* Adams, *Draft Convention, supra* note 123, at 1. Meanwhile, Seligman, the inventor of the personal/impersonal distinction would probably have characterized only the corporate income tax as impersonal. *See* SELIGMAN, *supra* note 81, at 105–06 (classifying business taxes as "semi-personal," a category which, like a strictly impersonal tax, is "primarily a tax upon a thing").

247 We use the term "unified" rather than the more common "global" in an effort to avoid (further) confusion. Such a system generally is contrasted to a "schedular" system. *See* AULT ET AL., *supra* note 13, at 155.

248 The disparities in the importance of the American surtaxes and normal taxes contributed to the problem. One possibility that was floating in the American delegation was to have the American normal tax classified as impersonal, and thus levied on the basis of source. *See* Carroll, *supra* note 120, at 13–14. This compromise would have mirrored the earlier system proposed by the International Chamber. *See supra* notes 286–87 and accompanying text. The objection in 1927, as during the Chamber process, was that the American normal tax, at 5%, represented too small a share of the overall American fiscal system. The personal/impersonal compromise would have left the American system far more residence-based than the U.S. delegation desired. If the normal tax were raised to 10%, the analysis might have been different, see Carroll, supra note 120, at 14, but apparently such a change to domestic tax laws was beyond serious contemplation.

249 The threat posed to Britain by the personal/impersonal distinction is discussed in Carroll, *id*. at 11–12.

250 Generally, these measures involved concessions in the source rules associated with impersonal taxes. Perhaps the most important of these was the removal of the right of payor nations to tax outgoing interest, which appeared in the 1927 draft, but was removed from the 1928 draft. *See* HERNDON, *supra* note 103, at 186–87. At the same time, the British were wrangling these concessions, they were also conceding that they would need to grant an FTC to residents for taxes paid abroad on foreign-source income. *See id*. at 218–19.

251 Adams, *Draft Convention, supra* note 123, at 1. Adams' concern about the uncertainty of the terms was also echoed by outside critics. *See, e.g.*, May, *supra* note 128, at 72 ("The practical value of the distinction [between personal and impersonal taxes] has been questioned, and it must be admitted that the modern income tax is usually in some respects a personal and in other respects an impersonal tax.").

252 *See* Adams, *Draft Convention, supra* note 123, at 3.

253 *See id.*

254 *See id.*

255 *See* Carroll, *supra* note 120, at 29.

256 Minutes of the Fifth Meeting of the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations 9–10 (Apr. 8, 1927) (available in T.S. Adams Papers, Yale University, Box 16, Apr. 1927 folder).

257 *See* Herndon, *supra* note 103, at 174–75.

258 *See id.* at 235.

259 *See id.* at 235–39.

260 *See id.*

261 *See id.* at 238–39.

262 *See id.* at 235–41.

263 The locus of this conflict (at least in 1927 and during the 1928 discussion of I–a) was the source rules applicable to impersonal taxes. Although impersonal taxes were supposedly only to be levied based on source, this principle was never sacred, and various exceptions grew up over time.

264 *See id.* at 240. In one such exchange, the Belgian Expert accused the British Expert of putting his nation's economic interests ahead of the general interests, and claimed that the British position would reduce debtor nations to "economic servitude." *See* Minutes of the Tenth Meeting of the Technical Experts on Double Taxation and Tax Evasion to the Financial Committee of the League of Nations, 6–7 (Apr. 12, 1927) (available in T.S. Adams Papers, Yale University, Box 16, Apr. 1927 folder).

265 Under Draft Treaty I–c, interest and dividend income were allocated to the nation of the recipient (the British position); however, the nation of the payor was entitled to levy a withholding tax on the income at the source, in which case the recipient nation was expected to exempt the income or provide a credit for the foreign tax. *See* Herndon, *supra* note 103, at 239–40. This approach seems the closest of the three to the subsequent development of the International model treaty by the OECD. The current version of the OECD Treaty sources interest and dividends to the nation of the recipient, but permits limited withholding taxes by the payor-nation. *See* OECD Model Treaty, *supra* note 188, art. 10–11. Today the U.S. Model Treay differs from the OECD Treaty, and more closely resembles Draft Treaty I-b, by prohibiting payor-nation withholding taxes. *See* Richard Oernberg, International Tax In A Nutshell 101 (1993).

With respect to most other source rules, the three League models of 1928 were in closer agreement. For instance, income from immovable property was sourced to the nation where the property was situated, while wages and salaries were to be taxed in the nation in which the employment was carried out. The current OECD Treaty mirrors most of these consensus source rules of 1928, although there have been some technical modifications. For instance, income from immovable property is sourced to the place where situated (Article 6) and the remuneration for "dependent personal services" depends on the place of employment (Article 15), but the current model distinguishes "independent personal services," the income from which is sourced to residence (Article 14). Similar provisions are found in Articles 14 and 15 of the U.S. Model Treaty.

As noted earlier, Adams' 1921 Act sourced dividends and interest to the nation of the payor (which is still the position of U.S. domestic law). The 1921 Act, however, foreshadowed other aspects of the 1928 Model Treaties, including their treatment of income from immovable property and personal services. *See* Revenue Act of 1921, ch. 136, § 217(a), 42 Stat. 227, 244. Again, these source rules generally remain intact in current U.S. law. *See* I.R.C. §§ 871(b), 897(c) (1994).

266 *See* Carroll, *supra* note 109, at 693–94.

267 *Id*. at 700. A business representative described the problem as follows:

Any plan which seeks to avoid double taxation by subjecting business income to taxation only in the country where made . . . necessarily raises an issue as to where income is earned. Further, it would be quite possible to have an international correlation of income tax laws such as would theoretically eliminate double taxation and yet the same would continue to exist under cover because of conflicting and overlapping theories of allocation by which two or more countries might consider the same income earned within their borders.

Letter from Elliott, Law Department of International Harvester Company, to T.S. Adams. 1 (May 8, 1922) (available in T.S. Adams Papers, Yale University, Box 12, 1921–22 folder).

268 Permanent establishments were defined as:

The real centres of management, branches, mining and oilfields, factories, workshops, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona fide agent of independent status (broker, commission agent, etc.), shall not be held to mean that the undertaking in question has a permanent establishment in that country.

Herndon, *supra* note 103, at 195 (quoting Draft Convention No. I–a, art. 5, *reprinted in* 1928 Report, *supra* note 5, at 7–9).

269 *See* Herndon, *supra* note 103, at 196.

270 *See id*.

271 Adams, *Double Taxation, supra* note 3, at 108.

272 *See* I.R.C. §§ 871(b), 882(a) (1994).

273 *See* Revenue Act of 1921, ch. 136, § 217(e), 42 Stat. 227, 244–45.

274 *See* Draft Convention No. I–a, art. 5 cmt., *reprinted in* 1928 Report, *supra* note 5, at 12 ("The words 'bona fide agent of independent status' are intended to imply absolute independence, both from the legal and economic point of view. The agent's remuneration must not be below what would be regarded as a normal remuneration.").

275 One imagines that Adams would have also been sympathetic to a formulary system such as the one he helped develop in Wisconsin; he seems to suggest as much in an essay written shortly before his death. *See* Adams, *Double Taxation, supra* note 3, at 121–22. Moreover, Adams' 1921 Act called for the Commissioner of Internal Revenue to develop "formulas of general apportionment" to allocate income from sources partly within and partly without the United States, such as income arising from the manufacture of goods in one country and sale in another. *See* Revenue Act of 1921, ch. 136, § 217(e), 42 Stat. 227, 244–45. This aspect of the 1921 Act source rules seems to have been somewhat less durable than others: current U.S. law employs a direct method of apportionment via the "effectively connected" test, rather than an indirect formulary apportionment. *See, e.g.*, Ault et al., *supra* note 13, at 435.

Regardless of his own personal preferences, Adams did not press the apportionment issue during the 1927 and 1928 League conferences, perhaps in recognition of the great disparity in existing systems of apportionment. For a description of then existing systems, *see* Carroll, *supra* note 109, at 704–05. Surely, taking up the problem of apportionment would have threatened the fragile set of compromises reflected in the model treaties of 1928. The League subsequently published a model Allocation Convention in 1935. *See id*. at 705–06. This Convention called for permanent establishments to be taxed based on the income that each would have earned hypothetically were it a distinct and separate enterprise. *See id*. This standard has largely been carried forward into Article 7 of the current OECD Treaty.

For an extended treatment of the allocation problem circa 1932, *see* Mitchell Carroll, *A Brief Survey of Methods of Allocating Taxable Income Throughout the World*, in Lectures On Taxation 131 (Roswell Magill ed., 1932).

276 T.S. Adams, *Ideals and Idealism in Taxation*, 18 Am. Econ. Rev. 1, 5 (1928) [hereinafter Adams, *Ideals and Idealism*].

277 *Id*.

278 Adams, *Double Taxation, supra* note 3, at 124.

279 Reading Adams' works today, it may seem odd that Adams was even considered an economist during his own time. In fact, Adams was an influential economist who was awarded with positions of leader ship by his colleagues. *See supra* notes 28, 42 and accompanying text. Adams' writing focuses far less on abstract reasoning and the models of classical economics than on institutional structure and capacity, technical aspects of drafting and implementing legal regulations, and the empirical study of actual practices of real people. These interests and methods made Adams a participant in what Herbert Hovenkamp has called "the first great law & economics movement," which he dates to the late nineteenth and early twentieth centuries. *See* Hovenkamp, *supra* note 28, at 994. During the late nineteenth century, when Adams was a student, economics was in a state of turmoil, as the discovery of marginal analysis had undermined the assumptions of British Classicism and the arrival of German Historicism in America had provided new perspectives on the social sciences. *See id*. at 995–96. There was "uncertainty within the economic community as to whether economics was a behavioral, historical, or a purely formal science." *Id*. at 996. Henry C. Adams, a professor at Johns Hopkins at the same time T.S. Adams was a graduate student there, played a pioneering role in bringing the German approach to America, rejecting laissez-faire dogma in favor of highly particularized, industry-by-industry analyses of the appropriate role of government regulation. *Id*. at 997–98. Concurrently, the founders of institutionalism were bringing to economics the understanding that people are not simply rational wealth-maximizers, and that "ideology, technology, history, habit, previous investment, and lack of information or difficulty in communication drive both individual human motivation and institutional structure." *Id*. at 1014. T.S. Adams clearly absorbed the lessons of the institutionalists. Indeed, the American Economic Association, of which T.S. Adams was a long-time member and ultimately president, was actually founded in 1885 as a forum for institutional economics. *Id*. at 1021–22. Since Adams' time, of course, the uncertainty over the nature of economics as a discipline has been resolved in favor of "formal science." The oddity today of considering Adams an economist reflects the shift of the discipline's field of vision. *See id*. at 1056.

280 In other contexts, too, Adams took something of an agnostic position on grand theoretical systems. In the conclusion to a textbook on the heated labor problems of his day, Adams wrote: "[W]e may be moving towards socialism or we may be moving towards anarchism, but whithersoever we do move, socialism, anarchism and every other 'ism' must stand or fall on the wisdom of its immediate proposals." Thomas Sewall Adams & Helen L. Sumner, Labor Problems 546 (1905).

281 Adams, *Double Taxation, supra* note 3, at 125.

282 *Id*. at 126.

283 *See* Edwin R.A. Seligman, The Income Tax 647–49 (1911).

284 *See* T.S. Adams, *Annual Address of the President,* Sept. 9, 1914, 8 Nat'l Tax Ass'n Proc. 199, 200 (1914).

285 Letter from T.S. Adams to E.R.A. Seligman 2 (Mar. 30, 1914) (available in E.R.A. Seligman Papers, Columbia University, Misc. Correspondence Section).

286 American Suggestions, *supra* note 56, at 1.

287 Adams, *Taxation of Business, supra* note 58, at 189.

288 Adams, *Aspects of Double Taxation, supra* note 65, at 194.

289 American Section Memo, *supra* note 192.

290 *Id*. at 2–3.

291 *See id.*; *see also* Herndon, *supra* note 103, at 207.

292 *See* Herndon, *supra* note 103, at 205–07.

293 *See* Adams, *Aspects of Double Taxation, supra* note 65, at 194–95.

294 Adams, *Double Taxation, supra* note 3, at 106–07.

295 This phrase is the title of an eloquent essay by Adams, *see* Adams, *Ideals and Idealism, supra* note 276. In the essay, Adams called on economists to adopt a more realistic attitude towards their role in the formulation of tax laws:

The world needs the economist's version of the truth when it is fashioned after mature study. But let the economist cherish no illusion that it will prevail; that belief is merely a bit of intellectual arrogance with which the scholar quiets the growling of his own particular form of inferiority complex. The economist's "truth" is only one factor in the contest we call taxation. He little knows when he launches it, on what side it will eventually fight, or in what unsuspected ways it will count and tell. Wearing the white armor of "science," it will fight side by side with grimy forces seeking their own so-called selfish ends. It will emerge from the contest a battered and a better truth. It will have gained from, as much as it will have given to, its fellow contestants. It will have proved to be no better and no holier than many of its fellows. It will have proved more effective, the more completely its author—the economist—recognized in advance its limitations, its functions, and the character of the other contestants.

Id. at 8.

296 Adams, *Double Taxation, supra* note 3, at 125.

297 *Id*.

298 American Section Report, *supra* note 77, at 1; *see also* Adams, *Double Taxation, supra* note 3, at 125 (arguing that double taxation could only be averted through agreements based upon "practical grounds").

299 *See* Adams, *Double Taxation, supra* note 3, at 107.

300 *Id*. ("On certain subjects, the taxation of interest and dividends in particular, there are deep seated differences of opinion and interest which show few signs of disappearing.").

301 Adams, *Ideals and Idealism, supra* note 276, at 4.

302 *See* John D. Buenker, The Income Tax And The Progressive Era 30–31 (1985). For a discussion of the particular failings of the Wisconsin property tax, *see* Brownlee, *supra* note 103, at 45–46; Adams, *Wisconsin Income Tax, supra* note 30, at 572. In one of his first published writings, Adams criticized the Maryland tax system for similarly failing to capture the wealth represented by personality. See Adams, *Taxation in Maryland, supra* note 107, at 73.

303 *See* Brownlee, *supra* note 103, at 44–64 (recounting the history of the Wisconsin income tax and describing the mobilization of rural interests behind the income tax proposal).

304 Adams often expressed fears about the imminent demise of the income tax. For example, he wrote, "The probability is strong that in four or five years the income tax will, as a matter of practical politics, be past patching." Witte, *supra* note 40, at 91 (quoting a letter from Adams to the Ways and Means Committee) (emphasis omitted). Elsewhere, he observed, "A successfully administered income tax I believe to be an essential part of financial democracy. Personally, therefore, I should regard its breakdown as something in the nature of a political tragedy." Thomas S. Adams, *Should the Excess Profits Tax Be Repealed*, 35 Q.J. Econ. 363, 370 (1921).

In addition to the failure of certain state property taxes, Adams also witnessed first-hand the rise and fall of the federal excess profits tax on business income. Adams himself changed over time from a supporter to an opponent of the tax; in the end, he felt that the complexity of the excess profits law exceeded the administrative capacity of the federal government. *See id*. at 371. Indeed, the problems of the excess profits tax contributed to Adams' fears about the future of the income tax: "No federal administration, in my opinion, is capable during the next five or six years of carrying with even moderate success two such burdens as the income tax and the excess profits tax." *Id.* at 370. Adams has been deemed the "most influential" authority behind the eventual repeal of the excess profits tax. *See* Rader, *supra* note 32, at 419.

305 *See* T.S. Adams, *The Financial Problems of Porto Rico*, 17 Annals Am. Acad. Pol. & Soc. Sci. 444, 445 (1901) [hereinafter Adams, *Financial Problems*]; Thomas S. Adams, *Porto Rican Finance Under the Spanish and American Governments*, 3 Pubs. Am. Econ. Ass'n 314, 330 (1902).

306 Adams, *Financial Problems, supra* note 305, at 445.

307 Tax avoidance generally, and investment in tax-exempt securities specifically, also presented a threat to the ability-to-pay principle of income taxation. It might be argued that tax-exempt securities do not threaten ability to-pay because tax-exempts typically carry lower interest rates than other bonds, with the foregone interest representing an implicit tax on the bondholder. Adams, however, believed that the interest rates of tax-exempts did not reflect the tax savings received by taxpayers in the highest brackets, and thus provided a windfall to those taxpayers who needed it least. *See* T.S. Adams, *Untitled Speech on Tax–Exempt Securities*, 15 Nat'l Tax Ass'n Proc. 261, 264 (1922) [hereinafter Adams, *Untitled Speech*].

The American foreign tax credit lessened the incentives for other nations to become tax havens, or other wise to compete with one another by providing tax relief for the residents of other nations, such as by floating tax-exempt bonds in International capital markets. Thus, one of Adams' chief targets in the 1927 and 1928 League of Nations conferences was tax-exempt securities issued by foreign governments, paralleling a similar crusade by his boss, Treasury Secretary Andrew Mellon, against the federal tax exemption for state and local government bonds. For a discussion of Mellon's position, *see* Paul, *supra* note 93, at 132–33. In reaction to the high marginal rates of the 1918 Act, high-income Americans had turned to tax-exempt securities on a massive scale; hence, "the wealthier taxpayers" were effectively escaping surtaxes (and the yield of the income tax was "shrinking rapidly"). *See* Adams, *Fundamental Problems, supra* note 61, at 529; *see also* Adams, *Untitled Speech, supra*, at 262–63 (noting that reported taxable income of taxpayers earning more than $300,000 a year dropped by more than half between 1916 and 1919 notwithstanding general economic prosperity). Such securities "pervert[ed] the normal and natural habits of investment," *see id.* at 264, and perhaps, as Mellon said, "le[d] in many cases to unnecessary or wasteful public expenditures." Love, *supra* note 94, at 58 (quoting a letter from Secretary Mellon to Congressman Green). Critics argued that Americans only invested in tax-exempt government bonds as a means of escaping federal income taxes. *See* Witte, *supra* note 40, at 88. In a similar vein, Adams viewed with alarm the tendency of foreign governments to offer bonds whose interest was free of taxation by the issuing government. *See* Minutes of Meeting of Committee on Double Taxation and Tax Evasion on April 7, 1927, at 5 (available in T.S. Adams Papers, Yale University, Box 16, April 7–8 1927 folder) ("[I] t would be disastrous for Europe to be flooded with securities entirely exempt from taxation, as was the case in the United States."). In the interests of discouraging the further development of tax-exempt securities in International capital markets, Adams supported amendments to the 1927 and 1928 draft treaties that would have provided for residence-based taxation of interest that was not taxed by the source state—a reversal of his typical pro-source position. *See id.* at 2; *see also* Herndon, *supra* note 60, at 188. Adams' efforts failed with respect to Draft Convention No. I–a, *see* Herndon, *supra* note 103, at 188–89, but the interest provision of Draft Convention No. I–b, allocating interest to residence under all circumstances, may in part have reflected Adams' attempt to preserve a safeguard against tax-exempt securities.

In addition to tax-exempt securities, other forms of tax avoidance that were of particular concern to Adams included: incorporation for purposes of avoiding surtaxes on income, gifts to family members, the sale of securities at a loss, and "extravagant and doubtful expenditure" by corporations (including much advertising). *See* Adams, *Fundamental Problems, supra* note 61, at 532–36.

308 Adams, *Double Taxation, supra* note 3, at 112–13.

309 The connection was also apparent to the League of Nations, which assembled the Committee of Technical Experts to draft model treaties dealing with both double taxation and tax evasion. *See* Herndon, *supra* note 103, at 58.

310 Adams, *Double Taxation, supra* note 3, at 126. Much of this reasoning likely rests upon an understanding that tax systems—particularly income tax systems—cannot function without a substantial amount of voluntary taxpayer compliance and honesty. Adams observed, "The American taxpayer. . . .has been compared, confused, and used synonymously with the liar. As a matter of fact, when confronted with an equitable tax and a fearless assessor, he is amazingly honest." Adams, *Wisconsin Income Tax, supra* note 30, at 575 (emphasis added). The implication is that an inequitable tax—and Adams clearly felt that double taxation deserved that label—will produce dishonest taxpayers. Charles Bullock, a Harvard professor and colleague of Adams on the National Tax Association, made a similar point: "Not taxation itself, but unfair, excessive, and discriminating taxation is what has made the average American a tax-dodger." Charles J. Bullock, *The Federal Income Tax*, 8 Nat'l Tax Ass'n Proc. 264, 274 (1914).

311 Adams argued that "complexity [in tax legislation] is a major evil, involving the taxpayer in a cloud of uncertainty, stimulating evasion and rebellion, clogging the administrative machine, and bringing the tax into disrepute." Adams, *Fundamental Problems, supra* note 61, at 552. Adams felt that the fundamental problem of the net income tax, and of ability-to-pay taxation generally, was the inherent complexity of calculating the tax. Although Adams recognized that public sentiment heavily favored the ability-to-pay principle, he declared that he would "vote for simplicity and inequality, selecting many simple taxes at light rates rather than more equitable but more complex taxes at heavier rates." *Id*. at 553.

312 *See, e.g.*, American Section Report, *supra* note 77, at 2–3 ("It is more important to secure the adoption of one uniform rule than to insist that an exactly correct theoretical rule be developed.").

313 *1921 Hearings, supra* note 39, at 66.

314 Adams, *Draft Convention, supra* note 123, at 2.

315 *See* Minutes of Meeting on April 5, 1927, at 2 (available in T.S. Adams Papers, Yale University, Box 16).

316 *See* Adams, *Draft Convention, supra* note 123, at 1. Adams, in fact, had a long running dispute with Seligman over the utility and clarity of the distinction. *See* Letter to E.R.A. Seligman (Aug. 9, 1911) (available in T.S. Adams Papers, Yale University, Box 25, 1911–1912 folder) ("There is no common understanding of the terms 'real' [impersonal] and 'personal' taxes. . . .Ought we to place so much emphasis upon a general concept which is not clearly under stood?").

317 Adams, *Double Taxation, supra* note 3, at 112.

318 *Id*. at 105–06.

319 *See supra* text accompanying notes 143–45. Adams voiced similar concerns about an International Chamber proposal to tax income "where earned." 1922 Chamber Memo, *supra* note 185, at 9.

320 Adams, *Double Taxation, supra* note 3, at 125.

321 *Id*. at 124–25.

322 *See, e.g.*, Bradford, *supra* note 50, at 89–90 ("A number of considerations point to the residence principle as the more desirable principle to establish"); President's Tax Proposals, *supra* note 50, at 383 ("The longstanding position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions.")

323 *See, e.g.*, KEMP COMMISSION REPORT, *supra* note 14, at 449–50; *see also* HUFBAUER, *supra* note 12, at 93 (1992) (arguing that U.S. should abolish the foreign tax credit and adopt a territorial system for taxing foreign corporate income).

324 *See* Reuven S. Avi-Yonah, *The International Implications of Tax Reform*, 69 TAX NOTES 913, 917 (1995).

325 *See, e.g.*, KEMP COMMISSION REPORT, *supra* note 14, at 426 (calling for a flat rate tax system to stimulate investment).

326 *See* I.R.C. § 163(j) (1994).

327 *See* H.R. REP. NO. 101–247, at 1240–50 (1989), *reprinted in* 1989 U.S.C.C.A.N. 1906, 2710–20.

328 Adams, *Aspects of Double Taxation, supra* note 65, at 196.

329 *Id.* at 195. Adams foreshadowed this argument with his earlier advocacy of a single, nationwide standard for the apportionment of railway property for purposes of state taxation: "[C]ompeting state jurisdictions should not—by using different methods of apportionment —tax the same property twice; and. . .no interstate railway company, by reason of existing laxity and confusion, should escape without the full taxation of all its property in one state or another." T.S. Adams, *Valuation of Railway Property for Purposes of Taxation*, 23 J. POL. ECON. 1, 5 (1915).

330 *See* HERNDON, *supra* note 103, at 230.

331 *See, e.g.*, Bruce Zagaris, *Double Taxation Agreements of CARICOM: A Review of Existing Practice and Prospective Policy Options*, 47 BULL. INT'L FISCAL DOCUMENTATION 129, 137 (1993); C. Gaston Perera, *Double Tax Treaties in the Eastern Caribbean*, 1993 BRIT. TAX REV. 395, 398.

332 *See* Vital, *supra* note 7, at 34–35.

The texts of the two multilateral Nordic double tax treaties show the strong influence of the bilateral treaties that they replaced, and, behind them, the work of the OE CD of which all five states are members. There are no major new concepts or approaches in these agreements, which in some clauses resort to lists to cover the differences between the treaty partners. But they have shown that, given a common cultural and economic background, genuine multilateral cooperation on an evolving basis is achievable.

DAVID W. WILLIAMS, TRENDS IN INTERNATIONAL TAXATION 87 (1991).

333 Article 220 of the EEC Agreement urges the adoption of bilateral treaties for the elimination of double taxation. The first efforts at harmonization have focused on value-added taxes and have been under way for thirty years.

334 *See* RUDING COMMITTEE REPORT, *supra* note 18. For critical views on the Ruding Report, see John Chown, *Commentary on the Ruding Report*, 32 EUROPEAN TAXATION 123 (1992); Maarten J. Ellis, *A Practitioner's View of the Ruding Report*, 32 EUROPEAN TAXATION 129 (1992); Rijkele Betten, *Aspects of a Future EC Corporate Tax System: Commentary on the Ruding Report and the Commission Guidelines*, 32 EUROPEAN TAXATION 314 (1992). For views of Committee members themselves on the Ruding Report, see F. Vanistendael, *Round Table on the Ruding Report: Some Basic Problems on the Road to Tax Harmonization*, 33 EUROPEAN TAXATION 22 (1993); Ken Messere, *Round Table on the Ruding Report: A Personal View on Certain Aspects of the Ruding Committee Report and the EC Commission's Reaction to It*, 33 European Taxation 2 (1993).

The Ruding Report recommended community-wide minimal rates of corporate taxation, the adopt ion of standard procedures for resolving transfer pricing disputes, harmonized methods for depreciation and stock valuation and carry-back of losses. Not much has come of the Ruding Committee's proposals so far.

335 The 1928 Model was the basis for the 1964 OECD Model Treaty. *See* OECD FISCAL COMMITTEE, DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL (1963). The 1977 Model changed relatively little and even the 1992 Model

had relatively few changes. *See* Ken Messere, *The 1992 OECD Model Treaty: The Precursors and Successors of the New OECD Model Tax Convention on Income and Capital*, 33 European Taxation 246, 248–49 (1993).

336 Richard J. Vann, *A Model Tax Treaty for the Asian-Pacific Region?*, 45 Bull. Int'l Fiscal Documentation 99, 103 (1991). Indeed, one of the few occasions when the 1920s League effort failed to have lasting success was in the proposal for a multilateral dispute resolution procedure. *See supra* notes 203, 244.

337 *See supra* notes 85–91, 171–78 and accompanying text; *see also* Joint Committee On Taxation, *supra* note 25, at 246.

338 *See, e.g.*, Joint Committee On Taxation, *supra* note 25, at 246.

339 This way of putting the dilemma was first expressed in a speech given on March 1, 1990 to the U.S. chapter of the International Fiscal Association by Michael Graetz, when serving as Treasury Deputy Assistant Secretary (Tax Policy) in Philadelphia, Pennsylvania. *See International Tax Policy Makers Should Strive for Balance, Treasury Official Says*, BNA Daily Tax Report, Mar. 2, 1990, at G–7. The speech was subsequently delivered again and published by Kenneth W. Gideon, then the Assistant Secretary. *See* Kenneth W. Gideon, *Dinner Speech*, 9 Am. J. Tax Pol'y 71, 72–74 (1991). Principle 1 states a requirement of capital export neutrality. Principle 2 states a version of capital import neutrality, although it also expresses a desire for nondiscrimination either in favor of or against foreign-owned businesses and investments.

340 Adams, *Ideals and Idealism, supra* note 276, at 12.

Chapter 2

Originally published as:

Michael J. Graetz, *Historical Perspective on Subpart F* in The NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY, 37-58 (Fred F. Murray ed., 2001).

1 "Capital export neutrality" is a term used to describe the situation in which, because investors in the capital exporting country are subject to the same tax consequences with respect to similar investments, whether made domestically or abroad, tax considerations will play no part in influencing a decision to invest in another country. See Chapter 6 for a more complete discussion of this concept.

2 *See* Michael J. Graetz & Michael O'Hear, *The Original Intent of U.S. International Taxation*, 46 Duke L.J. 1021 (1997).

3 *Id.* The original system had allowed only a deduction for foreign income taxes.

4 *See*, *supra*, note 3 in the Executive Summary.

5 *See* I.R.C. §§ 552,553.

6 The State of the Union Address of the President of the United States, January 11, 1962, *reprinted in* H.R. Doc. No. 87-251, at 12 (1962).

7 Message of the President's Tax Recommendations, April 20, 1961, *reprinted in* H.R. Doc. No. 87-140, at 6 (1961).

8 H.R. 5, 86th Cong. (1959); *see Foreign Investment Incentive Act: Hearings Before the Comm. on Ways and Means*, 86th Cong. (1959).

9 In addition to extending deferral privileges, the Boggs Bill contained a number of other measures favorable to foreign business activities: a liberalization of tax-free transfers of property to foreign corporations; a 14 percent reduction in tax rates for foreign business corporations; a provision permitting corporations to elect either an overall foreign tax credit limitation or a per-country limitation; a credit for taxes spared by foreign countries; and a provision for the non-recognition of gain on involuntarily converted property. H.R. 5, 86th Cong. § 2 (1959).

10 *Foreign Investment Incentive Act: Hearings Before the Comm. on Ways and Means*, 86th Cong. iii–xiii (1959).

11 *Id.*

12 *Id.* at 512 (Statement of Stanley Ruttenberg, Director of Research, AFL-CIO).

13 *Id.* at 10-12 (Statement of Hon. Henry Kearns, Assistant Secretary of Commerce for International Affairs).

14 *Id.* at 36 (Statement of Hon. David A. Lindsay, Assistant to the Secretary of the Treasury). Lindsay presented a one-page report on the balance of payments issue that noted that European nations and Japan were building up a significant balance of payments surplus with the United States. *Id.*, at 69. The issue appeared to be of particular concern to Representatives Richard M. Simpson, the ranking Republican on the Committee and Noah M. Mason, the next most senior minority member of the Committee.

15 *Id.* at 80 (Statement of Hon. Douglas Dillon, Under Secretary of State).

16 *Id.* at 82.

17 *Id.* at 92.

18 *Id.* at 61 (Statement of Hon. David A. Lindsay, Assistant to the Secretary of the Treasury).

19 *Id.* at 74.

20 *See id.* at 22-23 (Statement of Hon. Henry Kearns, Assistant Secretary of Commerce for International Affairs); *Id.* at 61(Statement of Hon. David A. Lindsay, Assistant to the Secretary of the Treasury).

21 *Id.*, at 61 (Statement of Hon. David A. Lindsay, Assistant to the Secretary of the Treasury).

22 *See* II. above.

23 *See* H.R. Rep. No. 87-2508, at 2 (1962) (Conference Report).

24 *See* Message of the President's Tax Recommendations (April 20, 1961), reprinted in H.R. DOC. NO. 87-140, at 4 (1961).

25 *Id.* at 6-7.

26 *Id.* at 7.

27 *Id.*

28 Staff of the House Comm. on Ways and Means, 90th Cong., 1 Legislative History of H.R. 10650, 87TH Cong., of the Revenue Act of 1962, at 126 (Comm. Print 1967) (Statement by Hon. Douglas Dillon, Secretary of the Treasury, Before the Committee on Ways and Means of the House of Representatives, on the President's Message on Taxation, May 3, 1961).

29 *Id.*

30 *Id.* at 170.

31 *Id.* at 169.

32 *Id.*

33 *Id.* at 170.

34 *Hearings on H.R. 10650 Before the Comm. on Ways and Means on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress, April 20, 1961*, 87th Cong. 2921, 2926–27 (1961) (Statement of Hon. Neil McElroy).

35 *Id.* at 2425.

36 *See, e.g.*, *Hearings on H.R. 10650 Before the Comm. on Ways and Means on the Tax Recommendations of the President Contained in His Message Transmitted to the Congress, April 20, 1961*, 87th Cong. 2727, 2728–29 (1961) (Statement of Warren S. Adams II).

37 *Hearings on H.R. 10650 before the Comm. on Ways and Means on the Tax*

Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961, 87th Cong. 2595, 2597 (1961) (Statement of Stanley H. Ruttenberg, Director of Research, AFL-CIO).

38 *Id.* at 2598.

39 *Hearings on H.R. 10650 Before the Comm. On Ways and Means on the Tax Recommendations of the President Contained in his Message Transmitted to the Congress, April 20, 1961*, 87th Cong. 807, 807 (1961) (Statement of Dan Throop Smith, Graduate School of Business, Harvard University).

40 Staff of the Joint Comm. on Internal Revenue Taxation, 87th Cong., 1st Sess., General Explanation of Comm. Discussion Draft of Reveneue Bill of 1961, at 5, 51-54 (Comm. Print 1961).

41 H.R. 10650, 87th Cong. (1962).

42 H.R. Rep. No. 87-1447, at 58 (1962) (Revenue Act of 1962, Report of the Committee on Ways and Means).

43 *Id.*

44 *See* Staff of the Joint Comm. on Internal Revenue Taxation, 87th Cong., General Explanation of Comm. Discussion Draft of Revenue Bill of 1961 at 7 (Comm. Print 1961).

45 *See* H.R. 10650, 87th Cong. § 2 (1962).

46 1 *Revenue Act of 1962: Hearings Before the Senate Comm. on Finance*, 87th Cong. at 89 (1962) (Statement by Hon. Douglas Dillon, Secretary of the Treasury).

47 *Id.* at 99.

48 *Id.* at 101.

49 *See* Stanford G. Ross, *Report on the United States Jurisdiction to Tax Foreign Income*, 49b Stud. on Int'l Fiscal L. 184, 212 (1964).

50 1 *Revenue Act of 1962: Hearings Before the Senate Comm. on Finance*, 87th Cong. at 98 (1962) (Statement by Hon. Douglas Dillon, Secretary of the Treasury).

51 *Id.*

52 *Id.* at 99.

53 *Id.* at 449.

54 *Id.* at 103.

55 *Id.* at 106.

56 *Id.* at 449.

57 *See* S. Rep. No. 87-1881 (1962).

58 S. Rep. No. 87-1881 at 351, 354 (1962) (Additional Views of Sen. Eugene J. McCarthy on H.R. 10650).

59 S. Rep. No. 87-1881 AT 357, 373-75 (1962) (Dissenting Views of Senators Frank Carlson, Wallace F. Bennett, John Marshall Butler, Carl T. Curtis, and Thurston B. Morton on Sec. 11—Foreign Source Income, H.R. 10650 as Amended by Senate Finance Committee) (quoting 10 *Revenue Act of 1962: Hearings Before the Senate Comm. on Finance*, 87th Cong., 2d Sess., on H.R. 10650 at 4309-4310 (1962)).

60 S. Rep. No. 87-1881 at 389, 424 (1962) (Supplemental and Minority Views of Senators Paul Douglas and Albert Gore).

61 *See* H.R. Rep. No. 87-2508 (1962) (Conference Report).

62 Staff of the Joint Comm. on Internal Revenue Taxation, 87th Cong., 1st Sess., General Explanation of Comm. Discussion Draft of Reveneue Bill of 1961, at 5 (Comm. Print 1961).

63 H.R. Rep. No. 87-1447, at 58 (1962) (Committee on Ways and Means, Revenue Act of

1962).

64 *Id.*

65 *See* Stanford G. Ross, *Report on the United States Jurisdiction to Tax Foreign Income*, 49b Stud. on Int'l Fiscal L. 184, 212 (1964).

Chapter 3

Originally published as:

Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax Law Review 261 (2001).

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

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

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

4 Revenue Act of 1918, Pub. L. No. 65-245, ch. 18, § 238(a), 40 Stat. 1057, 1080.81 (1919).

5 Graetz & O'Hear, *supra* note 2, at 1045-48.

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

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

8 *Id.* at 1066-89.

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

10 Graetz & O'Hear, *supra* note 2, at 1026.

11 Professor Richard Vann of Australia has described this circumstance as follows:

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

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

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

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

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

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

16 Reg. § 1.482-1 to -8.

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

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

19 Internal Revenue Act of 1954, Pub. L. No. 83-591, ch. 736, § 904, 6SA Stat. 3, 287-88.

20 Act of Sept. 14, 1960, Pub. L. No. 86-280, § l(a), 74 Stat. 1010, 1010.

21 Tax Reform Act of 1976, Pub. L. No. 94-455, § 1031, 90 Stat. 1610, 1620-24 (codified as amended at I.R.C. § 904).

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

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

24 *See* text accompanying note 149 (statement of T.S. Adams).

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

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

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

28 *See* fig.7.

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

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

U.S. international tax policy. TREASURY DEP'T., THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 23-54 (2000) [hereinafter TREASURY SUBPART F STUDY].

31 TREASURY SUBPART F STUDY, *supra* note 30, at 23-54, contains a review of the economic literature.

32 *E.g.*, sources cited in note 30; *see also* Michael Keen, *The Welfare Economics of Tax Coordination in the European Community*, 1993 FISCAL STUD., reprinted in MICHAEL P. DEVEREUX, THE ECONOMICS OF TAX POLICY (1996).

33 Several authors have urged that zero is the optimum tax rate on inward investment. *See, e.g.*, Roger H. Gordon, *Taxation of Investment and Savings in a World Economy*, 76 AM. ECON. REV. 1086 (1986); Joel Slemrod, *Effect of Taxation With Capital Mobility*, *in* UNEASY COMPROMISE: PROBLEMS OF A HYBRID INCOME-CONSUMPTION TAX 115 (Henry J. Aaron et al. eds., 1988).

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

35 TREASURY SUBPART F STUDY, *supra* note 30, at ix-xi, makes much of the distinction between "worldwide" and "territorial" systems.

36 *See*, *e.g.*, JCT COMPETITIVENESS REPORT, *supra* note 30, at 5. My favorite way of making this point is in terms of an irreconcilable conflict among the following three simple principles:

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

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

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

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

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

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

37 *See*, *e.g.*, TREASURY SUBPART F STUDY, *supra* note 30, at 42-54; Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax*

Rules, 51 U. Miami L. Rev. 975 (1997).

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

39 Keen, *supra* note 32, at 206, and authenticated therein.

40 *Id.*

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

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

43 Treasury Subpart F Study, *supra* note 30, at 56, for example, contends that enhancing "competitiveness" of U.S. multinationals could "cause a decrease in overall economic welfare."

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

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

46 *E.g.*, NFTC Foreign Income Project, *supra* note 41, ¶ 7.

47 *See, e.g.*, JCT Economic Issues Report, *supra* note 30, at 2-4; JCT Competitiveness Report, note 30, at 5.

48 British Green Paper, *supra* note 30, ¶¶ 3.6-3.25.

49 Frisch, *supra* note 34, at 584-85; *see also* sources cited in note 30.

50 C. Fred Bergsten et al., American Multinationals and American Interests 111-12, 174 (1978).

51 H.R. 62, 93d Cong. (1973); *see also* S. 2592, 92d Cong. (1971).

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

53 *See* Graetz & O'Hear, *supra* note 2, at 1049-53.

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

55 Treasury Subpart F Study, *supra* note 30, at 16-19.

56 Message of the President, *supra* note 44, at 6-8.

57 *Id.* at 3-6.

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

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

59 For a good theoretical discussion of nations' obligations of international redistribution, see, *for example*, Charles Beitz, Political Theory and International Relations (1979).

60 For a nuanced discussion of this position, see, for example, John Rawls, The Law of Peoples (1999).

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

62 *See, e.g.*, Rawls, *supra* note 60, at 36 (Rawls discussion of this view, based on similar views set forth by Immanuel Kant *in* Perpetual Peace (Liberal Arts Press 1948) (1795), by David Hume *in Of the Balance of Power*, *in* Political Essays (K. Haakonssen ed., 1994), and by F. H. Hinsley *in* Power and the Pursuit of Peace 162 (1996) (discussing the ideas of Montesquieu, Voltaire, and Gibbon regarding universal monarchy)).

This, of course, is not to suggest that there are not important roles for international organizations such as the United Nations, the World Trade Organization, and the OECD, to name the three most relevant to international tax policy.

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

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

65 *See, e.g.*, Jagdish Bhagwati, *The Capital Myth: The Difference Between Trade in Widgets and Dollars*, Foreign Aff., May-June 1998, at 7 (distinguishing the case for free trade and for liberal capital flows); *see also* Joel B. Slemrod, *Effect of Taxation With International Capital Mobility*, *in* Uneasy Compromise, *supra* note 33 , at 115, 121-22; Joel B. Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 Tax & Pub. Fin. 471 (1995) (comparing international tax policy to international trade policy). As Peggy Musgrave has pointed out, foreign investment involves transfers abroad of productive resources whereas free trade involves the most productive use of existing resources. (Communication to the author on file).

66 *See generally* Frisch, *supra* note 34, at 583-84; Treasury Subpart F Study, *supra* note 30, at 36-37; *see also* note 51.

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

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

69 The Treasury Subpart F Study asserts, without offering any independent evidence, that national welfare always demands taxation of outward investment at a rate at least as high as domestic investment. Treasury Subpart F Study, *supra* note 30, at 41-42. This conclusion starts from the premise that "national neutrality" allowing only a deduction for foreign taxes-maximizes national welfare, followed by criticisms of articles in the economics literature that suggest that under some circumstances it would be in the national interest to favor foreign investments. *Id.* at 36-41.

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

71 *See, e.g.*, Peter Smith, *Lessons From the British Poll Tax Disaster*, 44 Nat'l Tax J. 421 (1991); Eric M. Zolt, *Prospects for Fundamental Tax Reform: United States vs. Japan*, 83 Tax Notes 903, 905 (May 10, 1999) ("[O]ne could design a tax system that imposes a head tax on each individual over 18 years old. While a head tax may strike some as fair, the fall of Margaret Thatcher's government regarding replacing a properly tax with a per person 'community charge' illustrates the political costs of misreading what the public considers fair.")

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

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

74 OECD, Harmful Tax Competition: An Emerging Global Issue (1998).

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

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

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

78 *See generally* Musgrave, U.S. Taxation, *supra* note 76.

79 *Id.*

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

81 *See generally* Musgrave, Economic Analysis, *supra* note 76; Musgrave, U.S. Taxation, note 76.

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

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

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

85 *See* text accompanying note 82.

86 Musgrave, U.S. Taxation, *supra* note 76, at 134.

87 *Id.*

88 *Id.* at 134, 153-54.

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

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

91 Musgrave, U.S. Taxation, *supra* note 76, at 24.

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

93 *Id.* at 437-39, 565.

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

95 I.R.C. § 46 (before amendment in 1986).

96 I.R.C. § 168(g)(1)(A), (B), (h).

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

98 *See* Graetz & O'Hear, *supra* note 2, at 1055 n.138; text accompanying note notes 17-23.

99 *See, e.g.*, British Green Paper, *supra* note 30.

100 Musgrave, U.S. Taxation, *supra* note 76, at 30, 55.

101 On direct investment, see UN Report, *supra* note 9, at 141-53. On portfolio investment, see also Rousslang, *supra* note 77, at 594.

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

103 Dunning, *supra* note 92, at 569.

104 Musgrave, U.S. Taxation, *supra* note 76, at 30-31, 55.

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

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

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

108 Hines, *Reconsideration*, *supra* note 80, at 397.

109 *Id.*

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

111 *See* Figure 1, at page305 .

112 *See* page 305 .

113 *See* note 26.

114 *See* UN Report, *supra* note 9, at 143, 152.

115 *Id.*

116 *Id.* at 151.

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

118 *Id.*

119 *See generally* Graetz & Warren, *supra* note 97, at 3.

120 Rousslang notes that none of the analyses to date "accounts for the substantial two way flows of international corporate investments that are actually observed," but he claims that so long as countries can cooperate, these flows should "do little to alter the optimal tax strategy" to "maximize global welfare." Rousslang, *supra* note 77, at 595. More comprehensive analysis than he offers, however, will be necessary to evaluate the validity of that claim and Rousslang offers no observations regarding the effects of two-way capital flows if the goal is national well-being rather than global. The Treasury Subpart F Study, *supra* note 30, at 38, points out that the optimum policy for capital importing nations is sometimes to tax inbound investment income at zero, or up to the tax rate of the capital-exporting nation if that nation allows a foreign tax credit, and in general to balance the benefits of inbound investment against the revenue lost from lowering taxes on such investment. But such flexibility in making tax policy may not exist as a practical matter. For example, it would not be possible politically in the United States to tax U.S. source business income earned by a foreign-owned corporation at a rate lower than the rate applicable to U.S. corporations, and our commitment to nondiscrimination prohibits a higher rate. Therefore, adjusting the rate of tax on inbound investment here requires also lowering or raising the tax on domestic investment by U.S. companies.

121 *See* Hines, *Reconsideration*, *supra* note 80, at 400.

122 MUSGRAVE, U.S. TAXATION, *supra* note 76, at 128, 134, 153, 162.

123 Revenue Act of 1918, ch. 18, 40 Stat. 1057.

124 *See* Graetz & O'Hear, *supra* note 2, at 1043-44, 1048-49.

125 *See id.* at 1061 n.181, 1074-80.

126 *Id.* at 1082.

127 *Id.* at 1072.

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

129 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 945- 47 (Regnery Publishing, Inc. ed., 1998) (1776).

130 Graetz & O'Hear, *supra* note 2, at 1043.

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

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

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

134 *See, e.g.*, Graetz, U.S. Income Tax, *supra* note 58, chs. 13, 14, 15.

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

136 U.S. Const. amend. XVI.

137 Graetz & O'Hear, *supra* note 2, at 1043.

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

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

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

141 *Id.* at 197 (emphasis added).

142 Graetz & O'Hear, *supra* note 2, at 1098-99, n.307.

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

144 *Id.*

145 *Id.* at 1074-78.

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

147 *Id.*

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

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

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

151 *See, e.g.*, U.S. MODEL INCOME TAX CONVENTION, Sept. 20, 1996, art. VII, Tax Treaties (CCH) ¶ 214 (reserving the right to tax business profits attributable to a permanent establishment in the United States).

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

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

154 *E.g.*, GRAETZ, U.S. INCOME TAX, note 58, at 212-43; Alvin C. Warren, Jr., *How Much Capital Income Taxed Under An Income Tax Is Exempt Under a Cash Flow Tax*, 52 TAX L. REV. 1 (1996).

155 Michael J. Graetz, *International Aspects of Fundamental Tax Restructuring: Practice or Principle?*, 51 UNIV. OF MIAMI L. REV. 1093, 1097-98 (1997).

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

157 *See, e.g.*, BLUEPRINTS, *supra* note 30, at 89-90.

158 *See* text accompanying notes 138-146.

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

160 *E.g.*, Alvin C. Warren, Jr., Income Tax Discrimination Against International Commerce, 54 TAX L. REV. 131 (2001).

161 *E.g.*, JOHN G. HERNDON, JR., RELIEF FROM INTERNATIONAL INCOME TAXATION: THE DEVELOPMENT OF INTERNATIONAL RECIPROCITY FOR THE PREVENTION OF DOUBLE INCOME TAXATION (1932).

162 OECD, *supra* note 74.

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

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

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

166 *See* page 306.

167 Graetz & Warren, *supra* note 97, at 18-20.

168 *Id.*

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

170 Most economists now regard an income tax on corporations as a tax on capital income, borne by suppliers of capital, but the burden of actual corporate income taxes, at least in part, may be borne by consumers and/or workers. It is standard practice

in government analyses either to assume the U.S. corporate income tax is split 50-50 by owners of capital and consumers or to treat the incidence of the tax as uncertain. For analysis of incidence of the corporate tax in an open economy, see Jane Gravelle & Kent Smelters, *Who Bears the Burden of the Corporate Tax in the Open Economy* (Nat'l Bureau of Econ. Research, Working Paper No. W8280, 2001), available at www.nber.org (concluding that the incidence is borne by domestic capital or is exported).

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

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

173 Graetz, U.S. Income Tax, supra note 58, at 262-66, 293-314.

174 Joint Comm. on Tax'n, Tax Evasion and Avoidance, 75th Cong., lst Sess. 1-2 (1937).

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

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

177 *See, e.g.*, Andrew B. Lyon & Mathew Haag, Optimality of the Foreign Tax Credit System: Separate vs. Overall Limitations, mimeo, January 2000, available at http:// www.bsos.umd.edu/econ//Lyon. 178 *See* note 145 and accompanying text.

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

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

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

182 *Primetime Live: No Yen for Taxes* (ABC television broadcast Apr. 9, 1992).

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

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

185 Revenue Act of 1921, ch. 136, § 262, 42 Stat 227, 271.

186 I.R.C. § 109 (1942).

187 China Trade Act of 1922, § 26, 42 Stat. 856.

188 Bergsten et al., *supra* note 50, at 168.

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

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

191 UN Report, note 9, at 147.

192 I.R.C. §§ 908(a), 999.

193 I.R.C. § 901(j); Rev. Rul. 90-53, 1990-2 C.B. 343.

194 The example is from Bergsten, et al., *supra* note 50, at 160-64.

195 In 1997, for example, the total U.S. foreign aid budget was $l23 billion. Foreign Operations and Export Financing and Related Programs Appropriations Act, 1997, H.R. 3540, 104th Cong. (1997). In contrast, foreign tax credits claimed by businesses and individuals on their 1997 tax returns totaled nearly $29 billion, more than twice as much. IRS, Statistics of Income Bull. 170 tbl. 1, 184 tbl. 13 (Winter 2000-2001).

196 Marsha Blumenthal & Joel B. Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications*, 2 INT'L TAX & PUB. FIN. 37 (1995).

197 Jeff Curry et al., *Individual Foreign-Earned Income and Foreign Tax Credit, 1996*, 19 STATISTICS OF INCOME BULL. 1, 130 (Summer 1999).

198 *Id.*

199 *See, e.g.*, Rosanne Altshuler, *Recent Developments in the Debate on Deferral*, 87 TAX NOTES 255 (Apr. 10, 2000); Treasury Report on Subpart F, *supra* note 30, at viii.

200 UN Report, *supra* note 9, at xviii.

201 *Id.*

202 Enrique G. Mendoza, *The International Macroeonomics of Taxation and the Case Against European Tax Harmonization* (Nat'l Bureau of Econ. Research, Working Paper 8217, 2001), available at http://papers.nber.org/papers/w8217.

203 Graetz & O'Hear, *supra* note 2, at 1056-59.

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

205 Christopher I. Bach, *U.S. International Transactions, Revised Estimates for 1974-96*, SURVEY OF CURRENT BUSINESS (1997).

206 *Id.*

207 *Id.*

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

209 *See* U.S. Treasury Report, *supra* note 204, at 1, for a list of countries.

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

211 Commission Proposal for a Council Directive to Ensure a Minimum of Effective

Taxation of Savings Income in the Form of Interest Payments Within the Community, COM (1998) 295 final.

212 U.S. Treasury Report, *supra* note 204.

213 Tax Reform Act of 1984, Pub. L. No. 98-369, § 127, 98 Stat. 494, CHS (1984).

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

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

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

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

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

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

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

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

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

223 Charles E. McLure, Jr., *U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles*, 14 Tax Notes Int'l 859 (Mar. 10, 1997), and literature cited therein; Charles E. McLure, Jr. & Joann M. Weiner, *Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income*, in Taxing Capital in the European Union (Sijbren Cnossen ed.) (forthcoming).

224 Graetz & O'Hear, *supra* note 2, at 1086-89.

225 *See, e.g.*, Noren, *supra* note 220.

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

227 *See, e.g.*, § 861(a)(1) (interest); § 861(a)(2) (dividends).

228 I.R.C. §§ 877, 2107, 2501(a)(3).

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

230 I.R.C. §§ 7701(a)(4), (a)(S).

231 Joseph Isenbergh, International Taxation: U.S. Taxation of Foreign Taxpayers and Foreign Income 83 (1990).

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

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

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

235 *Id.*

236 Reg. § 301.7701-1 to-3; *see generally*, TREASURY SUBPART F STUDY, *supra* note 30, at 68-70.

237 1998-1 C.B. 433.

238 *See* Reinhold, *supra* note 232, at 664.

239 U.S. Model Treaty, *supra* note 151, art. 22, Tax Treaties (CCH) ¶ 214.

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

241 Taylor, note 240, at 149-52.

242 *See, e.g.*, *id.* at 146.

243 *See, e.g.*, NFTC Foreign Income Project, note 41, ¶ 57; *cf.* TREASURY SUBPART F STUDY, *supra* note 30, at vii.

244 For a good example of such talk, see generally TREASURY SUBPART F STUDY, *supra* note 30, at x.

245 *See, e.g.*, text accompanying note 45; TREASURY SUBPART F STUDY, *supra* note 30, at 87; Peroni, *supra* note 37, at 977, 986-94; Robert J. Peroni et al., *Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

246 *E.g.*, TREASURY SUBPART F STUDY, *supra* note 30, at ix-xi.

247 *E.g.*, OECD, TAXING PROFITS IN A GLOBAL ECONOMY: DOMESTIC AND INTERNATIONAL ISSUES 183 (1991).

248 *See* text accompanying notes 35-57.

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

250 See, for example, the sources cited at note 13.

251 *See* UN Report, *supra* note 9, at 14-16.

252 *See id.* at 89; Dunning, *supra* note 92, at 79-80.

253 *See* World Investment Report, *supra* note 101, at 90.

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

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

256 *See* text accompanying note 27.

257 GRAETZ, U.S. INCOME TAX, *supra* note 58, at 303-14.

258 *See generally* Graetz & Warren, *supra* note 97.

259 *See* text accompanying *s*notes 178-203.

260 *See* text accompanying notes 18-19 and note 245.

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

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

263 *Id.* at 384-85.

264 *E.g.*, OECD, note 247, at 183.

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

266 *See* Grubert & Mutti, *supra* note 265.

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

268 Business Taxation: The Report of the President's Task Force on Business Taxation 44 (1970).

269 *See* Graetz & O'Hear, *supra* note 2, at 1033, 1038-39.

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

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

272 *See* text accompanying note 99.

273 UN Report, *supra* note 9, at 14-16.

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

275 I.R.C. §§ 871(a), 881(a).

276 *See* Richard L. Doemberg & Kees van Raad, U.S. Tax Treaties (1999).

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

278 *See generally id.*

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

280 *See* I.R.C. §§ 877, 2107, 2501(a)(3).

281 I.R.C. §§ 901(a), 911(a)(1), (b)(2)(D), (d)(6).

282 I.R.C. § 911(a)(2), (c).

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

CHAPTER 4

Originally published as:

Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 Columbia Law Review 347 (2013).

1 Robert M. Solow, *Technical Change and the Aggregate Production Function*, 39 Rev. Econ. & Stat. 312, 320 (1957). Solow's original estimate was 87.5%, but that was later corrected to 81%. Interview with Robert Solow, in Arnold Kling & Nick Schulz, From Poverty to Prosperity 66 (2009).

2 *See, e.g.*, Joseph F. Brodley, *The Economic Goals of Antitrust: Efficiency, Consumer Welfare, and Technological Progress*, 62 N.Y.U. L. Rev. 1020, 1026 (1987) (asserting innovation "is the single most important factor in the growth of real output in . . . the industrialized world"); Herbert Hovenkamp, *Restraints on Innovation*, 29 Cardozo L. Rev. 247, 253 (2007) ("[T]oday no one doubts . . . that innovation and technological progress very likely contribute much more to economic growth than [other factors]."); Susan Hockfield, President, Mass. Inst. of Tech., Keynote Address at the National Governors Association Annual Meeting: Restarting America's Job Creation Engine (July 15, 2011), available at http://web.mit.edu/newsoffice/2011/nga-conference-hockfield-0715.html (on file with the Columbia Law Review) ("Innovations that drive lasting economic growth emerge from the most advanced science, mathematics and technology.").

3 *See, e.g.*, Charles I. Jones & John C. Williams, *Measuring the Social Return to R&D*, 113 Q. J. Econ. 1119, 1133 (1998) (finding actual R&D investment in United States was only quarter to half of optimal amount); *see also, e.g.*, OECD, Tax Incentives for Research and Development: Trends and Issues 6 (2002), available at http://www.metutech.metu.edu.tr/download/tax incentives for R&D.pdf (on file with the Columbia Law Review) ("Both economic theory and empirical analysis underline the key role of research and development (R&D) in economic growth."); Office of Tax Policy, U.S. Dep't of the Treasury, Investing in U.S. Competitiveness: The Benefits of Enhancing the Research and Experimentation (R&E) Tax Credit 1 (2011), available at http://www.treasury.gov/resource-center/tax-policy/Documents/Research and Experimentation report FINAL.PDF (on file with the Columbia Law Review) ("Investments in research and experimentation produce technological advancements that drive productivity growth and improvements in U.S. living standards.").

4 *See, e.g.*, Chiara Criscuolo, The Effect of R&D Tax Incentives on Location of R&D Investment, in Expert Grp. on Impacts of R&D Tax Incentives, Design and Evaluation of Tax Incentives for Business Research and Development: Good Practice and Future Developments 32, 32 (Nov. 15, 2009) [hereinafter E.C. Report], available at http://ec.europa.eu/invest-in-research/pdf/download_en/tax_expert_group_final_report_2009.pdf (on file with the Columbia Law Review) ("[T]he returns to investment in knowledge and innovation cannot be fully appropriated by innovating firms as knowledge is a public good that can 'spill over' to others."); Dep't of Fin. Can. & Revenue Can., The Federal System of Income Tax Incentives for Scientific Research and Experimental Development: Evaluation Report, at vi-vii (1997), available at http://publications.gc.ca/collections/Collection/F32-1-1997E.pdf (on file with the Columbia Law Review) (noting "spillover benefits" of R&D "mean that, in the absence of government support, firms would perform less research and development than is desirable from the economy's point of view").

5 *See, e.g.*, Nat'l Sci. Bd., Nat'l Sci. Found., Research and Development: Essential Foundation for U.S. Competitiveness in a Global Economy 1 (2008), available at http://www.nsf.gov/statistics/nsb0803/nsb0803.pdf (on file with the Columbia Law Review) ("The scientific and technological advances that have led to our Nation's remarkable ability to create new industries and jobs, improve the standard of living for people, and provide sophisticated technology that ensures our national security can be traced back to the outcomes of basic research.").

6 Ammon Salter et al., Sci. & Tech. Policy Research, Univ. of Sussex, Talent, Not Technology: Publicly Funded Research and Innovation in the UK 20 (2000), available at http://www.sussex.ac.uk/Units/spru/nprnet/documents/talentshort.pdf (on file with the Columbia Law Review) (finding social returns to R&D investment five times better than private); Laura Tyson & Greg Linden, Ctr. for Am. Progress, The Corporate R&D Tax Credit and U.S. Innovation and Competitiveness: Gauging the Economic and Fiscal Effectiveness of the Credit 7 (2012), available at http://www.americanprogress.org/wp-content/uploads/issues/2012/01/pdf/corporate_r_and_d.pdf (on file with the Columbia Law Review) (noting estimates for ratio are typically on order of two to one).

7 *See, e.g.*, Tax Reform Options: Incentives for Innovation: Hearing Before the S. Comm. on Fin., 112th Cong. 57 (2011) (prepared testimony of Dirk Pilat, Head, Structural Policy Division, OECD Directorate for Science, Technology, and Industry) [hereinafter OECD, The International Experience], available at http://www.finance.senate.gov/imo/media/doc/oECD%20SFC%20Hearing%20testimony%209%2020%2011.pdf (on file with the Columbia Law Review) (proffering policy for and evidence of effectiveness of international R&D incentives).

8 *See infra* Part IV (describing how MNEs manipulate intercompany prices to reduce taxes).

9 Julian S. Alworth, Commentary on International Capital Taxation, in 1 Inst. for Fiscal Studies, Mirrlees Review: Dimensions of Tax Design 997, 1004 (2010), available at http://www.ifs.org.uk/mirrleesreview/dimensions/ch10.pdf (on file with the Columbia Law Review).

10 *See* Francisco Moris, Nat'l Sci. Found., The U.S. Research and Experimentation Tax Credit in the 1990s 1 (2005), available at http://www.nsf.gov/statistics/infbrief/ nsf05316/nsf05316.pdf (on file with the Columbia Law Review) ("The R&E tax credit, part of the U.S. Internal Revenue Code, was established by the Economic Recovery Tax Act of 1981.").

11 *See* Benoit Mulkay & Jacques Mairesse, Financing R&D Through Tax Credit in France 3 (May 2008) [hereinafter Mulkay & Mairesse, Financing] (unpublished manuscript), available at http://ftp.zew.de/pub/zew-docs/veranstaltungen/innovation patenting2008/papers/MulkayMairesse.pdf (on file with the Columbia Law Review) (noting French R&D credit was established in 1983).

12 *See* Robert D. Atkinson & Scott Andes, Info. Tech. & Innovation Found., Patent Boxes: Innovation in Tax Policy and Tax Policy for Innovation 5 (2011), available at http://www.itif.org/files/2011-patent-box-final.pdf (on file with the Columbia Law Review) (listing Ireland's tax credit inception date as 1973).

13 For example, House Committee on Ways and Means Chairman David Camp has proposed tax reforms that would include a 15% rate on certain IP income. See H. Comm. on Ways & Means, 112th Cong., Technical Explanation of the Ways and Means Discussion Draft Provisions to Establish a Participation Exemption System for the Taxation of Foreign Income 34 (2011) [hereinafter Technical Explanation], available at http://waysandmeans.house.gov/uploadedfiles/final_te_--_ways_and_means_participation_exemption_discussion_draft.pdf (on file with the Columbia Law Review) (observing effect of proposed tax provision would be "tax rate of [15] percent for the income from foreign exploitation of intangible property"). For a more detailed discussion of this proposal, see *infra* Part II.B (discussing patent box application to United States).

14 The R&D credit was established by the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 221, 95 Stat. 172, 241-47.

15 I.R.C. § 41 (2006).

16 I.R.C. § 41(c)(5).

17 The credit was allowed to lapse for a twelve-month period in 1995--1996. Tyson & Linden, *supra* note 6, at 25-26.

18 Office of Mgmt. & Budget, Exec. Office of the President, Budget of the United States Government, Fiscal Year 2003, 218 tbl.S-9 (2012), [hereinafter OMB, 2013 Budget], available at http://www.whitehouse.gov/sites/default/files/omb/budget/

fy2013/assets/ budget.pdf (on file with the Columbia Law Review); White House & Dep't of the Treasury, The President's Framework for Business Tax Reform 12 (2012) [hereinafter President's Framework], available at http://www.treasury.gov/resource-center/tax-policy/Documents/The-Presidents-Framework-for-Business-Tax-Reform-02-22-2012.pdf (on file with the Columbia Law Review).

19 Scitax, Overview of Research & Development Tax Incentives in Selected Global Knowledge Economies 2 (2011) [hereinafter Scitax Overview], available at http://www.scitax.com/pdf/Scitax.International.RD.Tax.Credit.Survey.Table.pdf (on file with the Columbia Law Review).

20 Tax & Legal Servs., PricewaterhouseCoopers Czech Republic, Study on the Impact of R&D Tax Incentives on Investments of Private Companies into R&D 6 (2008) [hereinafter PricewaterhouseCoopers, R&D Tax Incentives], available at http:// www.pwc.com/cz/en/studie-analyzy/impact-of-r-end-d-tax-incentives-on-investments-of-private-companies-into-r-and-d.pdf (on file with the Columbia Law Review).

21 *Id.* at 3.

22 Eduard Sporken & Edwin Gommers revised by Henrik Lund, *Tax Treatment of R&D Costs in Denmark*, 14 Int'l Transfer Pricing J. 11, 12 (2007).

23 PricewaterhouseCoopers, R&D Incentives in Belgium 1, 2 (2012) [hereinafter PricewaterhouseCoopers, R&D Belgium], available at http://www.investinbrussels.com/en/?LinkServID=05D261AC-0196-F71E-ADE2AE94FDE7CB37 (on file with the Columbia Law Review).

24 PricewaterhouseCoopers, R&D Tax Incentives, *supra* note 20, at 2.

25 Mulkay & Mairesse, Financing, *supra* note 11, at 1.

26 Scitax Overview, *supra* note 19, at 7.

27 Eduard Sporken & Edwin Gommers revised by Csaba Laszlo, Tamas Mlinarik & Zsofia Pongracz, *Tax Treatment of R&D Expenses in Hungary*, 14 Int'l Transfer Pricing J. 24, 25 (2007) [hereinafter Sporken et al., *Hungary*].

28 Eduard Sporken & Edwin Gommers revised by Tom Maguire, *Tax Treatment of R&D Expenses in Ireland*, 14 Int'l Transfer Pricing J. 27, 28 (2007) [hereinafter Sporken et al., Ireland].

29 Scitax Overview, *supra* note 19, at 5.

30 PricewaterhouseCoopers, R&D Belgium, *supra* note 23, at 1.

31 PricewaterhouseCoopers, R&D Tax Incentives, *supra* note 20, at 7.

32 Patrick Eparvier, Monitoring and Analysis of Policies and Public Financing Instruments Conducive to Higher Levels of R&D Investment—The "POLICY MIX" Project—Country Review FRANCE 19 (2007), available at http://ec.europa.eu/invest-in-research/pdf/download_en/france.pdf (on file with the Columbia Law Review).

33 PricewaterhouseCoopers, R&D Tax Incentives, *supra* note 20, at 5 (discussing 2008 simplification of incentive structure); Eduard Sporken & Edwin Gommers revised by Alan Katiya, Nathalie Cordier-Deltour & Vincent Berger, *Tax Treatment of R&D Expenses in France*, 14 Int'l Transfer Pricing J. 14, 18 (2007) (discussing previous scheme).

34 Invest in Fr. Agency, France Caters to Innovative Companies and Offers the Best Research Tax Credit in Europe 2 (2008), available at http://www.diplomatie.gouv.fr/en/IMG/pdf/ArguCIR_nov08_UK.pdf (on file with the Columbia Law Review).

35 Wim Eynatten, *European R&D and IP Tax Regimes: A Comparative Study*, 36 Intertax 502, 505 (2008) [hereinafter Eynatten, *European R&D*].

36 *Id.* at 505-06. Because the tax credit can be recorded as an above-the-line saving, it increases earnings before tax. *Id.* at 506.

37 PricewaterhouseCoopers, R&D Tax Incentives, *supra* note 20, at 6.

38 Sporken et al., *Hungary*, *supra* note 27, at 25.

39 Russel Thomson, *Tax Policy and the Globalisation of R&D* 50 (Intellectual Prop. Research Inst. of Austl., Working Paper No. 01/09, 2009).

40 Sporken et al., *Ireland*, *supra* note 28, at 28, 30.

41 IDA Ireland, Tax Guide Ireland 12 (2012), available at http://www.idaireland.com/news-media/publications/library-publications/ida-ireland-publications/ IDA_Tax_2012.pdf (on file with the Columbia Law Review).

42 PricewaterhouseCoopers, R&D Tax Incentives, *supra* note 20, at 3.

43 PricewaterhouseCoopers, Global Research & Development Incentives Group 18 (2012), available at http://www.pwc.com/en_GX/gx/tax/assets/pwc-global-r-and-d-brochure-may-2012.pdf (on file with the Columbia Law Review).

44 R&D tax incentives come in a variety of forms, and it therefore may not be obvious from direct comparison how various incentives rank in generosity. The B-index, which provides a measure of the present value of before-tax income required to cover the initial cost of R&D investment and pay corporate tax, is a commonly used and useful way of comparing the generosity of various countries' R&D tax regimes. For a description of how the B-index works, see Jacek Warda, *Measuring the Value of R&D Tax Treatment in OECD Countries*, STI Rev., no. 27 at 185 (2001), available at http://www.oecd.org/sti/37124998.pdf (on file with the Columbia Law Review) (describing B-index as representing "a ratio of the after-tax cost (ATC) of one dollar of expenditure on R&D divided by 1 less the corporate income tax rate").

45 *See, e.g.*, HM Revenue & Customs, Report No. 107, An Evaluation of Research and Development Tax Credits 14-15 (U.K.) [hereinafter HM Revenue & Customs Report], available at http://www.hmrc.gov.uk/research/report107.pdf (on file with the Columbia Law Review) (describing methods for measuring effectiveness of R&D incentives).

46 *See id.* at 14 ("If the ratio is greater than one, then the policy may in reality be ineffective due to a high transfer cost (or deadweight loss) as it subsidises R&D that would have been carried out anyway . . . .").

47 *See id.* at 14-15 ("[I]f the [benefit-cost] ratio is small it may only demonstrate that the total R&D expenditure generated does not fully reflect the total benefits from the tax policy . . . ."); *see also* Mark Parsons & Nicholas Phillips, *An Evaluation of the Federal Tax Credit for Scientific Research and Experimental Development* 8-13 (Canadian Dep't of Fin., Working Paper No. 2007-08, 2007), available at http://publications.gc.ca/collections/collection_2008/fin/F21-8-2007-8E.pdf (on file with the Columbia Law Review) (discussing "spillover benefits" of R&D spending).

48 For a comparison of various estimates, see HM Revenue & Customs Report, *supra* note 45, at 16-17 tbl.2 (providing divergent estimates of benefit-cost ratios for R&D incentives).

49 Bronwyn H. Hall, *R&D Tax Policy During the 1980s: Success or Failure? in* 7 Tax Policy and the Economy 1, 29 (James Poterba ed., 1993).

50 William W. McCutchen, Jr., *Estimating the Impact of the R&D Tax Credit on Strategic Groups in the Pharmaceutical Industry*, 22 Res. Pol'y 337, 344 (1993). McCutchen noted, however, that his low benefit estimate does not account for various secondary benefits, such as savings resulting from less need for surgery. *Id.*

51 *See, e.g.,* Boris Lokshin & Pierre Mohnen, *Measuring the Effectiveness of R&D Tax Credits in the Netherlands* 25 (United Nations Univ., UNU-MERIT Working Paper No. 2007-025, 2007) (noting that complete cost-benefit analysis of R&D incentive would have to take account of external effects as well as administrative and implementation costs, all of which are difficult to measure accurately).

52 *Id.* at 23.

53 *Id.*

54 Daniel J. Wilson, *Beggar Thy Neighbor? The In-State, Out-of-State, and Aggregate Effects of R&D Tax Credits*, 91 Rev. Econ. & Stat. 431, 434-35 (2009).

55 Nick Bloom, Rachel Griffith & John Van Reenen, *Do R&D Tax Credits Work? Evidence from a Panel of Countries 1979-1997*, 85 J. Pub. Econ. 1, 14 (2000).

56 Bronwyn Hall & John Van Reenen, *How Effective are Fiscal Incentives for R&D? A Review of the Evidence*, 29 Res. Pol'y 449, 462 (2002). Hall and Van Reenan also found that the price elasticity was around one for the US R&E credit in the 1980s. *Id.*

57 U.S. Gov't Accountability Office, GAO/GGD-89-114, Tax Policy and Administration: The Research Tax Credit Has Stimulated Some Additional Research Spending 3 (1989), available at http://archive.gao.gov/d26t7/139607.pdf (on file with the Columbia Law Review).

58 HM Revenue & Customs Report, *supra* note 45, at 16-17.

59 Marcel Dagenais et al., *Do Canadian Firms Respond to Fiscal Incentives to Research and Development?* 7, 17 (Centre Interuniversitaire de Recherche en Analyse des Organisations, Working Paper No. 97s-34, 1997).

60 Jacques Mairesse & Benoit Mulkay, *Une Evaluation du Credit d'Impot Recherche en France, 1980-1997* [An Evaluation of the Research Tax Credit in France, 1980-1997] 18 (Centre de Recherche en Economie et Statistique, Working Paper No. 2004-43, 2004).

61 John Cantwell & Ram Mudambi, *The Location of MNE R&D Activity: The Role of Investment Incentives*, 40 Mgmt. Int'l Rev. 127 (2000).

62 *Id.* at 142.

63 E.C. Report, *supra* note 4, at 35.

64 *See id.* at 38. According to the E.C. Report, scholars are forced to rely on surveys and single-country studies because of a lack of microdata containing information on both the cross-country location of MNEs and the specifics of the tax regimes of different countries. *Id.* at 39.

65 *See, e.g.*, Nicholas Bloom & Rachel Griffith, *The Internationalisation of UK R&D,* 22 Fiscal Stud. 337, 337 (2001); Wilson, *supra* note 54, at 431.

66 E.C. Report, *supra* note 4, at 42.

67 *See id.* ("The studies presented in this section show that still little is known about the importance of tax incentives for the location of R&D . . . ."). Studies on the effect of grants and subsidies on location decisions similarly fail to establish a causal connection. *Id.* at 40.

68 *See id.* at 42 ("[Q]uestions on whether (the introduction of) R&D tax incentives can cause the location of R&D investment in a country/region or which design of the tax incentives is better for achieving such a policy goal cannot be answered.").

69 James R. Hines, Jr., *Taxes, Technology Transfer, and the R&D Activities of Multinational Firms*, *in* The Effects of Taxation on Multinational Corporations 225, 226 (James R. Hines, Jr. et al. eds., 1995).

70 James R. Hines, Jr. & Adam B. Jaffe, *International Taxation and the Location of Inventive Activity*, *in* International Taxation and Multinational Activity 201, 203 (James R. Hines, Jr. ed., 2000).

71 Bloom & Griffith, *supra* note 65, at 353.

72 Wilson, *supra* note 54, at 434.

73 Bloom & Griffith, *supra* note 65, at 350-53.

74 Michael P. Devereux & Rachel Griffith, *Taxes and the Location of Production: Evidence from a Panel of US Multinationals*, 68 J. Pub. Econ. 335, 362-63 (1998).

75 Sven Stowhase, *Profit Shifting Opportunities, Multinationals, and the Determinants of FDI* 22-23 (Dep't of Econ., Univ. of Munich, Munich Discussion Paper No. 2002-11, 2002), available at http://epub.ub.uni-muenchen.dc/29/1/0211_stoewhase.pdf (on file with the Columbia Law Review).

76 *See, e.g.*, Harry Grubert & Joel Slemrod, *The Effect of Taxes on Investment and Income Shifting to Puerto Rico*, 80 Rev. Econ. & Stat. 365, 371-72 (1998) (finding that, among firms that invest in Puerto Rico, pharmaceutical companies are particularly likely to do so for income-shifting purposes, and providing wage subsidy would have least effect on curbing exodus of pharmaceutical companies from Puerto Rico were benefits of income-

shifting eliminated); *see also* Mihir A. Desai et al., *The Demand for Tax Haven Operations*, 90 J. Pub. Econ. 513, 529-30 (2006) (finding larger, more international firms with higher R&D intensity are most likely to use tax havens).

77 *Cf.* Pew Ctr. on the States, Evidence Counts: Evaluating State Tax Incentives for Jobs and Growth 1 (2012) (finding most states fail to effectively evaluate efficacy of their tax incentives, including R&D credits, and fail to use information to inform policy decisions).

78 Sergey Lychagin et al., Spillovers in Space: Does Geography Matter? 30 (Ctr. for Econ. Performance, Discussion Paper No. 991, 2010), available at http://cep.lse.ac.uk/pubs/download/dp0991.pdf (on file with the Columbia Law Review) (analyzing geographic spillover effect with econometric model based on firms' inventor locations).

79 Rachel Griffith et al., *Measuring the Cost- Effectiveness of an R&D Tax Credit for the UK*, 22 Fiscal Stud. 375, 390 (2001).

80 *Id.*

81 Stephen Machin & John Van Reenen, *Technology and Changes in Skill Structure: Evidence from Seven OECD Countries*, 113 Q. J. Econ. 1215, 1239 (1998) (explaining R&D "intensity" drives demand for skilled labor).

82 Austan Goolsbee, *Does Government R&D Policy Mainly Benefit Scientists and Engineers?*, 88 Am. Econ. Rev. 298, 298 (1998).

83 Russell Thomson & Paul H. Jensen, *The Effects of Public Subsidies on R&D Employment: Evidence from OECD Countries* 23-24 (Intellectual Prop. Research Inst. of Austl., Working Paper No. 2/11, 2011), available at http://www.ipria.org/publications/wp/2011/WP2_2011.pdf (on file with the Columbia Law Review).

84 Kris Aerts, Katholieke Universiteit Leuven, *Who Writes the Pay Slip? Do R&D Subsidies Merely Increase Researcher Wages*? 33 (2008).

85 Atkinson & Andes, *supra* note 12, at 3. There is considerable variation among the incentives in terms of the income that qualifies and how related expenses are treated. *Id.* at 3-4.

86 *Id.*

87 Peter R. Merrill et al., *Is It Time for the United States To Consider the Patent Box?*, 134 Tax Notes 1665, 1668 (2012).

88 *Id.*

89 Deloitte, Hungary Highlights 2012, available at http://www.deloitte.com/ assets/Dcom-Global/Local%20Assets/Documents/Tax/Taxation%20and%20Investment%20Guides/2012/dttl_tax_highlight_2012_Hungary.pdf (on file with the Columbia Law Review).

90 Merrill et al., *supra* note 87, at 1668.

91 *Id.*

92 *Id.*

93 Wim Eynatten & Patrick Brauns, *Benelux Tax Competition To Attract IP Income Is On Again*, Int'l Tax Rev., Mar. 2010, at 43, 43; Merrill et. al, *supra* note 87, at 1666.

94 Twenty percent multiplied by Belgium's regular corporate tax rate of 33.99%. Merrill et al, *supra* note 87, at 1666.

95 *Id.*

96 *Id.*

97 *Id.*

98 *Id.* at 1666-67.

99 *Id.* at 1666.

100 *Id.*

101 Eynatten & Brauns, *supra* note 93, at 43.

102 Merrill et al., *supra* note 87, at 1666.

103 *Id.*

104 *Id.* at 1666-68.

105 *Id.* at 1667.

106 *Id.* at 1668.

107 *Id.* at 1668-69; *see also* Dutch IP Regime with a 5% Effective Tax Rate, Taxand (Jan. 28, 2010), http://www.taxand.com/news/newsletters/Dutch_IP_Regime_with_a_5_percent_Effective_Tax_Rate (on file with the Columbia Law Review) (describing Netherlands' change from patent box to innovation box).

108 Merrill et al., *supra* note 87, at 1669.

109 *Id.*

110 *Id.*

111 *Id.*

112 *Id.*

113 *Id.*

114 *Id.* at 1668.

115 Twenty percent multiplied by Luxembourg's regular corporate tax rate of 29.22%. *See* KPMG, Luxembourg Budget 2013/ Tax Package 2013 (Oct. 2012), available at http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/taxnewsflash/Documents/luxembourg-oct4-2012.pdf (on file with the Columbia Law Review).

116 Merrill et al., *supra* note 87, at 1668.

117 *Id.*

118 *Id.* at 1669.

119 Fifty percent multiplied by Spain's regular corporate tax rate of 30%. *See id.* at 1667.

120 *Id.* at 1669.

121 *Id.*

122 *Id.* at 1670.

123 *Id.* at 1669-70.

124 *Id.* at 1667.

125 Antonio Matute Nardiz, *The Basque Patent Box Regime*, 50 Eur. Tax'n 37, 37 (2010).

126 The Basque Country's regular corporate income tax rate is 28%, so the effective rates are 40% multiplied by 28%, and 70% multiplied by 28%. *See id.* (comparing Basque Country's 28% corporate income tax rate to Spain's 30% rate).

127 However, they may be tax exempt "if the proceeds from the transfer are reinvested in certain qualifying assets." *See id.* at 38.

128 *Id.*

129 The Irish Budget 2011 and Recent Tax Developments, Taxand (Jan. 17, 2011), http://www.taxand.com/news/newsletters/The_Irish_Budget_2011_and_Recent_Tax_Developments (on file with the Columbia Law Review).

130 *See* Eynatten, *European R&D*, *supra* note 35, at 512.

131 Press Release IP/07/408, European Commission, Direct Taxation: Commission Requests Ireland To End Discriminatory Rules on Tax Treatment of Patent Royalties (Mar. 23, 2007), available at http://europa.eu/rapid/press-release_IP-07-408_en.htm#PR_metaPressRelease_bottom (on file with the Columbia Law Review).

132 *See* Eynatten, *European R&D*, *supra* note 35, at 512.

133 The Irish Budget 2011 and Recent Tax Developments, *supra* note 129.

134 Finance Act 2012, c. 14, sch. 2 (U.K.).

135 HM Revenue & Customs, The Patent Box: Technical Note and Guide to the Finance Bill 2012 Clauses, at 8 (2012) (U.K.) [hereinafter HM Revenue & Customs, Technical Note], available at http://www.hmrc.gov.uk/budget-updates/march2012/patent-box-tech-note.pdf (on file with the Columbia Law Review). The regular corporate tax rate is 23% for 2013. Corporation Tax Rates, HM Revenue & Customs (U.K.), http://www.hmrc.gov.uk/rates/corp.htm (on file with the Columbia Law Review) (last visited Feb. 9, 2013). The 10% rate will be implemented using a computational deduction. The amount of the deduction is the company's relevant IP profits multiplied by the difference between the regular corporate tax rate and the patent box rate (10%), divided by the regular rate. HM Revenue & Customs, Patent Box Consultation Draft 2 (2011) (U.K.), available at http://www.hmrc.gov.uk/budget-updates/06dec11/patent-box-draft.pdf (on file with the Columbia Law Review). This amount will be deducted from the company's profits, and the remainder will be taxed at the regular corporate tax rate. *Id.*; *see* Finance Act 2012 c. 14, § 357A(2), (3) (U.K.) (demonstrating how deduction is calculated).

136 HM Treasury, Corporate Tax Reform: Delivering a More Competitive System 51 (Nov. 2010) (U.K.) [hereinafter HM Treasury, Corporate Tax Reform], available at http://www.hm-treasury.gov.uk/d/ corporate_tax_reform_complete_document.pdf (on file with the Columbia Law Review).

137 Lee A. Sheppard, *News Analysis: What Hath Britain Wrought?*, Worldwide Tax Daily, Dec. 22, 2010, at 7-8, available at LexisNexis, 2010 WTD 250-2.

138 HM Treasury, Corporate Tax Reform, *supra* note 136, at 51. See *infra* Part V.A for further discussion of "competitiveness" among nations.

139 HM Revenue & Customs, Technical Note, *supra* note 135, at 5, 9; HM Treasury, The Patent Box: Response to Consultation 5, 10 (2011) (U.K.) [hereinafter HM Treasury, Response to Consultation], available at http://www.hm-treasury.gov.uk/d/condoc_responses_patent_box.pdf (on file with the Columbia Law Review). The patent box will also apply to supplementary protection certificates (which extend the protection afforded by qualifying patents for pharmaceutical and agrochemical products), plant breeders and variety rights, certain medicinal and veterinary products, and certain plant protection products. HM Revenue & Customs, Technical Note, *supra* note 135, at 19-20.

140 HM Revenue & Customs, Technical Note, *supra* note 135, at 15; HM Treasury, Response to Consultation, *supra* note 139, at 10. For groups that hold IP centrally, a company will be eligible if it has all rights in the IP, or all rights except rights to enforce, assign or license the IP. HM Revenue & Customs, Technical Note, *supra* note 135, at 17; HM Treasury, Response to Consultation, *supra* note 139, at 10.

141 HM Revenue & Customs, Technical Note, *supra* note 135, at 21; HM Treasury, Response to Consultation, *supra* note 139, at 10.

142 HM Revenue & Customs, Technical Note, *supra* note 135, at 21. This rule applies on a group level, so a company will qualify if it owns IP it developed itself or owns IP developed by another member of its group. *Id.* at 24.

143 *Id.* at 32-40; HM Treasury, Response to Consultation, *supra* note 139, at 6.

144 HM Revenue & Customs, Technical Note, *supra* note 135, at 57.

145 *Id.* at 46-48.

146 HM Revenue & Customs, Technical Note, *supra* note 135, at 50-51; HM Treasury, Response to Consultation, *supra* note 139, at 11 (describing allocation of residual profit to patent and nonpatent sources).

147 HM Revenue & Customs, Technical Note, *supra* note 135, at 50-51; HM Treasury, Response to Consultation, *supra* note 139, at 11.

148 For further discussion of transfer pricing, see *infra* Parts IV and V.B .

149 HM Treasury, Consultation on the Patent Box 24 (2011) (U.K.) [hereinafter HM Treasury, Consultation], available at http://www.hm-treasury.gov.uk/d7consult_patent_box.pdf (on file with the Columbia Law Review). Compliance with transfer pricing is

particularly important since the patent box will apply on a company-by-company basis, rather than to consolidated returns. *Id.* Small companies are usually exempt from the transfer pricing regime, but if they elect to receive a patent box deduction, they will have to forfeit that exemption. *Id.*; HM Revenue & Customs, Technical Note, *supra* note 135, at 79.

150 HM Treasury, Response to Consultation, *supra* note 139, at 8 (discussing U.K. government's proposals for IP inclusion). Because the government originally proposed that the patent box would not apply to existing IP, it decided to phase in the regime over five years in order to offset the cost of expanding its application. *Id.*; *see* HM Revenue & Customs, Technical Note, *supra* note 135, at 81 (reflecting five year phase-in period).

151 *See* Technical Explanation, *supra* note 13, at 1-2, 34-35 (discussing generally corporate income tax rate reduction and specific proposal to create limited patent box). Currently, U.S. persons—which includes all U.S. citizens and residents as well as domestic entities, I.R.C. § 7701(a)(1), (30) (2006)—are taxed on all income wherever earned, though U.S. companies can defer taxes on foreign income earned by foreign subsidiaries until the income is distributed as a dividend to the domestic parent corporation. Technical Explanation, *supra* note 13, at 3. In order to avoid double taxation of foreign- source income, a foreign tax credit is available for foreign taxes paid. *Id.* As an alternative to this system, the Camp proposal would allow a 95% deduction for the foreign-source portion of dividends received from a controlled foreign corporation ("CFC") by a domestic corporation that is a 10% U.S. shareholder of the CFC. *Id.* at 18. The remaining 5% of the dividend would be taxed as a substitute for disallowing deductions for expenses incurred to generate exempt foreign income. *Id.* The deduction would be subject to a one- year holding period requirement for the CFC stock. *Id.* at 20.

Subpart F of the Internal Revenue Code, which provides for current taxation of certain categories of a CFC's foreign income, would remain largely in effect. *Id.* at 18. Thus, U.S. shareholders would still be taxed in the United States on passive or highly mobile income of the CFC that qualified for subpart F, and the exemption would apply only to income from the conduct of an active foreign trade or business. *Cf. id.* ("[T]he 10- percent U.S. shareholder remains taxable in the United States on a current basis under the discussion draft on its pro rata share of certain items of passive or highly mobile income of the CFC."). Where the 95% deduction applies, foreign tax credits and deductions of foreign taxes paid would not be allowed. *Id.* A foreign tax credit would be available on income taxed under subpart F and for foreign taxes paid directly by a domestic corporation on foreign-source income. *Id.* Further, a foreign tax credit would be available for foreign withholding taxes imposed on royalties and interest. *Id.*

Shareholders of foreign corporations that are not CFCs but have 10% U.S. corporate shareholders ("10/50 companies") could elect to treat those 10/50 companies as CFCs. *Id.* at 20-21. The 95% exemption would then apply to dividends received by the 10% U.S. shareholders from the 10/50 companies. *Id.* at 21.

Under the proposal, foreign branches of domestic corporations would be treated as CFCs and the domestic corporations as 10% U.S. shareholders. *Id.* at 22. The domestic corporation would then be entitled to the 95% deduction on payments treated as dividends from the branch. *Id.*

In addition to the 95% deduction on the foreign-source portion of dividends, 95% of gains on the sale or exchange of the stock of a qualified foreign corporation by a domestic corporation that is a 10% U.S. shareholder would be exempt from tax. *Id.* at 23. No deduction would be allowed for a loss on the sale or exchange, and the domestic corporation would have to hold the stock for one year to qualify. *Id.* Also, in order to qualify, 70% of the assets of the CFC would have to be assets used in the active conduct of a trade or business. *Id.*

Upon transition to the participation exemption system, deferred foreign income would be taxed at a reduced rate of 5.25%, whether or not repatriated. *Id.* at 24-25. This rate could be further reduced by applying foreign tax credits. *Id.* at 24.

152 *See* Technical Explanation, *supra* note 13, at 32-35 (explaining specific terms of Camp's three alternatives). The first option is based on a proposal made by the Obama

Administration in its budget recommendations for fiscal years 2011 and 2012. This option would treat excess income from the transfer of intangible property to low-taxed affiliates as subpart F income. It would apply where a U.S. person transfers intangible property from the United States to a related CFC. Income attributable to such intangibles that has not been subject to foreign tax above 10% would be taxed in the United States to the extent that the income exceeds 150% of costs. (A sliding scale would apply where foreign tax rates are between 10% and 15%, such that all income would be included in subpart F if the foreign rate is below 10% and none would be included if the foreign rate is above 15%.) *Id.* at 32-33.

Under the second option, income earned by a CFC that is not derived from the active conduct of a U.S. trade or business in the CFC's home country and is taxed at a rate below 10% would be included as subpart F income. In order to qualify for the "home-country exception," the CFC would have to maintain an office or fixed place of business in the jurisdiction in which it is organized, and the income would have to arise from activities serving the home country's local market. *Id.* at 33-34; *see also infra* Part V.B (explaining CFC rules require that specified categories of income earned by foreign subsidiaries must be taxed currently to domestic parent at home-country tax rate).

153 *See* Technical Explanation, *supra* note 13, at 34 (describing third alternative, "[f]oreign intangible income subject to taxation at reduced rate, intangible income treated as subpart F income").

154 *Id.* at 34-35.

155 *Id.* at 34. Apparently, given the large size of the U.S. market, Chairman Camp concluded that extending such a low tax rate to domestic sales would be too costly. Applying a lower rate to exports than to domestic sales may, however, create difficulties under our trade treaties. Applying a lower rate to exports than to domestic sales may, however, create difficulties under our trade treaties. *See, e.g.*, Appellate Body Report, United States—Tax Treatment for "Foreign Sales Corporations," WT/DS108/AB/RW (Jan. 14, 2002) (World Trade Organization document) (holding that an income tax benefit for exports violated the 1994 General Agreement on Trade and Tariffs); Appellate Body Report, United States—Tax Treatment for "Foreign Sales Corporations,", WT/DS108/AB/R (February 24, 2000) (World Trade Organization document) (same holding for an earlier variation).

156 *See* Technical Explanation, *supra* note 13, at 1 ("The provision reduces the maximum corporate tax rate from 35 percent to 25 percent.").

157 *Id.* at 34.

158 *Id.* at 35. The Camp Proposal also includes a thin capitalization rule to mitigate income-stripping concerns. *See id.* at 35-36. The rule would impose a limit on the deductibility of the interest expense of a U.S. corporation that is a U.S. shareholder of a CFC and part of the same worldwide affiliated group (as defined in I.R.C. § 1504 (2006), but using an ownership threshold of 50% rather than 80%). The rule would disallow deduction of part of a U.S. company's net interest expense (the excess of the interest expense over interest income) if the U.S. company fails two tests: 1) the U.S. group (consisting of U.S. members of the worldwide affiliated group) is overleveraged relative to the worldwide group, and 2) the U.S. company's net interest expense exceeds a prescribed percentage of its adjusted taxable income. *Id.*

159 730 No. 2, Dail Deb., Written Answers—Tax Code, at 296 (Apr. 14, 2011), http://debates.oireachtas.ie/dail/2011/04/14/unrevised2.pdf (Ir.) (on file with the Columbia Law Review).

160 *Id.*

161 *Id.*

162 *See, e.g.*, Rachel Griffith & Helen Miller, Support for Research and Innovation, in The IFS Green Budget: February 2010, at 238, 240 (Robert Chote et al. eds., 2010), available at http://www.ifs.org.uk/budgets/gb2010/gb2010.pdf (on file with the Columbia Law Review) ("A policy of subsidizing income from patents is not well targeted at the market failures that typically justify government intervention in innovation markets."); Martin A. Sullivan, *Time for a U.S. Patent Box?*, 133 TAX NOTES 1304, 1305 (2011) ("[A] patent

box does a particularly poor job of linking tax benefits to the activities that deserve subsidizing.").

163 Atkinson & Andes, *supra* note 12, at 14.

164 Rachel Griffith, Helen Miller & Martin O'Connell, *Corporate Taxes and the Location of Intellectual Property* 3 (Ctr. for Econ. Policy Research, Discussion Paper No. 8424, 2011), available at http://www.cepr.org/pubs/dps/DP8424 (on file with the Columbia Law Review).

165 *See id.* at 22-26 ("The share of new patents locating in the Benelux countries increases, with the proportional increase being largest in Belgium and Luxembourg and the absolute increase largest in the Netherlands. The shares elsewhere fall.").

166 *Id.* at 24 tbl.5 (specifying percentage change in Benelux patent share when United Kingdom introduces patent box regime).

167 *Id.* at 32.

168 *See, e.g.*, HM Treasury, Consultation, supra note 149, at 5 (indicating aim of U.K. patent box is to provide incentive for companies to locate high-value jobs in United Kingdom and to maintain United Kingdom's position as world leader in patented technologies).

169 Atkinson & Andes, *supra* note 12, at 9-11 (noting that measuring effect of patent boxes on research, patents, and sales of patented products is difficult, given newness of incentives and fact that global recession coincided with their institution).

170 *Id.* at 11-12. Eurostat is a data source collected and maintained by the European Commission. For background information about Eurostat and access to Eurostat data, see generally Eurostat, epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home (on file with the Columbia Law Review) (last updated Nov. 13, 2012).

171 Atkinson & Andes, *supra* note 12, at 11.

172 *Id.*

173 *Id.* at 12.

174 *Id.*

175 Staff of Joint Comm. on Taxation, 111th Cong., JCX-37-10, Present Law and Background Related to Possible Income Shifting and Transfer Pricing 105-06 (2010) [hereinafter Joint Comm. Pamphlet], available at https://www.jct.gov/publications.html?func=startdown&id=3692 (on file with the Columbia Law Review) (discussing various scenarios through which companies perform "a significant portion" of their manufacturing and research work in United States "but the rights to exploit the intangible property are either transferred to or licensed by an affiliate in a low-tax jurisdiction"); *see also infra* notes 304-322 and accompanying text (explaining Joint Committee on Taxation's findings in depth).

176 Joint Comm. Pamphlet, *supra* note 175, at 105.

177 *See* text accompanying *supra* notes 129-133 and accompanying text (discussing conflict between Ireland's patent income exemption for domestic companies and E.C. Treaty rules regarding freedom of establishment and movement of services).

178 *See infra* Part IV (describing income-shifting techniques that shift IP ownership).

179 *See supra* Part II.A (providing overview of European countries' approaches to IP income taxation).

180 Simon Loretz has done some preliminary work finding colocation between firms' tangible and intangible assets, suggesting that the locations of IP and actual activity are not divorced from each other. See Simon Loretz, Taxes and the Co-Location of Intangibles and Tangibles 24 (Apr. 27, 2012) (unpublished presentation), available at http://www.etpf.org/papers/CEPS2012/CEPS2012Loretz.pdf (on file with the Columbia Law Review) ("Evidence suggests that in the long run tangible and intangible assets colocate."). The results, however, are far from conclusive.

181 For a comprehensive description and analysis of U.S. income tax provisions affecting

manufacturing, see generally Staff of Joint Comm. on Taxation, 112th Cong., JCX-61-12, Background and Present Law Relating to Manufacturing Activities within the United States (2012), available at https://www.jct.gov/publications.htmlPfunc=startdown&id=4473 (on file with the Columbia Law Review) (describing federal income tax rules related to manufacturing sector).

182 For a discussion of cost recovery, see generally Staff of Joint Comm. on Taxation, 112th Cong., JCX-19-12, Background and Present Law Relating to Cost Recovery and Domestic Production Activities (2012) [hereinafter Joint Comm. on Taxation, Cost Recovery], available at https://www.jct.gov/publications.html?func=startdown&id=4401 (on file with the Columbia Law Review) (describing federal income tax law relating to cost recovery).

183 *See* Michael J. Graetz & Deborah H. Schenk, Federal Income Taxation: Principles and Policies 339-40 (6th ed. 2009) (describing history of depreciation methods from introduction of corporate tax in 1909 through Congress's adoption of Accelerated Cost Recovery System in 1981).

184 Pub. L. No. 107-147, § 101, 116 Stat. 21, 22 (2002) (codified as amended at I.R.C. § 168). The basis of the property and the subsequent depreciation deductions were adjusted to account for the first-year bonus deduction. However, there were no adjustments to the allowable amount of depreciation for purposes of calculating the alternative minimum tax. *See* Joint Comm. on Taxation, Cost Recovery, *supra* note 182, at 25 (describing history and extent of bonus depreciation).

185 Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 201, 117 Stat. 752, 756 (codified as amended at I.R.C. § 168). The American Jobs Creation Act of 2004 expanded the definition of qualified property to include certain restaurant property and leasehold improvements. Pub. L. No. 108-357, § 211, 118 Stat. 1418, 1429 (codified as amended at I.R.C. § 168 (2006)).

186 American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1201, 123 Stat. 115, 333 (codified as amended at I.R.C. § 168).

187 Small Business Jobs Act of 2010, Pub. L. No. 111-240, § 2022, 124 Stat. 2504, 2558 (codified as amended at I.R.C. § 168).

188 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, § 401, 124 Stat. 3296, 3304 (codified at I.R.C. § 168). The deduction is reduced to 50% for property placed in service after January 1, 2012. Congress recently extended the deduction again, so property placed in service before January 1, 2014 (2015 for certain property) will qualify for the 50% rate. American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 331, 126 Stat. 2313 (codified at I.R.C. § 168). Corporations can elect to claim additional research and minimum tax credits instead of claiming bonus depreciation. Such an election increases the limitation on either the research or minimum tax credit and the increase is refundable. Additional benefits are provided to small businesses. For tax years beginning before 2014, a taxpayer can expense up to $500,000 of the cost of qualifying property placed in service that year, but the $500,000 is reduced by the amount by which the cost of the property exceeds $2,000,000. *See* I.R.C. § 179(b), as amended by the American Taxpayer Relief Act of 2012 § 315(a). For tax years beginning in 2014 or later, taxpayers can elect to deduct up to $25,000 of the cost of qualifying property placed in service that year. The $25,000 is reduced by the amount by which the cost exceeds $200,000. *Id.* The amount to be expensed in a tax year cannot exceed the taxable income for that year that is derived from the active conduct of a trade or business. I.R.C. § 179(b)(3)(A).

189 § 102, 118 Stat. at 1424-29.

190 I.R.C. § 199. For taxpayers with income from oil-related production activities, the rate is 6% of the least of oil-related production activities income, qualified production activities income, and taxable income.

191 *See* Molly F. Sherlock, Cong. Research Serv., R41988, The Section 199 Production Activities Deduction: Background and Analysis 5-6 (2011). The deduction may not exceed 50% of wages allocable to domestic production gross receipts paid by the taxpayer in a given year. Joint Comm. on Taxation, Cost Recovery, *supra* note

182, at 61.

192 *See* Kim Dixon, *Manufacturing Tax Break Goes Wide*, Fiscal Times (Mar. 9, 2012), http://www.thefiscaltimes.com/Articles/2012/03/09/Manufacturing-Tax-Break Goes-Wide.aspx (on file with the Columbia Law Review).

193 Sherlock, *supra* note 191, at 5.

194 *Id.* at 13.

195 *See* Dixon, *supra* note 192.

196 *See* Treas. Reg. § 1.199-3(e) (2012).

197 *See* I.R.C. § 199(d)(9) (2006).

198 Pub. L. No. 111-5, 123 Stat. 115 (codified at I.R.C. § 48C).

199 I.R.C. § 48C (Supp. IV 2011). The Clean Energy Jobs Act of 2012 would have reauthorized the credit with a cap of $5 billion. HR 4108, 112th Cong. (2012).

200 *See* President's Framework, *supra* note 18. Other proposals to benefit manufacturing have been proposed in Congress. *See, e.g.*, Rebuilding American Manufacturing Act of 2012, H.R. 5795, 112th Cong. (2012) (introduced by Rep. Ron Kind) (proposing to reduce domestic manufacturing tax rate to 20%).

201 President's Framework, *supra* note 18, at 12. Combined with the Administration's proposed 28% corporate tax rate, the 10.7% deduction would result in a 25% rate for regular manufacturing activities, thereby maintaining the three percentage point reduction of current law. Id.; *see also* Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals (2012) [hereinafter Dep't of the Treasury, General Explanations 2013], available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf (on file with the Columbia Law Review).

202 Sherlock, *supra* note 191, at 2. This change is predicted to generate $18.2 billion in revenues from 2011 to 2021, and those revenues would be used to fund the increased deduction on advanced manufacturing activities. *Id.* at 18.

203 Dave Camp, Chairman, House Comm. on Ways & Means, Opening Statement at House Ways and Means Committee Hearing on Tax Reform and the U.S. Manufacturing Sector (July 19, 2012) [hereinafter Camp Opening Statement], available at http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=303688 (on file with the Columbia Law Review).

204 Martin Chapman, *Why Ireland Is Getting a Bad Reputation for Its Low Corporation Tax Rate*, Helium (May 23, 2011), http://www.helium.com/items/2161740-ireland-and-its-low-corporation-tax-rate (on file with the Columbia Law Review).

205 Office of the Revenue Comm'rs, 10% Rate of Corporation Tax for Manufacturing Enterprises, Irish Tax & Customs, http://www.revenue.ie/en/business/incentives/tax-incentives-investors-ireland.html (on file with the Columbia Law Review) (last visited Jan. 25, 2013).

206 *Ireland: Domestic Corporate Taxation*, Lowtax, http://www.lowtax.net/lowtax/html/jirdctx.html (on file with the Columbia Law Review) (last visited Nov. 14, 2012) (tracking decrease in Ireland's corporate tax rate from 1998 to 2003).

207 *Ireland: Offshore Legal and Tax Regimes*, Lowtax, http://www.lowtax.net/lowtax/html/jiroltr.html#manu (on file with the Columbia Law Review) (last visited Nov. 14, 2012).

208 *See* CzechInvest, *Investment Incentives* 1 (July 2012), available at http://www.czechinvest.org/data/files/fs-04-investment-incentives-68-en.pdf (on file with the Columbia Law Review) (noting that tax incentives support introduction or expansion of production in manufacturing industry); *Investment Incentives*, BusinessInfo.cz (July 24, 2012), http://www.businessinfo.cz/en/articles/text-investment-incentives-8263.html (on file with the Columbia Law Review) (same).

209 CzechInvest, *supra* note 208.

210 *Id.*

211 *Id.*

212 *See* Hungarian Inv. and Trade Dev. Agency, *Incentives for Investments in Manufacturing Industry*, available at http://www.mfa.gov.hu/NR/rdonlyres/4190D433-6F46-4723-BCE9-72C354CEB7A4/0/manuf1025.pdf (on file with the Columbia Law Review) (last visited Nov. 14, 2012).

213 *Id.* at 5.

214 *Id.* at 6.

215 *See* OECD Tax Ctr. for Tax Policy & Admin. et al., Tax Policy Assessment and Design in Support of Direct Investment: A Study of Countries in South East Europe 178 (2003), available at http://www.oecd.org/investment/investmentfordevelopment/34466352.pdf (on file with the Columbia Law Review).

216 *Id.*

217 *See, e.g.*, Dixon, *supra* note 192 (characterizing tax deduction as overly broad and noting that "it may be nearly impossible to keep it focused on manufacturing").

218 *See* David Cay Johnston, *Obama's Hamburger Problem*, Reuters (Mar. 8, 2012), http://blogs.reuters.com/david-cay-johnston/2012/03/08/ obamas-hamburger-problem/ (on file with the Columbia Law Review) (discussing line-drawing problem inherent in defining manufacturing and noting that making hamburgers does definitionally seem like manufacturing).

219 President's Framework, *supra* note 18, at 11 (footnotes omitted).

220 *See, e.g.*, Camp Opening Statement, *supra* note 203 ("[T]he manufacturing industry is a cornerstone of our economy that provides high-paying and high-quality jobs . . . . Manufacturing is closely connected with research and innovation . . . . [Manufacturing companies contribute to the American economy every day."). For a description of current manufacturing incentives, current legislative proposals, and a summary of the arguments in favor of and against manufacturing incentives, see generally Gary Guenther, Cong. Research Serv., R42742, Federal Tax Benefits for Manufacturing: Current Law, Legislative Proposals, and Issues for the 112th Congress 19-25 (2012), available at http://www.fas.org/sgp/crs/misc/R42742.pdf (on file with the Columbia Law Review). In addition to the arguments discussed here, some proponents justify manufacturing incentives to support energy production from renewable sources. *Id.* at 21-22. That argument is not discussed in this Article since it is actually a justification for targeted subsidies for green energy, not for broad manufacturing incentives. For a discussion of subsidies for green energy, see Michael J. Graetz, The End of Energy: The Unmaking of America's Environment, Security, and Independence 187-95 (2011) [hereinafter Graetz, Energy].

221 Indeed, in a recent survey of academics on whether government policies should focus on manufacturing employment over employment in other sectors, only 5% supported such policies. Initiative on Global Mkts., *Manufacturing*, IGM Forum (Oct. 30, 2012, 11:18 AM), http://www.igmchicago.org/igm-economic-experts-panel/poll-results?SurveyID=SV_bf1N9m71c1yF6jr (on file with the Columbia Law Review). By contrast, 64% supported an R&D tax incentive. *Id.*

222 Dep't of the Treasury, General Explanations 2013, *supra* note 201, at 30.

223 *See* President's Framework, *supra* note 18, at 11; *see also* Dep't of the Treasury, General Explanations 2013, *supra* note 201, at 30 (proposing doubling special deduction for domestic "advanced manufacturing activities").

224 *See* President's Council of Advisors on Sci. & Tech., Exec. Office of the President, Report to the President on Ensuring American Leadership in Advanced Manufacturing 1 (2011) [hereinafter Advisors' Report to the President], available at http://www.whitehouse.gov/sites/default/files/microsites/ostp/pcast-advanced-manufacturing-june2011.pdf (on file with the Columbia Law Review) ("Historically, the manufacturing sector has been tightly linked with the nation's R&D activities. . . . Despite this historic strength, the U.S. manufacturing sector faces enormous challenges, and American leadership and competitiveness in manufacturing is at risk.").

225 *See id.* at 1 & n.11 ("As a fraction of U.S. GDP, manufacturing declined from 27% in 1957 to about 11% by 2009.").

226 *See id.* at 1 & n.12 ("Manufacturing employment declined from 17.6 million jobs in 1998 to just 11.6 million jobs at the end of 2010." (footnote omitted) (citing Bureau of Labor Statistics, Table B-1. Employees on Nonfarm Payrolls by Industry Sector and Selected Industry Detail, Data Retrieval: Employment, Hours, and Earnings, http://www.bls.gov/webapps/legacy/cesbtab1.htm (on file with the Columbia Law Review) (last modified Feb. 5, 2010))).

227 *See id.* at 5 & n.27 ("Between 1999 and 2007, foreign R&D funded by U.S. manufacturing firms grew 191% and their funded R&D performed domestically grew 67% . . . ." (citing Gregory Tassey, *Rationales and Mechanisms for Revitalizing U.S. Manufacturing R&D Strategies*, 35 J. Tech. Transfer 283 (2010))).

228 Office of Sen. Joseph I. Lieberman, Offshore Outsourcing and America's Competitive Edge: Losing Out in the High Technology R&D and Services Sectors 5 (2004), available at http://www.econlineservices.com/lieberman.pdf (on file with the Columbia Law Review).

229 *Id.* at 14.

230 Paul Krugman, *Scale Economies, Product Differentiation, and the Pattern of Trade*, 70 Am. Econ. Rev. 950, 955-58 (1980) (explaining how "home market" effect results in countries exporting products for which they have large domestic demand).

231 *See, e.g.*, Karolina Ekholm & Katarina Hakkala, *Location of R&D and High- Tech Production by Vertically Integrated Multinationals*, 117 Econ. J. 512, 518 (2007) (modeling consumer preferences and firm location decisions).

232 *Cf.* Adam B. Jaffe et al., *Geographic Localization of Knowledge Spillovers as Evidenced by Patent Citations*, 108 Q.J. Econ. 577, 585-97 (1993) (providing evidence that spillovers from R&D are geographically localized).

233 *See, e.g.*, Isabel Tecu, The Location of Industrial Innovation: Does Manufacturing Matter? 1-2 (Sept. 2011) (unpublished manuscript), available at http://www.econ.brown.edu/econ/events/Tecu.pdf (on file with the Columbia Law Review) (noting that manufacturing generally takes place in small cities or rural areas, where land is cheaper, while research institutions are more likely to be found in large metropolitan areas); *see also* Gerald A. Carlino et al., *The Agglomeration of R&D Labs* 1-2 (Research Dep't, Fed. Reserve Bank of Phila., Working Paper No. 11-42, 2011), available at http://www.seas.upenn.edu/~tesmith/R&D_Clustering_Paper.pdf (on file with the Columbia Law Review) (finding that R&D labs are much more geographically concentrated than are manufacturing facilities and attributing concentration of R&D to localized spillover effects).

234 *See, e.g.*, Advisors' Report to the President, *supra* note 224, at 11-12 ("When different aspects of manufacturing–from R&D to production to customer delivery–are located in the same region, they breed efficiencies in knowledge transfer that allow new technologies to develop and businesses to innovate.").

235 Tecu, *supra* note 233, at 3.

236 Björn Ambos, *Foreign Direct Investment in Industrial Research and Development: A Study of German MNCs*, 34 Res. Pol'y 395, 403 (2005).

237 *Id.* at 404 tbl.6.

238 *Id.*

239 Walter Kuemmerle, *Foreign Direct Investment in Industrial Research in the Pharmaceutical and Electronics Industries—Results from a Survey of Multinational Firms*, 28 Res. Pol'y 179, 185-86 (1999).

240 *Id.* at 186 tbl.5.

241 *Id.*

242 Lars Håkanson and Robert Nobel surveyed Sweden's twenty largest manufacturing companies in the chemical and engineering industries regarding their 151 foreign R&D

establishments. Lars Håkanson & Robert Nobel, *Determinants of Foreign R&D in Swedish Multinationals*, 22 Res. Pol'y 397, 398-99 (1993). The authors found that, overall, most of the establishments were geographically linked to producing subsidiaries. *Id.* at 402. However, most of the units that were dedicated exclusively to long-range basic research were not. *Id.* at 400. By contrast, R&D establishments that were intended primarily to support local production or adapt products to local market conditions tended to be colocated with production facilities. *Id.* at 399-400.

Martin Kenney and Richard Florida also suggest that applied research facilities are more likely to be colocated with production. Martin Kenney & Richard Florida, *The Organization and Geography of Japanese R&D: Results from a Survey of Japanese Electronics and Biotechnology Firms*, 23 Res. Pol'y 305, 316 (1994). Based on a mail survey and interviews with R&D managers of large Japanese electronics and biotechnology firms, the authors found that the managers believed it necessary to colocate applied research and production engineering with manufacturing. *Id.* at 307-08, 316. However, the managers indicated that basic research facilities have substantial locational flexibility and need not be colocated with manufacturing, though they may still be. *Id.* at 314.

243 *Cf., e.g.*, Ekholm & Hakkala, *supra* note 231, at 542 (defining high-technology goods as those produced by industries that rank in top ten according to R&D expenditures).

244 Myriam Mariani, *Next to Production or to Technological Clusters? The Economics and Management of R&D Location*, 6 J. Mgmt & Governance 131 (2002).

245 She classified pharmaceuticals and electronics as high-tech industries; chemicals, electrical machinery, and motor vehicles as medium-tech industries; and food, drink and tobacco, and paper and printing as low-tech industries. *Id.* at 36. She found that 37% of R&D affiliates in the high-tech sector were independent from production, while 16.7% were independent in the medium-tech sector and 5.6% were independent in the low-tech sector. *Id.* at 138.

246 Mikko Ketokivi & Jyrki Ali-Yrkkö, Determinants of Manufacturing-R&D CoLocation (Research Inst. of the Finnish Econ., Discussion Paper No. 1082, 2007).

247 *Id.* at 13.

248 *Id.* at 15.

249 *Id.*

250 Nat'l Sci. Found., Science and Engineering Indicators 2012, ch. 4, (2012), available at http://www.nsf.gov/statistics/seind12/pdf/c04.pdf (on file with the Columbia Law Review).

251 *Id.* app. tbl.4-16, at 2, available at http://www.nsf.gov/statistics/seind12/append/c4/at04-16.pdf (on file with the Columbia Law Review).

252 *Id.* at 1.

253 *Id.*

254 *Id.*

255 *Id.*

256 *Id.* at 2.

257 *E.g.*, Gene Sperling, Dir., Nat'l Econ. Council, Remarks at the Conference on the Renaissance of American Manufacturing 1 (Mar. 27, 2012), available at http ://www.whitehouse.gov/sites/default/files/administration-official/sperling_-_renaissance_of_american_manufacturing_-_03_27_12.pdf (on file with the Columbia Law Review) (stating that manufacturing produces high-wage jobs and spillover).

258 President's Framework, *supra* note 18, at 11 ("[M]anufacturing firms . . . employ the majority of scientists and engineers in the private sector.").

259 *See, e.g.*, Eduardo Porter, *The Promise of Today's Factory Jobs*, N.Y. Times, Apr. 4, 2012, at B1 ("Most of the factory jobs lost over the last three decades in this country are gone for good."); *see also* Josh Boak, *White House's Manufacturing Math May Not Add Up*, Politico (Feb. 14, 2012, 11:04 PM), http://www.politico.com/news/stories/0212/72875.

html (on file with the Columbia Law Review) (noting that job loss caused by automation and cheap foreign labor is irreversible trend).

260 *See* Enrico Moretti, The New Geography of Jobs 10-17 (2012) (discussing effects of increased productivity, including decline of traditional manufacturing jobs).

261 Porter, *supra* note 259.

262 *See* Bruce Bartlett, *Does Manufacturing Deserve Special Tax Breaks?*, 134 Tax Notes 1561, 1562 (2012) (attributing decline in U.S. manufacturing to growth of China).

263 Sperling, *supra* note 257, at 6. Before 1999, the percentage of the U.S. workforce engaged in manufacturing was decreasing but the absolute number of manufacturing employees was relatively constant, though the trend toward increased productivity was under way before 1999. *See* William Nordhaus, *The Sources of the Productivity Rebound and the Manufacturing Employment Puzzle* 1 (Nat'l Bureau of Econ. Research, Working Paper No. 11354, 2005), available at http://www.nber.org/papers/w11354.pdf?new_window=1 (on file with the Columbia Law Review) (charting productivity growth since 1970s).

264 Sperling, *supra* note 257, at 5.

265 *See* US Real Gross Domestic Product History: US from FY 1993 to FY 1999, U.S. Gov't Spending, http://www.usgovernmentspending.com/spending_chart_1993_1999USb_13s1li011lcnUS_Real_Gross_Domestic_Product_History#view (on file with the Columbia Law Review) (last visited Jan. 2, 2013) (charting GDP from 1993 to 1999).

266 Nordhaus, *supra* note 263, at 16-17. This study was updated with similar results by the Brookings Institute. *See* Susan Helper, et al., *Why Does Manufacturing Matter? Which Manufacturing Matters?* (2012), available at http://www.brookings.edu/~/media/research/files/papers/2012/2/22%20manufacturing%20helper%20krueger%20wial/0222_manufacturing_helper_krueger_wial.pdf (on file with the Columbia Law Review) (stating that manufacturing has high potential for increasing employment).

267 Nordhaus, *supra* note 263, at 17.

268 Sperling, *supra* note 257, at 6.

269 *See, e.g.*, Boak, *supra* note 259 (discussing "three-decade-long slide" in manufacturing employment).

270 *Id.* (stating Intel's employment rates from 2000 to 2010).

271 *Id.*

272 Michael Greenstone et al., *Identifying Agglomeration Spillovers: Evidence from Winners and Losers of Large Plant Openings*, 118 J. Pol. Econ. 536 (2010).

273 *Id.* at 589.

274 *Id.* at 592.

275 *Id.*

276 Christina D. Romer, *Do Manufacturers Need Special Treatment?*, N.Y. Times, Feb. 5, 2012, at BU4.

277 *See* Glenn Ellison & Edward L. Glaeser, *Geographic Concentration in U.S. Manufacturing Industries: A Dartboard Approach*, 105 J. Pol. Econ. 889, 909 (1997) (finding "slight" concentration to be norm).

278 Romer, *supra* note 276.

279 *See supra* notes 3-6 and accompanying text (discussing underinvestment in R&D).

280 Michael Spence & Sandile Hlatshwayo, *The Evolving Structure of the American Economy and the Employment Challenge* 1 (Mar. 2011) (Council on Foreign Rel., unpublished working paper), available at http://cfr.org/content/publications/attachments/CGS_WorkingPaper13_USEconomy.pdf (on file with the Columbia Law Review).

281 *Id.* at 11.

282 *Id.* at 9.

283 *Id.* at 14-15.

284 *Id.* at 12 (finding almost all job growth in nontradable sector). At the same time, the tradable sector experienced a slightly greater increase in value added, the difference between a company's final sales and its purchase inputs. *Id.* at 19. The authors suggest that value added of the tradable sector increased despite loss of jobs because low-value-added jobs were outsourced abroad while the higher-value-added jobs stayed in the United States. *See id.* at 24 (noting movement of low-value jobs out of United States).

285 *Id.* at 31 ("In our view, it is unlikely that this pattern will continue.").

286 *Id.*

287 *Id.* at 31-32.

288 *See id.* at 33-34 (acknowledging lack of market failure but identifying difficulties middle-class Americans face in obtaining employment); *see also* Michael Spence, The Next Convergence: The Future of Economic Growth in a Multispeed World 262-64 (2011) (describing difficulties for middle-class Americans due to job migration to other countries).

289 Spence & Hlatshwayo, *supra* note 280, at 35-36.

290 *Id.* at 36.

291 *See, e.g.*, Spence, *supra* note 288, at 200 (describing services that are outsourced to India, including information technology services, business processes, expert medical services, film editing for television, grading exams, and writing political speeches).

292 Linda Levine, Cong. Research Serv., RL32292, Offshoring (or Offshore Outsourcing) and Job Loss Among U.S. Workers 9 (2011); *see also* J. Bradford Jensen & Lori G. Kletzer, *Tradable Services: Understanding the Scope and Impact of Services Outsourcing* 1 (Inst. for Int'l Econ., Working Paper No. 05-9, 2005) (finding a significant number of service occupations tradable); Eric B. Figueroa & Rose A. Woods, Bureau of Labor Statistics, *Employment Outlook: 2006-2016—Industry Output and Employment Projections to 2016*, Monthly Lab. Rev., Nov. 2007, at 53, 56-57, 63, 65, 72, available at http://www.bls.gov/opub/mlr/2007/11/art4full.pdf (on file with the Columbia Law Review) (projecting offshore outsourcing would slow rate of employment growth in professional and business services, computer systems design and related services, information services, and software publishing).

293 Levine, *supra* note 292, at 9.

294 Sherlock, *supra* note 191, at 1.

295 Jane G. Gravelle, Cong. Research Serv., R41743, International Corporate Tax Rate Comparisons and Policy Implications 20 (2011); *see also* Sherlock, *supra* note 191, at 1.

296 *See* Sherlock, *supra* note 191, at 18 (arguing one policy option would be "to allow the deduction for activities that tend to be associated with positive externalities" such as R&D).

297 *See, e.g.*, Jeffrey H. Birnbaum, The Lobbyists: How Influence Peddlers Work Their Way in Washington 3 (1993) (noting reluctance of government to crack down on businesses).

298 *See generally* R&D Credit Coalition—Invest in America's Future, http://www.investinamericasfuture.org (on file with the Columbia Law Review) (last visited Feb. 1, 2013) (stating Coalition's objectives). Between its initial enactment and January 2012, the credit was amended or extended fifteen times, see Tyson & Linden, *supra* note 6, at 26 tbl.5, and the R&D Credit Coalition has played an active role in the process. *E.g.*, Certain Expiring Tax Provisions: Hearing Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means, 112th Cong. (2012) (statement of R&D Credit Coalition).

299 *Cf.* Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: A Tale of Death, Money & Taxes* 6 (USC Law & Econ. Research Paper No. 04-20, 2004), available at http://ssrn.com/abstract=581084 (on file with the Columbia Law Review) (arguing similar

phenomenon has occurred with estate tax reform).

300 *See GlaxoSmithKline Threatens to Move Investment out of U.K. in Tax Debate*, WRAL Tech Wire (Dec. 11, 2009, 1:30 PM), http://wraltechwire.com/business/ tech_wire/news/blogpost/6597968/ (on file with the Columbia Law Review) (discussing GSK's threat to move investments out of United Kingdom); *see also* Press Release, GlaxoSmithKline, GSK Confirms Significant Investment in UK Manufacturing: Ulverston in Cumbria Selected as Site of New Biopharmaceutical Factory (Mar. 22, 2012), http://www.gsk.com/media/press-releases/2012/gsk-confirms-significant-investments-in-uk-manufacturing-ulverston-in-cumbria-selected-as-site-of-new-biopharmaceutical-factory.html (on file with the Columbia Law Review) (quoting GSK CEO Andrew Witty as saying, "The introduction of the patent box has transformed the way in which we view the UK as a location for new investments, ensuring that the medicines of the future will not only be discovered, but can also continue to be made here in Britain." (internal quotation marks omitted)).

301 2 Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 375-76 (Edwin Cannan ed., Univ. of Chi. 1976) (1776).

302 Much has been written about these strategies, and proposals for reform are ubiquitous. *See, e.g.*, Dep't of the Treasury, General Explanations 2013, *supra* note 201, at 88-89 (describing President Obama's proposal to tax currently excess returns associated with transfer of intangibles offshore); Elizabeth Chorvat, *Forcing Multinationals to Play Fair: Proposals for a Rigorous Transfer Pricing Theory*, 54 Ala. L. Rev. 1251, 1254 (2003) (proposing use of modern valuation pricing theories such as capital asset pricing model to better allocate income among parties); Charles McClure, Jr., *U.S. Federal Use of Formula Apportionment to Tax Income from Intangibles*, 14 Tax Notes Int'l 859, 860 (1997) (discussing coordinated multilateral adoption of formulary apportionment); Reuven S. Avi- Yonah & Kimberly A. Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment* 2 (Brookings Inst., Hamilton Project Discussion Paper No. 2007-08, 2007), available at http://www.brookings.edu/~/media/research/files/papers/2007/6/corporatetaxes-clausing/200706clausing_aviyonah (on file with the Columbia Law Review) (proposing system of formulary apportionment); infra Part V (reviewing proposals).

303 *See* Joint Comm. Pamphlet, *supra* note 175, at 105 ("Shifting income from high-tax to low-tax jurisdictions increases the after-tax earnings of multinational companies."); Rachel Griffith et al., *International Capital Taxation*, in 1 Mirrlees Review: Dimensions of Tax Design, *supra* note 9, at 914, 929-31, available at http://www.ifs.org.uk/mirrleesreview/dimensions/ch10.pdf (on file with the Columbia Law Review) (analyzing effects of tax rates on corporate and government behavior); Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy*, 132 Tax Notes 1021, 1021 (2011) (describing how MNEs capture "tax rents" by moving income from high-tax to low-tax jurisdictions).

304 OECD, Transfer Pricing Aspects of Business Restructurings: Discussion Draft for Public Comment 19 September 2008 to 19 February 2009, f A.1, at 6, available at http://www.oecd.org/tax/transferpricing/41346644.pdf (on file with the Columbia Law Review); Joint Comm. Pamphlet, *supra* note 175, at 51-102.

305 Hearing on Transfer Pricing Issues Before the H. Comm. on Ways and Means, 111th Cong. 2, 4-5 (2010) (prepared testimony of Thomas A. Barthold, Chief of Staff, J. Comm. on Taxation).

306 *Id.* at 2 ("Each of the six cases selected had an effective (i.e., average) tax rate on worldwide income of less than 25 percent during at least one multi-year period since 1999.").

307 Joint Comm. Pamphlet, *supra* note 175, at 16-17.

308 This can occur by having the low-tax principal incur expenses related to production, enhancement, or exploitation of IP. *Id.* at 15-16.

309 Robert J. Misey, Jr. & Michael S. Schadewald, Practical Guide to U.S. Taxation of International Transactions ¶ 805.04, at 251 (7th ed. 2009).

310 Joint Comm. Pamphlet, *supra* note 175, at 14.

311 *Id.* at 14-15.

312 *Id.* at 20-22.

313 *Id.* at 115.

314 *See* I.R.C. §§ 861 (a)(4), 862(a)(4) (taxing U.S. royalty income based on IP location within United States).

315 Because the United States now has a higher statutory corporate tax rate than other developed countries, some companies may not now have sufficient credits from high-tax countries to shelter their royalties this way. Most European nations in recent years have broadened their corporate income tax bases by slowing depreciation allowances and eliminating or reducing other special provisions to help fund lower corporate income tax rates. *See* OECD, Policy Brief, Reforming Corporate Income Tax 3 & fig.2 (2008), available at www.oecd.org/dataoecd/30/16/41069272.pdf (on file with the Columbia Law Review) (noting most countries have broadened their corporate tax bases in line with reductions in corporate tax rates and providing data on Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and United Kingdom). The top statutory corporate tax rates in Europe have been reduced from an average of 31.9% in 2000 to 23.2% in 2010. Press Release, Eurostat, EU27 Tax Ratio Fell to 39.3% of GDP in 2008 (June 28, 2010), available at epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-28062010-BP/EN/2-28062010-BP- EN.PDF (on file with the Columbia Law Review).

316 Joint Comm. Pamphlet, *supra* note 175, at 115.

317 *Id.* at 20.

318 In 2008, the Treasury Department and IRS issued temporary regulations that sought to temper the tax reduction benefits of cost-sharing arrangements. In 2011, the temporary regulations were replaced with final regulations. T.D. 9568, 2012-12 I.R.B. 499, available at http://www.irs.gov/pub/irs-irbs/irb12-12.pdf (on file with the Columbia Law Review). The regulations apply an investor model to determine buy-in payments. Under this investor model, participants that contribute only cash are viewed as making a low-risk investment (because they do not share in the risk of developing the contributed IP in the first place) and are thus required to pay more to the entity that contributes the IP.

319 Joint Comm. Pamphlet, *supra* note 175, at 51-102.

320 *Id.* at 62-72.

321 *Id.* at 77-83.

322 In another example, "Alpha," a company that manufactures and markets consumer products makes extensive use of contract manufacturing to shift a significant portion of its profits to a jurisdiction where it pays no tax. *Id.* at 54-61. Alpha Asia, a 99.9%-owned subsidiary, manufactures many of Alpha's products through hundreds of contract manufacturers. Alpha Asia oversees production and bears substantial risk and responsibility, but its Asian office has fewer than fifty employees. Alpha U.S. (Alpha and its domestic affiliates) conducts R&D for Alpha Asia and then licenses technical information and IP to Alpha Asia and its contract manufacturers for a license fee equal to 3% of the standard cost of production for manufactured products or 3% of the purchase price for purchased products. Alpha U.S. also receives a 2% commission on sales to certain U.S. customers of products developed by Alpha U.S. Then, Alpha Asia sells its products to Alpha U.S., other foreign distributors, and U.S. customers. Sixty-five percent of Alpha Asia's sales are made to Alpha U.S. This structure shifts to Alpha Asia a substantial portion of Alpha's profits, including profits from U.S. sales. Alpha Asia is located in a jurisdiction where it is not taxed (such as Singapore). Alpha U.S. receives only a 3% license fee, perhaps some reimbursement for costs of product development, and potentially a 2% sales commission despite the fact that it provides product development and most of the engineering and manufacturing technology used by Alpha Asia. In this case, almost 60% of Alpha's sales are to U.S. customers, but less than 30% of its pretax earnings are reported as U.S. earnings. *Id.* at 54-61.

323 *Id.* at 105. The locations of contract manufacturers and limited-risk distributors

were typically chosen for nontax business or historical reasons, often in higher-tax jurisdictions. *Id.*

324 *See* Charles Duhigg & David Kocieniewski, *How Apple Sidesteps Billions in Taxes*, N.Y. Times, Apr. 29, 2012, at A1 (discussing Apple's use of "Double Irish with a Dutch Sandwich" to funnel earnings to low-tax regions); Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, Bloomberg (Oct. 21, 2010), http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html [hereinafter Drucker, *Google Tax Loopholes*] (on file with the Columbia Law Review) (detailing Google's use of "Double Irish" and "Dutch Sandwich" strategies to move foreign profits through Ireland and the Netherlands to tax haven Bermuda). For a detailed description of Google's use of the Double Irish Dutch Sandwich structure, see Edward D. Kleinbard, *Stateless Income*, 11 Fla. Tax Rev. 699, 70613 (2011) [hereinafter Kleinbard, *Stateless Income*]. Google makes use of cost-sharing agreements and licensing agreements between its foreign subsidiaries to reduce its tax burden. Basically, the "Double Irish" involves two Irish subsidiaries, one of which ("S1") has been given ownership of IP created by the U.S. parent corporation. J. Bryan Lowder, *The Double Irish and the Dutch Sandwich*, Slate (Apr. 14, 2011, 6:00 PM), http://www.slate.com/articles/news_and_politics/explainer/2011/04/the_double_irish_and_the_dutch_sandwich.html (on file with the Columbia Law Review). Alternatively, S1 may enter into a cost-sharing arrangement with the parent corporation to develop the relevant IP. Joseph B. Darby III & Kelsey Lemaster, *Double Irish More Than Doubles the Tax Savings*, Prac. US/Int'l Tax Strategies, May 15, 2007, at 2, 13. S1 transfers its headquarters to Bermuda, which has no income tax, thus becoming a Bermuda resident. Because of their different tax laws, the United States views the subsidiary as Irish but Ireland views the subsidiary as nonresident. S1 then licenses the IP to a wholly owned Irish subsidiary, "S2," which is not recognized as a corporation by the United States but is recognized by Ireland. The United States allows certain entities to elect to be classified as a corporation, partnership, or disregarded entity by "checking the box" on IRS Form 8832. Partnerships and disregarded entities are not recognized for U.S. tax purposes, and their assets and income are instead attributed to their parent corporation. S2 collects the income from the IP in Ireland, where it experiences a low tax rate, and is able to deduct the royalties it pays to S1 under Irish tax laws. This transaction is not taxed by the United States, as under U.S. law it is viewed as a transfer within a single Irish corporation. Thus, the royalties are untaxed but are deductible, and the IP income is taxed at a low rate. U.S. taxes are avoided. Google is able to attribute the income from the IP to Ireland, despite the fact that it is developed in the United States. Google may further minimize U.S. tax liability by setting an artificially low price on the IP in the first place. *See* Jesse Drucker, *Google Has Made $11.1 Billion Overseas Since 2007. It Paid Just 2.4% in Taxes. And That's Legal.*, Bloomberg Businessweek, Oct. 25-Oct. 31, 2010, at 43, 44 [hereinafter Drucker, *Tax Haven*] (discussing Google's incentive to set licensing price as low as possible to further shift profits overseas in "transfer pricing" arrangement). Alternatively, if Google initially made use of a cost-sharing arrangement between S1 and the parent corporation, the parent corporation's contribution might be undervalued, lowering the U.S.-taxed buy-in payment from S1. Such schemes have allowed Google to avoid billions of dollars in taxes. Drucker, *Google Tax Loopholes*, *supra*.

Google apparently also makes use of a slightly more complex scheme building on the Double Irish, the so-called Dutch Sandwich. Kleinbard, *Stateless Income*, *supra*, at 706-13 (detailing development and structure of Google's "Double Irish Dutch Sandwich" scheme); Lowder, *supra* (providing overview of Double Irish and Dutch Sandwich schemes). In addition to the two Irish subsidiaries (one of which has its headquarters in Bermuda), Google sets up a third subsidiary ("S3") in the Netherlands. Instead of licensing the U.S. parent's IP directly to S2, S1 grants it to S3, which then passes the IP along to S2. Thus, S3 serves as an intermediary between S1 and S2. Ireland does not tax money moved between EU countries, and the transfer from S3 to S2 is taxed at a very low rate by the Netherlands. The benefit of this agreement is that the royalties on the IP basically go untaxed. Apparently Apple uses similar arrangements. *See* Duhigg & Kocieniewski, *supra* (describing Apple's use of Double Irish Dutch Sandwich and other tax strategies).

325 *See supra* note 324 (providing details of Google and Apple's strategies).

326 Offshore Profit Shifting and the U.S. Tax Code: Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs, 112th Cong. 2 (2012) (statement of Sen. Carl Levin, Chairman, Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs), available at http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit- shifting-and-the-us-tax-code (follow "Chairman, Permanent Subcommittee on Investigations CARL LEVIN D (MI) —Download Statement" hyperlink) (on file with the Columbia Law Review).

327 *Id.* at 2-3. For more detail, also see the exhibits prepared by the subcommittee's staff for this hearing. *Id.* at 8-10. William J. Sample, Corporate Vice President for Worldwide Tax at Microsoft, described Microsoft's contributions to the U.S. economy, especially in the state of Washington, pointed out that Microsoft had complied with U.S. tax law and paid billions in U.S. taxes in connection with royalties and cost-sharing buy-in payments from its subsidiaries, emphasized that Microsoft's Ireland and Singapore subsidiaries served foreign markets, and urged that U.S. tax law be reformed "to support the ability of worldwide American businesses to compete in global markets and invest in the U.S." *Id.* at 1-10 (testimony of William J. Sample).

328 *See* Gonzalo Vina, *U.K. Lawmakers Accuse Starbucks, Amazon, Google of Tax Avoidance*, Bloomberg Businessweek (Nov. 12, 2012), available at, http://www.businessweek.com/news/2012-11-12/u-dot-k-dot-lawmakers-accuse-starbucks-amazon-google-of-tax-avoidance (on file with the Columbia Law Review) (describing Committee hearing).

329 Committee of Public Accounts, HM Revenue & Customs: Annual Report and Accounts 2011-12, 2012-13, H.C. 716, at 10 (U.K.), available at http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf.

330 Simon Neville & Jill Treanor, *Starbucks To Pay £20M in Tax Over Next Two Years After Customer Revolt*, Guardian (U.K.) (Dec. 6, 2012), http://www.guardian.co.uk/business/2012/dec/06/starbucks-to-pay-10m-corporation-tax.

331 Press Release, HM Treasury, Statement by the Chancellor of the Exchequer, Rt. Hon. George Osborne MP, Britain & Germany Call for International Action to Strengthen Tax Standard (Nov. 5, 2012), http://www.hm-treasury.gov.uk/chx_statement_051112.htm (on file with the Columbia Law Review). The OECD has also begun a multilateral project to combat "base erosion and profit shifting," the preliminary findings of which it recently reported to the G-20. OECD, Addressing Base Erosion and Profit Shifting (2013), available at http://www.oecd-ilibrary.org/ taxation/addressing-base-erosion-and-profit-shifting-9789264192744-en.

332 Julie Roin, *Can the Income Tax be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 Tax L. Rev. 169, 182 (2008).

333 *See* Kimberly A. Clausing, *The Revenue Effects of Multinational Firm Income Shifting*, 130 Tax Notes 1580, 1585 (2011) (estimating revenue loss of $90 billion in 2008 from corporate profit-shifting alone); Drucker, *Tax Haven*, *supra* note 324, at 44 (using estimate of $60 billion provided by Kimberly Clausing, economics professor at Reed College). For additional estimates and further analysis of profit-shifting by U.S. MNEs, see Mark P. Keightly, Cong. Research Serv., R24927, An Analysis of Where American Companies Report Profits: Indications of Profit Shifting 1 (2013) (concluding that profits in tax havens are far greater than either employment or capital investment there and that profit-shifting has increased in recent years).

334 Joint Comm. Pamphlet, *supra* note 175, at 110. Because I.R.C. § 41 treats all members of a group under common control as a single entity, the regulations allow R&D credits even when a foreign affiliate funds the R&D, which will serve in shifting the resulting income abroad. I.R.C. § 41(f)(1) (2006); Treas. Reg. § 1.41-6(i) (2011).

335 *See* sources cited *supra* note 331; Dhammika Dharmapala & Nadine Riedel, *Earnings Shocks and Tax-Motivated Income-Shifting: Evidence from European Multinationals* 2 (Ill. Program in Law, Behavior & Soc. Sci., Working Paper No. LBSS11-09, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1629792 (on file with the Columbia Law Review) (finding evidence of significant income-shifting by European multinationals

and noting income-shifting is seen as problem for high-tax countries worldwide).

336 *See* James R. Hines, Jr., *Income Misattribution Under Formula Apportionment*, 54 Eur. Econ. Rev. 108, 110 (2010) [hereinafter Hines, *Income Misattribution*] (discussing proposals implementing formulas based on employment, sales, and property); McClure, *supra* note 302, at 860 (proposing coordinated multilateral adoption of formulary apportionment with formula potentially including some weighting of payroll, property, and sales); Roin, *supra* note 332, at 235-39 (identifying two potential solutions: countries extending jurisdictional claim over business profits or proceeds from wider variety of agency relationships and extending reach of gross basis taxation of income derived from nonresident taxpayers); *see also infra* notes 401-410 and accompanying text (discussing proposals to adopt formulary apportionment and assessing their shortcomings).

337 *See, e.g.*, Jason Gorringe, *OECD Members Tighten up Their CFC Rules*, Tax-News (Apr. 11, 2001), available at http://www.tax-news.com/news/OECD_Member_States_Tighten_Up_Their_CFC_Rules3080.html (on file with the Columbia Law Review) (describing efforts of OECD countries to tighten CFC rules).

338 *See* President's Framework, *supra* note 18, at 14 (describing minimum tax on foreign earnings to protect U.S. tax base and strengthen international corporate tax system).

339 For a discussion of the fragility of both the "residence" and "source" concepts, see Michael J. Graetz, *The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L. Rev. 261, 320 (2001) [hereinafter Graetz, *Inadequate Principles*].

340 *Supra* Parts I, II, III.

341 A credit for R&D, for example, was adopted in the Economic Recovery Tax Act of 1981, more than thirty years ago. Pub. L. 97-34, § 221, 95 Stat. 172, 241-47. The credit was then located in section 44F of the Internal Revenue Code. § 221(a), 95 Stat. at 241.

342 *Cf., e.g.*, Atkinson & Andes, *supra* note 12, at 15 (referring to race for global innovation advantage).

343 *See* Ian Roxan, *Limits to Globalization: Some Implications for Taxation, Tax Policy, and the Developing World* 23-24 (LSE Law, Soc'y & Econ., Working Paper No. 3/2012, 2012), available at http://ssrn.com/abstract=1995633 (on file with the Columbia Law Review) ("In the case of tax competition, governments actively set tax rates, so this does not look like the result of perfect competition.").

344 *See* Michael P. Devereux, Ben Lockwood & Michela Redoano, *Do Countries Compete over Corporate Tax Rates?*, 92 J. Pub. Econ. 1210, 1211 (2008) (stating that "[b]oth the European Union and the OECD introduced initiatives in the late 1990s designed to combat what they see as 'harmful' tax competition"); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 Yale L.J. 1186, 1228 n.143 (2006) (explaining "the Commission's ongoing efforts to harmonize member states' corporate income taxes"); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility*, 121 Yale L.J. 1118, 1122 (2012) ("[I]ncome tax rates and bases differ markedly throughout the EU."); Roxan, *supra* note 343, at 21-32 (discussing question of whether tax competition is desirable).

345 For a good summary of the statements of U.S. politicians about the need for the United States to "compete," see Eric Toder, *Urban-Brookings Tax Policy Ctr., International Competitiveness: Who Competes Against Whom and for What?* 1-2 (2012), available at http://tpcprod.urban.org/UploadedPDF/ 412477-international-competitive ness.pdf (on file with the Columbia Law Review).

346 *See generally id.*

347 *See id.* at 2-3 (" [I]s there an economic competition between nations that is analogous to this zero-sum competition between . . . companies? The basic premise of most economic theory says no.").

348 *Id.* at 2; *see also* David Ricardo, On the Principles of Political Economy and Taxation 146 (1817) ("No extension of foreign trade will immediately increase the

amount of value in a country, although it will powerfully contribute to increase the mass of commodities, and therefore sum of enjoyments.").

349 Toder, *supra* note 345, at 3 (quoting Paul Krugman, *Competitiveness: A Dangerous Obsession*, Foreign Affairs, March/April 1994, at 28, 41).

350 Toder, *supra* note 345, at 3.

351 *See* Rosanne Altshuler & Harry Grubert, *The Three Parties in the Race to the Bottom: Host Governments, Home Governments and Multinational Companies*, 7 Fla. Tax Rev. 153, 155 (2005) (discussing international competition to attract mobile companies); Eric Solomon, *Corporate Inversions: A Symptom of Larger Tax System Problems*, 67 Tax Notes Int'l 1203, 1211 (2012) (describing proliferation of corporate inversions, which rearrange corporate structures to locate parent corporation in lower-tax jurisdiction).

352 *See supra* Part II.D (summarizing data on benefits of R&D tax incentives).

353 For more information on the justifications for manufacturing incentives, see *supra* Part III.C.

354 *See* Staff of J. Comm. on Taxation, 110th Cong., Present Law and Analysis Relating to Individual Retirement Arrangements 5-7 (Comm. Print 2008), available at https://www.jct.gov/publications.html?func=startdown&id=1286 (on file with the Columbia Law Review) (noting that traditional IRAs, which allow for immediate deduction of contributions but require inclusion of distributions in income, and Roth IRAs, which do not allow for deduction of contributions but do not require taxation of distributions, are economically equivalent if taxpayer's marginal tax rate remains constant); Graetz & Schenk, *supra* note 183, at 298-301 (demonstrating that, under certain conditions, immediate deduction is equivalent to yield exemption).

355 For more discussion of the geographical scope of spillovers from R&D, see *supra* note 78 and accompanying text.

356 This is because of the "home country bias," which disproportionately concentrates ownership of home-country MNEs in residents and citizens of the home country. *See generally, e.g.*, Kenneth R. French & James M. Poterba, *Investor Diversification and International Equity Markets*, 81 Am. Econ. Rev. 222 (1991) (discussing why investors invest disproportionately in domestic stocks compared to optimally diverse portfolio); Piet Sercu & Rosanne Vanpee, Home Bias in International Equity Portfolios: A Review (Aug. 8, 2007) (unpublished manuscript), available at https://lirias.kuleuven.be/bitstream/123456789/175483/1/AFI_0710.pdf (on file with the Columbia Law Review) (same).

357 *See generally* Nirupama Rao, Do Tax Credits Stimulate R&D Spending?: Revisiting the Effect of the R&D Tax Credit in its First Decade (Sept. 2010) (unpublished manuscript), available at http://economics.mit.edu/files/5540 (on file with the Columbia Law Review) (last visited Jan. 25, 2013) (finding R&D credit has had substantial effect on qualified research spending but not necessarily total spending).

358 *See supra* notes 15-16 and accompanying text (discussing R&D tax credit's base-period requirements).

359 *See, e.g.*, OECD, The International Experience, *supra* note 7, at 16 ("The most common scheme used by countries is a volume-based tax incentive with current R&D . . . or current and machinery and equipment (M&E) R&D as eligible expenditures . . . .").

360 From 1981 until 1989, the base period was a rolling three-year period, but in 1989, the base period was set at 1984-1989, where it has remained ever since. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7110, 103 Stat. 2106, 2322.

361 *See* Deloitte, 2012 Global Survey of R&D Tax Incentives 38 (2012), available at http://www.nam.org/~/media/0C454F85FE324C678330C1CCA0E92168/Global_RD_Survey_September_2012_FINAL.pdf (on file with the Columbia Law Review) (noting only eight of twenty-eight countries surveyed offer some form of refundable credit).

362 *See* Graetz, Energy, *supra* note 220, at 188-95 (describing inadequacies of congressional subsidies and earmarks for green energy projects).

363 *See supra* notes 134-150 and accompanying text (describing structure of U.K.'s patent

box).

364 *See supra* Part II.A (describing tax benefits for IP income in various EU countries).

365 *See, e.g.*, HM Revenue & Customs, Technical Note, *supra* note 135, at 9-11 (describing calculation of income, including subtracting routine return, for operation of U.K. patent box).

366 For example, the U.K. patent box calculates the routine return as a fixed 10% markup above costs. *Id.* at 11.

367 For a discussion of the European Commission's decision to prevent Ireland from limiting its patent income exemption to IP for which the R&D took place in Ireland, see *supra* notes 131-132 and accompanying text.

368 *See* Merrill et al., *supra* note 87, at 1673 ("Other than the Netherlands, EU countries with patent box regimes generally do not require that development costs be deducted from IP box income.").

369 *Id.* at 1673 (emphasis in original). "Determined as the present value of tax liability (-$20.4) divided by the present value of net patent income ($100)." *Id.* at 1673 n.6.

370 For examples and some estimates for U.S. MNEs, see Harry Grubert & Rosanne Altshuler, Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax 21-25, 55 tbl.1 (June 7, 2012) [hereinafter Grubert & Altshuler, Fixing the System] (unpublished manuscript), available at http://www.sbs.ox.ac.uk/centres/tax/symposia/Documents/2012/Grubert%20Altshuler%20Fixing%20the%20Syst em%20 Oxford%20Version.pdf (on file with the Columbia Law Review). For a discussion of income-shifting techniques, see supra Part IV.

371 *See* Cong. Budget Office, Federal Support for Research and Development 10 (2007), available at http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/82xx/doc8221/06-18-research.pdf (on file with the Columbia Law Review) (comparing benefits of research simpliciter with research and development).

372 *See supra* Part III.C.1 (describing link between R&D and manufacturing).

373 *See supra* notes 250-256 and accompanying text (discussing R&D performed by manufacturing firms).

374 Laura D'Andrea Tyson, *Why Manufacturing Still Matters*, Economix Blog, N.Y. Times, (Feb. 10, 2012, 6:00 AM), http://economix.blogs.nytimes.com/2012/02/10/why-manufacturing-still-matters (on file with the Columbia Law Review).

375 J. Bradford Jensen, *Op-Ed., Think Services, Not Manufacturing*, Wash. Post, Feb. 24, 2012, at A15.

376 *Id.*

377 Romer, *supra* note 276, at BU4 ("Increased international competition has forced American manufacturers to reduce costs. As a result, the pay premium for low-skilled workers in manufacturing is smaller than it once was.").

378 *Id.*

379 *Id.*

380 *Id.*

381 Total employment is projected to grow by 14.3% over the decade. Of the 20.5 million new jobs, the two largest contributors are the health care and social assistance sector (5.6 million) and the professional and business services sector (3.8 million). By comparison, many of the specific industries projected to lose the most jobs are in the manufacturing sector. Bureau of Labor Stat., U.S. Dep't of Labor, Employment Projections: 2010-2020 Summary 1-2 (2012), available at http://bls.gov/news.release/pdf/ecopro.pdf (on file with the Columbia Law Review).

382 *See supra* notes 272-279 and accompanying text (examining claim that manufacturing causes spillover effects).

383 Spence, *supra* note 288, at 64-68.

384 *Id.* at 65-66.

385 *Id.* at 67 ("Growth strategy and policy have everything to do with . . . avoiding barriers and structural impediments . . . .").

386 Id. at 68.

387 *See* HM Treasury, Corporate Tax Reform, *supra* note 136, at 23-44 (discussing United Kingdom's plan for reform of CFC rules to target artificially diverted U.K. profit); *supra* notes 151-158 and accompanying text (discussing Camp proposal). Because the low rate of the Camp proposal applies to foreign, but not domestic, sales, it might create a new incentive to shift income abroad, offering an additional reason to address IP income-shifting.

388 OMB, 2013 Budget, *supra* note 18, at 220 tbl.S-9; Office of Mgmt. & Budget, Exec. Office of the President, Budget of the United States Government, Fiscal Year 2012, at 220 tbl.S-9 (2011); Office of Mgmt. & Budget, Exec. Office of the President, Budget of the United States Government, Fiscal Year 2011, at 161 tbl.S-8 (2010); Office of Mgmt. & Budget, Exec. Office of the President, Budget of the United States Government, Fiscal Year 2010, Updated Summary Tables 21 tbl.S-11 (2009). Many observers are concerned that eliminating any tax barrier to repatriation would increase companies' incentives for shifting income to low- or zero-tax jurisdictions. The limited economic evidence, however, does not indicate that this is likely. *See* Kevin S. Markle, *A Comparison of the Tax-Motivated Income Shifting of Multinationals in Territorial and Worldwide Countries* 40 (2010), available at http://eureka.bodleian.ox.ac.uk/3199/1/WP_12_06.pdf (on file with the Columbia Law Review) (finding no statistically significant difference in income-shifting when firms can defer repatriation of shifted income).

389 *See* President's Framework, *supra* note 18, at 1.

390 *See* Technical Explanation, *supra* note 13, at 18 (discussing Camp's proposed dividends-received deduction). The United Kingdom adopted a 100% dividend exemption in 2009. *See* Barbara Angus et al., *Special Report: The U.S. International System at a Crossroads*, Tax Notes, Apr. 5, 2010, at 45, 54 tbl.3, available at http://taxprof.typepad.com/files/angus.pdf (on file with the Columbia Law Review).

391 *See supra* note 302 and accompanying text (describing several proposals).

392 *See* Timothy J. Goodspeed & Ann Dryden White, *International Taxation*, *in* 4 Encyclopedia of Law and Economics 256, 257 (Boudewijn Bouckaert & Gerrit de Geest eds., 2000) ("All countries claim the right to tax all income generated within that country's border; that is, all countries begin with a source basis for taxation.").

393 President's Framework, *supra* note 18, at 14-15.

394 Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (amending I.R.C. § 482 (2006)).

395 *See* Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11312, 104 Stat. 1388, 1388-454 to -455 (amending I.R.C. § 6662(e), (h)) (amending tax code to penalize misstatements, rather than just overstatements, and lowering threshold from 400% to 200% overvaluation).

396 For a discussion of the proposed and final regulations implementing I.R.C. § 482, see PricewaterhouseCoopers LLP, International Transfer Pricing 2012, at 792-95 (2012), available at http://download.pwc.com/ie/pubs/2012_international_transfer_pricing.pdf (on file with the Columbia Law Review). In 1993, the IRS issued temporary regulations under § 482 and proposed regulations under § 6662(e) and (h), the penalty provisions. Temp. Treas. Reg. § 1.482 (1993); Prop. Treas. Reg. § 1.6662-5, 58 Fed. Reg. 5304, 5306-10 (Jan. 21, 1993). In 1994, the IRS issued temporary and proposed regulations under § 6662(e) and (h) and final regulations under § 482. Temp. Treas. Reg. §§ 1.6662-5T to 1.6662-6T (1994); Treas. Reg. § 1.482 (1994). In 1995, the IRS issued final regulations on cost sharing. Treas. Reg. § 1.482-7 (1995). In 1996, the IRS issued final transfer pricing penalty regulations under Treas. Reg. § 1.6662-6 (1996). In 2003, the IRS issued final regulations on costs associated with stock options involved in cost-sharing arrangements. Treas. Reg.

§ 1.482 (2003). Also in 2003, the IRS issued proposed regulations on intragroup services. Prop. Treas. Reg. § 1.482, 68 Fed. Reg. 53448, 53448-82 (Sept. 10, 2003). Temporary and proposed regulations were issued in 2006 and finalized in 2009. Temp. Treas. Reg. § 1.482 (2006); Treas. Reg. § 1.482 (2009).

397 For information on the OECD's efforts, see Transfer Pricing, OECD, http://www.oecd.org/ctp/transferpricing (on file with the Columbia Law Review) (last visited Jan. 25, 2012). The OECD first issued guidelines in 1979. It issued the first draft of the current guidelines in 1995. OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995). Those guidelines were expanded between 1996 and 1999. In 2010, the OECD issued a substantially revised version of the guidelines. OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010), available at http://codfiscal.realitatea.net/act-pdf/OECD-transfer-pricing- guidelines.pdf (on file with the Columbia Law Review). Those guidelines provide additional guidance on selecting the appropriate transfer pricing method, applying transactional profit methods, and performing a comparability analysis. *Id.* at 22. In 2010, the OECD began a project on the transfer pricing treatment of intangibles. OECD, Discussion Draft: Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions 3 (2012), available at http://www.oecd.org/ctp/transferpricing/50526258.pdf (on file with the Columbia Law Review). After public consultations in the interim, the OECD released a discussion draft on the transfer pricing aspects of intangibles on June 6, 2012. *Id.* The discussion draft proposes revisions to the Transfer Pricing Guidelines, but the OECD indicates that it does not reflect a consensus. *Id.* It requested comments on the discussion draft by September 2012. *Id.*

398 Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, *in* Taxation in the Global Economy 11, 30-31 (Assaf Razin & Joel Slemrod eds., 1990), available at http://www.nber.org/ chapters/c7203.pdf (on file with the Columbia Law Review). Mitchell Kane has recently offered a contrary view, but, even so, offers relatively little guidance on how to source IP income. Mitchell A. Kane, Reflections on Some Small, Medium, and Large Design Issues with Income Source Rules in International Taxation 1-4 (2012) (unpublished manuscript) (on file with the Columbia Law Review) (arguing that there is "some core way in which source of income is coherent as a geographic concept").

399 *See* Hugh J. Ault, Recent Developments in the OECD Work on Transfer Pricing: Increasing Sophistication and Increasing Simplification 1-2, 10-11 (2012) (unpublished manuscript) (on file with the Columbia Law Review) (describing OECD's increasing use of and perceived benefits of profit split methods).

400 For example, in its 2010 Transfer Pricing Guidelines, the OECD revised its 1995 Guidelines to provide new guidance on selecting the most appropriate transfer pricing method and applying the profit-split method. *See* OECD Approves the 2010 Transfer Pricing Guidelines, OECD (July 22, 2010), http://www.oecd.org/ctp/taxtreaties/oecdapprovesthe2010transferpricingguidelines.htm (on file with the Columbia Law Review) (announcing approval of 2010 version of Transfer Pricing Guidelines and outlining changes); *see also* Ilan Benshalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method*, 28 Va. Tax Rev. 619, 623 (2009) (suggesting application of formulary apportionment to financial transactions); Michael C. Durst & Robert E. Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 Tax L. Rev. 37, 127-34 (2003) (suggesting various improvements to transfer pricing rules).

401 *See* Jerome R. Hellerstein & Walter Hellerstein, State Taxation 8-346-8-365 (3d. ed. 2003) (describing state apportionment rules in detail).

402 The proposed Common Consolidated Corporate Tax Base ("CCCTB") provides a single set of rules that could be used by companies operating in the European Union to calculate taxable profits. Under the CCCTB, companies would only have to comply with one set of rules instead of having to comply with the different rules of every country in which they operate. Common Tax Base, Taxation and Customs Union, European Comm'n, http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm (on file with the Columbia Law Review) (last updated Dec. 6, 2012)

(outlining CCCTB proposal and its background).

403 *See* Rosanne Altshuler & Harry Grubert, *Formula Apportionment: Is It Better than the Current System and Are There Better Alternatives?*, 63 Nat'l Tax J. 1145, 1182 (2010) (finding formulary apportionment offers no clear advantage over current system and noting firms' incentive under formulary apportionment to shift capital and routine activities abroad).

404 *See* Hines, *Income Misattribution*, *supra* note 336, at 109 ("[T]he formulas do not apportion income accurately among the jurisdictions in which it is earned.").

405 *See* Walter Hellerstein, *Tax Planning Under the CCCTB's Formulary Apportionment Provisions: The Good, the Bad and the Ugly*, *in* CCCTB: Selected Issues 221, 233-52 (Dennis Weber ed., 2012) (presenting critical analysis of CCCTB proposals); Walter Hellerstein & Charles E. McLure, Jr., *The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the U.S. States*, 11 Int'l Tax & Pub. Fin. 199, 211-217 (2004) (discussing various difficulties with U.S. states' approaches and suggesting how European Union might learn from them); *see also* Roin, *supra* note 332, at 199-215 (describing and criticizing formulary apportionment).

406 Avi-Yonah & Clausing, *supra* note 302, at 12 (noting that using a formula based on property, payroll, and sales "creates an implicit tax on the factors used in the formula, thus discouraging assets and employment in high-tax locations").

407 *See, e.g.*, *id.* at 11 ("[W]e propose a far simpler formula, which would only consider the fraction of sales in each location.").

408 *See* Kirk J. Stark, *The Quiet Revolution in U.S. Subnational Corporate Income Taxation*, 55 Bull. for Int'l Fiscal Documentation 523, 528-29 (2001) (describing how states have moved toward sales-based formulas). The Supreme Court upheld the constitutionality of the single-factor sales-based formula in Moorman Manufacturing Co. v. Blair, 437 U.S. 267 (1978).

409 *See supra* notes 319-323 and accompanying text (describing JCT study); *see also* Harry Grubert, *Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized*, 65 Nat'l Tax J. 247, 263 (2012) ("[O]pportunities for tax-induced income-shifting are strongly influenced by the presence of intangible assets.").

410 *See, e.g.*, Grubert & Altshuler, Fixing the System, *supra* note 370, at 35 (describing scheme of using retail and wholesale methods to reduce tax expenditures). Julie Roin details another practical issue with a sales-only formula. Roin, *supra* note 332, at 230-32. Looking to sales in the United States would not capture situations where a U.S. producer sells to a foreign manufacturer who embeds the U.S. product in another commodity that is subsequently sold into the United States. An example is Corning's sale of LCD glass substrates to manufacturers of LCD panels, which are manufactured in Taiwan, Korea, Japan, and China, but not in the United States. The LCD panels, however, may end up in products that are sold in the United States. Tax Reform: Hearing Before the H. Comm. on Ways and Means, 112th Cong. 2 (2012) (testimony of Susan Ford, Vice President of Corning, Inc.) (on file with the Columbia Law Review) (describing Corning LCD panel sales).

411 Some countries impose a flat-rate source-based tax (known as a withholding tax) on such royalties, but bilateral tax treaties tend to reduce such taxes to zero or a very low rate. *See, e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, U.S.-Ger., art. 12, Aug. 29, 1989, 1708 U.N.T.S. 3.

412 *See* 26 C.F.R. § 1.861-4(b) (2012) (governing rule for services performed partially inside and partially outside United States).

413 I.R.C. §§ 861(a)(4), 862(a)(4) (2006).

414 *Id.* § 865(a), (d), (g). There is a special rule for goodwill: Noncontingent payments for goodwill are sourced in the country where the goodwill was generated. *Id.* § 865(d)(3).

415 *Id.* § 865(d)(1)(B).

416 *See supra* Part IV (discussing impact of various transaction structures on taxation).

417 In the United States, CFC rules are contained in subpart F of the Internal Revenue Code. I.R.C. §§ 961-964.

418 *See* Technical Explanation, *supra* note 13, at 32-33 (discussing differences between option A and current taxation system); *see also supra* note 151 (describing current state of taxation of foreign income for U.S. citizens and residents).

419 One hundred percent of excess returns would be included if the foreign effective rate were below 10%, and a sliding scale would apply to include a portion of the income if the foreign effective rate were between 10% and 15%. Technical Explanation, *supra* note 13, at 33.

420 *Id.* Costs for this purpose would not include interest or taxes. *Id.*

421 *See* Dep't of the Treasury, General Explanations 2013, *supra* note 201, at 88-89; Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals 44 (2011), available at http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2012.pdf (on file with the Columbia Law Review); Dep't of the Treasury, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals 43 (2010), available at http://www.treasury.gov/resource-center/tax-policy/documents/general-explanations-fy2011.pdf (on file with the Columbia Law Review).

422 *See* Technical Explanation, *supra* note 13, at 33-34 (detailing option B).

423 *See id.* at 34-35 (detailing option C).

424 H. Comm. on Ways & Means, 111th Cong., Summary of Ways and Means Discussion Draft: Participation Exemption (Territorial) System 2 (2011), available at http://waysandmeans.house.gov/uploadedfiles/summary_of_ways_and_means_draft_option.pdf (on file with the Columbia Law Review). The 15% U.S patent box rate would be accomplished through a deduction of 40% of the income, which otherwise would be subject to a normal U.S. corporate tax rate of 25%. Technical Explanation, *supra* note 13, at 1, 34.

425 President's Framework, *supra* note 18, at 14.

426 *Id.*

427 *See supra* notes 134-150 and accompanying text.

428 Technical Explanation, *supra* note 13, at 32.

429 *See* HM Revenue & Customs, Technical Note, *supra* note 135, at 11 (describing "routine return" of 10%, which is subtracted from qualifying income).

430 President's Framework, *supra* note 18, at 14.

431 For example, a U.S. automobile subsidiary of a foreign manufacturer, such as BMW, might pay large royalties to its parent.

432 *See* Graetz, *Inadequate Principles*, *supra* note 339, at 282 (discussing this proposition).

433 *See supra* notes 326-327, 333 and accompanying text (discussing loss of revenue to United States resulting from income-shifting techniques).

434 *See, e.g.*, Vina, *supra* note 328 (describing tax avoidance allegations from U.K. lawmakers against Starbucks, Amazon, and Google).

435 An inversion is a rearrangement of an MNE's corporate structure to replace the U.S. parent company with a foreign parent for the corporate group in order to take advantage of more favorable resident-based income tax rules in the jurisdiction of the new foreign parent. In 2004, Congress enacted Code § 7874 to limit such inversions, but these rules have gaps, as the 2012 inversions of Eaton Corporation, ADN Corporation, and Rowan Industries and the 2009 inversion of ENSCO International Inc. demonstrate. I.R.C. § 7874 (2006); Martin A. Sullivan, *Eaton Migrates to Ireland: Will the U.S. Now Go Territorial*?, 135 Tax Notes 1302, 1302 (2012) (discussing how exception to § 7874 may allow Eaton to reincorporate in Ireland to escape U.S. international tax rules if they have "substantial

business activities" there); Stuart Webber, *Escaping the U.S. Tax System: From Corporate Inversions to Re-Domiciling*, 63 Tax Notes Int'l 273, 274 (2011) (noting § 7874 did not eliminate specter of corporate inversions); *see also* Solomon, *supra* note 351, at 1203 (describing proliferation of corporate inversions, which rearrange corporate structures to locate parent corporation in lower-tax jurisdiction, and noting that lowering U.S. tax rate seems necessary to curtail problem).

436 *See supra* notes 319-323 and accompanying text (discussing how MNEs in JCT study used complex tax planning structures to avoid paying higher U.S. taxes on IP income despite significant proportion of R&D occurring in United States).

437 Grubert, *supra* note 409, at 41.

438 I.R.C. § 865(a).

439 *Id.* § 861(a)(4).

440 *Id.* § 861(a)(3).

441 These rules are currently used in determining the imposition of destination- based value-added taxes.

442 This could be a simple allocation based on the ratio of U.S. to worldwide sales, or one could refer to 26 C.F.R. § 1.861-8 (2012) for illustrations of how this might be done.

443 *See supra* notes 407-408 and accompanying text.

444 For a comprehensive analysis of the difficulties of allocating income based on sales, see Roin, *supra* note 332, at 207-09. Determining the location of services, for example, has been controversial under value-added taxes. For more discussion, see Hellerstein, *supra* note 405, at 229 ("Although the place where services are physically carried out may well reflect their destination, in many situations, particularly with respect to so-called 'intangible services,' this often will not be the case.").

445 A VAT is a form of consumption tax that taxes the value added to a product by each stage of manufacture or distribution. Under the "credit method," each seller in the chain charges the tax on the full price of goods or services it sells and remits the difference between that amount and the taxes it paid on its materials to the government. *See, e.g.*, Itai Grinberg, *Where Credit Is Due: Advantages of the Credit-Invoice Method for a Partial Replacement VAT*, 63 Tax L. Rev. 309, 312-13 (2010) (providing VAT overview). A VAT is thus similar to a sales tax, but a VAT is partially collected at earlier stages of production, while a retail sales tax is collected in full from retailers.

446 *See* Michael J. Graetz, 100 Million Unnecessary Returns: A Simple, Fair, and Competitive Tax Plan for the United States 108-09 (2008) [hereinafter Graetz, 100 Million Unnecessary Returns] (suggesting decrease in corporate income tax rate to 15% would "dramatically improve the competitive position of the American economy and reduce tax-sheltering behavior"); Michael J. Graetz, *How to Shrink the IRS and Grow the Economy*, Am. Int., Nov.-Dec. 2011, at 57, 61-63 (proposing seven-step plan to lower corporate income tax rate by taxing consumption). Other revenues from the VAT would be used to eliminate more than 100 million families from the individual income tax base and to lower the rate to 25% or less above a new family allowance of $100,000. All of this could be done on a revenue and distributionally-neutral basis. *See* Eric Toder, Jim Nunns & Joseph Rosenberg, Urban-Brookings Tax Policy Ctr., *Using a VAT to Reform the Income Tax* 1-2 (2012) (suggesting VAT rate of 12.3%, corporate income tax rate of 10%, income tax rates of 16% on income between $100,000 and $200,000, and 25.5% on income above $200,000 could be revenue and distributionally-neutral with appropriate relief for low and moderate-income taxpayers).

447 *See* Scott A. Hodge, The Countdown is Over: We're #1, Tax Foundation (Apr. 1, 2012), http://taxfoundation.org/article/countdown-over-were-1 (on file with the Columbia Law Review) (comparing U.S. tax rate to OECD averages).

448 The political difficulties of enacting a consumption tax in the United States are recounted in Graetz, 100 Million Unnecessary Returns, *supra* note 446, at 70-77.

449 *See, e.g.*, Robert Carroll & Alan D. Viard, Progressive Consumption Taxation: The X Tax Revisited 20-39 (2012) (advocating X tax developed by David

Bradford, a modified VAT applying graduated rates to wages and flat rate to business earnings); Robert E. Hall & Alvin Rabushka, The Flat Tax 56 (2d ed. 1995) (proposing flat tax of 19% on earnings above specified exemption); Paul D. Ryan, Comm. on Budget, *A Roadmap for America's Future, Version 2.0: A Plan to Solve America's Long-Term Economic and Fiscal Crisis* 59 (2010), available at http://roadmap.republicans.budget.house.gov/uploaded files/roadmap2final2.pdf (proposing 8.5% business consumption tax on difference between purchases and sales).

450 Under a subtraction-method VAT, the tax base is calculated by subtracting purchases of goods and services from sales of goods and services. Under the credit method, an alternative for ensuring that the same income is not taxed twice, a company is given a credit against the tax on its sales for the tax paid on its purchases from other firms. *See* Robert Carroll & Alan D. Viard, *Value Added Tax: Basic Concepts and Unresolved Issues*, 126 Tax Notes 1117, 1118 (2010) (noting subtraction method has gained particular attention in United States because it looks similar in form to current corporate income tax). Because it uses total sales and inputs, the subtraction method is considered "account-based," while the credit method is "transaction-based." Representative Ryan's proposal uses a subtraction method. Hall and Rabushka's flat tax and the X tax use a modified subtraction method. *See* Victoria P. Summers, *The Border Adjustability of Consumption Taxes, Existing and Proposed*, 12 Tax Notes Int'l 1793, 1798-99 (1996) (distinguishing Japanese tax strategy from invoice-based ones because "tax is credited against tax, rather than purchases subtracted from sales, and tax is calculated on the net amount [of total taxable sales]"). The form of VAT used in Japan bears certain similarities to the approach this Article suggests, as does the Grubert and Altshuler proposal that allows expensing of investments, as discussed in Fixing the System, *supra* note 370 and accompanying text.

451 *See* Grubert & Altshuler, Fixing the System, *supra* note 370, at 8.

452 *See* Joint Comm. Pamphlet, *supra* note 175, at 6 (noting as evidence of income- shifting that countries with low average tax rates tend to have income shares significantly larger than their shares of business measures that are relatively easier to value, like physical assets, compensation, and employment).

453 *See* Griffith, Hines & Sprenson, *supra* note 303, at 916 (discussing an "Allowance for Corporate Equity" system that would exempt normal returns to investment); Alvin C. Warren, Jr., *How Much Capital Income Taxed Under an Income Tax Is Exempt Under a Cash Flow Tax?*, 52 Tax L. Rev. 1, 4-6 (1997) (discussing exemption of normal rate of return as similar to cash flow (consumption) tax).

454 Alan J. Auerbach, Ctr. for Am. Progress & The Hamilton Project, *A Modern Corporate Tax* (2010), available at http://www.americanprogress.org/wp-content/uploads/issues/2010/12/pdf/auerbachpaper.pdf (on file with the Columbia Law Review). Because of the deduction for wages, this form of consumption tax might be considered a "direct" tax by the WTO, which might, in turn, raise the question of whether it can be imposed on a destination basis. *See* Michael Daly, *WTO Rules on Direct Taxation*, 29 World Econ. 527, 528 & nn.4-5 (2006) (noting WTO has increasingly focused on potential of direct taxes to impede cross-border flows, since direct taxes imposed on destination basis can mimic effect of tariffs); Michael J. Graetz, *International Aspects of Fundamental Tax Restructuring: Practice or Principle?*, 51 U. Miami L. Rev. 1093, 1097-98 (1997) (discussing consumption tax treatment under GATT).

455 Auerbach, *supra* note 454, at 19 tbl.A1.

456 *Id.*

457 Financial institutions would be exempt from the tax and would receive no refunds for their "losses" due to purchases in the United States under circumstances where their financial services income would not be included in the tax base. Taxing financial services has proved difficult under VATs, and omitting financial flows from the tax base should reduce tax planning that would occur under Auerbach's tax, which differs in its treatment of domestic and foreign financial flows. A tax such as this that omits financial flows is known as an "R-base" tax. One that includes financial flows is an "R&F-base" tax. *See* J.E. Meade, Inst. for Fiscal Studies, The Structure and Reform of Direct Taxation 23031 (1978), available at http://www.ifs.org.uk/docs/meade.pdf (on file with the Columbia Law

Review).

458 Because expensing is allowed for new domestic plants, equipment, and inventory, over time, as prior costs of goods sold and depreciation are deducted, this tax base would increase. This resembles the Meade Committee's R-base tax. *Id.*

459 *See* William B. Barker, *A Common Sense Corporate Tax: The Case for a Destination-Based, Cash Flow Tax on Corporations*, 61 Cath. U. L. Rev. 955, 978-87 (2012) (explaining how R&F-type tax takes into account all cash flows, and thereby removes tax arbitrage incentives). Professor Barker discusses the choice between an R and R&F tax base and is concerned especially with the distortions of the existing corporate tax on the choice of debt versus equity financing. *Id*. He does not discuss the implications of his proposal under the WTO.

460 For an analysis of the advantages of taxing corporate income on a destination basis, see Alan J. Auerbach, Michael P. Devereaux & Helen Simpson, Taxing Corporate Income, in 1 Mirrlees Review: Dimensions of Tax Design, *supra* note 9, at 837, 882-88, available at http://www.ifs.org.uk/mirrleesreview/dimensions/ch9.pdf (on file with the Columbia Law Review).

461 A fourth alternative would be to treat cross-border financial flows among related parties differently than those between unrelated entities. A fifth would be to combine the second alternative above with a separate tax on financial activities or transactions. *See generally* Daniel Shaviro, *The Financial Transactions Tax Versus (?) the Financial Activities Tax* (N.Y. Univ. Law & Econ. Research Paper No. 12-04) (Mar. 1, 2012), http://ssrn.com/abstract=1989163 (on file with the Columbia Law Review) (describing and evaluating variety of current proposals).

462 And it may provoke a challenge in the WTO.

463 The authors are grateful to Richard Vann for suggesting this to us.

464 *See generally* Austl. Taxation Office, Imputation Reference Guide (2004), available at http://www.ato.gov.au/content/downloads/n10832.pdf (on file with the Columbia Law Review) (describing Australia's dividend imputation system). No tax credit is available for gains on the sale of shares. Antiabuse rules limit Australian firms' ability to stream franked dividends selectively to individuals who will receive tax credits. *Id.* at 32.

465 *See* Peter Birch Sprenson & Shane Matthew Johnson, *Taxing Capital Income: Options for Reform in Australia*, *in* Melbourne Inst. of Applied Econ. and Soc. Research, Melbourne Institute—Australia's Future Tax and Transfer Policy Conference: Proceedings of a Conference 179, 185 (2010).

466 In Europe, such imputation systems were essentially eliminated because of decisions by the European Court of Justice. *See generally* Graetz & Warren, *supra* note 344, at 1578 (articulating ECJ's "vision of a non-discriminatory system for taxing corporate income distributed as dividends within the European Union"); Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination: Still Stuck in the Labyrinth of Impossibility*, 121 Yale L.J. 1118, 1121 (2012) (same).

467 Dep't of the Treasury, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once 16, 19 (1992), available at http://www.treasury.gov/resource-center/tax-policy/Documents/integration.pdf (on file with the Columbia Law Review).

468 I.R.C. § 1(h) (11) (2006) (applying 15% top rate to qualifying dividends). In 2013 the tax rate on dividends was increased to 20% under the fiscal cliff legislation known as the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, § 331, 126 Stat. 2313 (codified at I.R.C. § 168). Furthermore, section 1402 of the Health Care and Reconciliation Act of 2010 imposes an additional 3.8% tax on dividend income for individuals above a certain income threshold, effective 2013. Pub. L. No. 111-152, § 1402, 124 Stat. 1029. (codified as amended in scattered sections of 42 U.S.C.).

469 Richard J. Vann, *Reflections on Business Profits and the Arm's-Length Principle*, *in* The Taxation of Business Profits Under Tax Treaties 133, 157 & n.61 (B.J. Arnold, J. Sasseville & E.M. Zolt eds., 2003) (noting imputation systems that depend on domestic

taxes constrain corporate tax planning).

Chapter 5

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Michael J. Graetz, *A Multilateral Solution for the Income Tax Treatment of Interest Expenses*, 62 Bulletin for International Taxation 486 (2008), *reprinted in* Journal of Japanese Tax Association (2009).

1 For a useful summary of recent developments, see the excellent General Report authored by Pascal Hinny and the 34 Branch Reports on Subject 2: New tendencies in tax treatment of cross-border interest of corporations, in *Cahiers de droit fiscal international*, Vol. 93b (2008) (62nd Congress of the International Fiscal Association, Brussels, 2008); *See also* Brian Arnold, *General Report on Subject I: Deductibility of Interest and Other Financing Charges in Computing Income*, *in* Cahiers de droit fiscal international, Vol. 79a (1994), at 491 (48th Congress of the International Fiscal Association, Toronto, 1994); Daniel N. Shaviro, *Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of American Multinationals*, 54 Tax L. Rev. 353 (2001).

2 The proposals by the U.S. Joint Committee on Taxation and the President's Advisory Panel on Federal Tax Reform for a dividend exemption system would require the allocation and disallowance of interest expenses incurred to earn foreign-source income. *See* Staff of Joint Comm. on Tax'n, 109th Cong., Options to Improve Tax Compliance and Reform Tax Expenditures (Comm. Print 2005); and President's Advisory Panel on Federal Tax Reform, Simple, Fair, and Pro-Growth: Proposal to Fix America's Tax System (2005). In contrast, the U.S. Department of the Treasury recently issued a report on the competitiveness of U.S. businesses that suggests a dividend exemption system with no allocation of interest. U.S. Dep't of the Treas., Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century (2007). *See also* HM Treasury and HM Revenue & Customs, *Taxation of the Foreign Profits of Companies: A Discussion Document* (June 2007).

3 Tax Reduction and Reform Act of 2007, H.R. 3970, 110th Cong, §§ 975-977 (2007). This is one of several proposals designed to help finance a lower corporate income tax rate in the United States. In addition, Congress passed legislation in 2004, effective in 2009, that would shift from water's edge interest allocation to worldwide allocation for purposes of determining the foreign tax credit limitation, but that change has now been postponed until 2011. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 3039 (2008). *See infra* discussion at notes 19-21.

4 *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, Case C-324/00, 2002 ECR I-11,779. In *Lankhorst-Hohorst*, the ECJ considered a law under which German subsidiaries of non-German parent companies were denied deductions for interest paid to the foreign parent company when the subsidiary had a high debt-to-equity ratio, although such deductions were allowed for payments by German subsidiaries to German parent companies. *See also Bosal Holding*, Case C-168/01 (13 October 2003); and *Test Claimants in the Thin Cap Group Litigation*, Case C-524/04 (13 March 2007).

5 U.S. Dep't of the Treas., Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties (2007).

6 The 19 March 2007 Canadian federal budget included a proposal to eliminate the deductibility of interest on debt incurred by Canadian corporations to finance foreign affiliates. In the face of significant criticism, on 14 May 2007 Minister of Finance Jim Flaherty announced significant changes to the interest deductibility proposals. The 14 May 2007 news release is available on the Department of Finance web site at www.fin.gc.ca/news07/07-041e.html. The 2007 Canadian federal budget is available at www.

budget.gc.ca/2007/index_e.html.

7 *See* Stéphane Martin & Patrick Smet, *Branch Report for Belgium on Subject 2: New tendencies in Tax Treatment of Cross-border Interest of Corporations*, *in* Cahiers de droit fiscal international, Vol. 93b, *supra* note 1, at 127, 139.

8 I use an exemption system for illustrative purposes here both for clarity in the exposition of the issues and because it is the dominant method of relieving double taxation of income on outbound investment within the OECD. Only the Czech Republic, Ireland, Japan, Korea, Mexico, New Zealand, Poland, the United Kingdom and the United States use foreign tax credits. U.S. Dep't of the Treasury., *supra* note 2, at 19, tbl. 1.5.

9 I ignore here the theoretical difficulty and practical necessity of using the book value rather than the fair market value of assets. Relying on basis, rather than value, does have the advantage of resolving the difficult issue of intangible assets since the costs of self-created intangibles are typically deducted rather than capitalized.

10 In theory, the revenue lost to *H* through the interest deduction might be made up if *H* were to tax the lender on the interest income. While the precise dimensions of this possibility are difficult to get a handle on, as a practical matter, given the large holdings of U.S. corporate debt in tax-exempt retirement accounts, university endowments and other tax-exempt entities and by foreigners, this is quite unlikely – at least in the U.S.

11 *See* John Samuels, *"True North: Charting a Course for U.S. International Tax Policy in the Global Economy", the David R. Tillinghast Lecture on International Taxation*, 25 September 2007 (forthcoming in *Tax Law Review*); *see also* the discussion *infra* notes 35-37.

12 *Lankhorst-Hohorst*, *supra* note 4, and the cases cited there.

13 Such claims were made—but ignored by the United States – in connection with the enactment of the U.S. earnings stripping rules. Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 Yale L.J. 1186 (2006); Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce*, 54 Tax L. Rev. 131 (2001).

14 Hugh J. Ault & David Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, *in* Taxation in the Global Economy 11 (Assaf Razin & Joel Slemrod eds., 1990).

15 *See, e.g.*, Jeffery M. Colón, *Financial Products and Source Basis Taxation: U.S. International Tax Policy at the Crossroads*, 1999 U. Ill. L. Rev. 775.

16 *See* Michael J. Graetz & Michael O'Hear, *The "Original Intent" of International Taxation*, 46 Duke L.J. 1021 (1997).

17 Roger H. Gordon & James R. Hines, Jr., *International Taxation* (Nat'l Bureau of Econ. Research, Working Paper No. 8854-4, 2002); European Commission, Commission Staff Working Paper, *Company Taxation in the International Market*, (2001).

18 Mitchell Kane, *Strategy and Cooperation in National Responses to International Tax Arbitrage*, 53 Emory L.J. 89 (2004); Diane Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. Rev. 79 (2002); David H. Rosenbloom, *International Tax Arbitrage and the "International Tax System"*, 53 Tax L. Rev. 137 (2000).

19 For a history of interest allocation, see Gary Clyde Hufbauer & Ariel Assa, U.S. Taxation of Foreign Income 236-240 (2007). For an analysis suggesting that worldwide allocation of interest is "more consistent [than water's edge allocation] with the basic objective of the foreign tax credit limit" and details about the formulas that have been used in the United States, see Jane G Gravelle & Donald J. Marples, Cong. Research Serv., RL34494, The Foreign Tax Credit's Allocation Rules (2008).

20 To my knowledge, no respectable policy argument has been made in support of the U.S. system of water's edge allocation. It is an unprincipled revenue grab enacted in 1986 that has remained in the law far too long, but the U.S. Congress, seeking revenues

to finance other tax reductions, seems determined to keep it in place at least for a while longer.

21 American Jobs Creation Act of 2004, Pub. L. 108-357, 118 Stat. 1418, § 401.

22 *See supra* note 3.

23 The comparison, for example, is U.S. debt to U.S. assets versus worldwide debt to worldwide assets, with allocation to a foreign source required only when the former ratio is greater than the latter (or, alternatively, the ratio of U.S. borrowing to worldwide borrowing must be the same or less than the ratio of U.S. assets to worldwide assets). There may, however, be an argument for looking at interest on a net basis, i.e. looking only at the excess of interest expense over interest income, but I will put that issue aside here. It is probably most important for financial institutions.

24 European Commission, *supra* note 17. *See* James R. Hines, Jr., *Tax Policy and the Activities of Multinational Corporations*, (Nat'l Bureau of Econ. Research, Working Paper No. W5589, 1996).

25 *See, e.g.*, Alvin C. Warren, Jr. & Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 Harv. L. Rev. 1752 (1982); *see also* Ronald A. Pearlman, *A Tax Reform Caveat: In the Real World, There is no Perfect Tax System*, *in* Toward Fundamental Tax Reform (Alan J. Auerbach & Kevin A. Hassett eds., 2005).

26 There is controversy, for example, in the U.S. policy literature over the merits of § 265(a)(2) of the Internal Revenue Code, which disallows interest deductions on indebtedness used to purchase or carry state and local bonds the interest on which is exempt from income tax. 26 U.S.C. § 265(a)(2); *see* Marvin A. Chirelstein, Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts (10th ed., 2005), § 6.06(a).

27 The argument for repealing § 265 of the U.S. Internal Revenue Code is not applicable here; there is a great difference between transferring U.S. federal revenues to U.S. state and local governments to help them save interest costs and transferring such revenues to low-tax foreign countries. Moreover, although the advantages of repealing § 265 have long been known, this denial of interest deductions remains untouched.

28 *See, e.g.*, Graetz, Michael J. & Alvin C. Warren, Jr. (eds.), *Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports* (1998).

29 While corporations may have considerable control over where they locate their borrowing, that control may not be absolute: *L*, for example, may not have well-developed capital markets for corporate borrowing. And there may be economies of scale from concentrating borrowing in one or a few places. Moreover, a corporation will have to have assets in *L* to deduct interest there given *L*'s likely earnings stripping rules. But the government of *H* should prefer *L* as the place for corporate borrowing to finance investments in *L*.

30 The foreign company would need to have adequate assets or income in *H* in order not to run afoul of *H*'s earnings stripping rules.

31 This is because royalties are permitted to be deducted abroad, may bear little or no withholding tax, and can be sheltered from U.S. tax through cross-crediting.

32 *See e.g.*, Hufbauer & Assa, *supra* note 19, at 133-143.

33 Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex L. Rev. 1301 (1996); Graetz & O'Hear, *supra* note 16.

34 OECD Model Tax Convention on Income and on Capital, 15 July 2005, arts. 23 A and 23 B.

35 They do, however, require countries not to discriminate against foreigners.

36 U.S. Dep't of the Treas., *supra* note 2, at 60.

37 James R. Hines, Jr., *Reconsidering the Taxation of Foreign Income*, 62 Tax L. Rev. (forthcoming).38 Samuels, *supra* note 11.

39 Another possibility would be to allocate interest expense proportionately to income rather than assets. This would also be a major improvement over current laws and practices, but an allocation based on assets seems conceptually more sound and is probably easier to implement.

40 For an overview, see Joann M Weiner., *Approaching an EU Common Consolidated Tax Base*, 46 Tax Notes Int'l 647 (2007).

41 One cannot help but note the irony that the most promising path to a multilateral solution to an income tax issue is through revisions of bilateral treaties.

Chapter 6

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Notes

1 Capital export neutrality (CEN) is neutral about a resident's choice between domestic and foreign investments providing the same pretax rates of return and generally requires that a resident of any nation pays the same marginal rate of income taxation regardless of the nation in which she invests. Capital import neutrality (CIN) requires that all investments in a given country pay the same marginal rate of income taxation regardless of the residence of the investor. CIN thus subjects all business activity within a specific country to the same overall level of taxation, whether the activity is conducted by a resident or a foreigner. It is well known that it is impossible to achieve CEN and CIN simultaneously in the absence of either a worldwide government or identical income tax bases and rates in all nations.

2 Generally the foreign tax credit limitation is calculated by multiplying the U.S. tax on worldwide taxable income (before the foreign tax credit) by the ratio of foreign source taxable income to worldwide taxable income.

3 The categories include a separate basket for passive income, high withholding tax interest, financial services income, shipping income, dividends from each non-controlled §902 corporation, taxable income attributable to foreign trade income, dividends from a DISC or former DISC, distributions from a FSC, and "residual" or all other income. I.R.C. §904(d). Since income from each non-controlled §902 c orporation goes into a separate basket, U.S. corporations may have many more than nine separate baskets limiting their foreign tax credits.

4 Income received by U.S. corporations from foreign corporations in the form of interest and royalties could conceivably be exempt on a look-through basis (i.e., if allocated to the exempt income of the payer). While such an approach would generally be consistent with our foreign tax credit rules today, it would be unprecedented among countries adopting an exemption system, because it would allow income to go untaxed in both the interest or royalty paying jurisdiction (assuming the interest or royalty is deducted and does not generate a substantial withholding tax) and the interest or royalty earning jurisdiction. Consequently, any exemption system would likely subject interest and royalties from abroad to U.S. tax, as foreign source income eligible for a foreign tax credit.

5 The Dutch, for example, have a foreign tax credit regime that applies to foreign financial

services income on the ground that this income is often subject to low or no income tax abroad.

6 We believe that to accomplish effective simplification, such a de minimis rule should be based on assets or gross income and not limited to a specified dollar amount as is currently the case under Subpart F.

7 Here we are suggesting modifications to the rules under §1248 of the Internal Revenue Code.

8 Rules would be necessary to determine such amounts on a per share basis.

9 Some analysts have suggested that the fact that U.S. companies would typically have excess foreign tax credit limitations might stimulate other countries to raise taxes, especially withholding taxes. The trend, however, is very much in the direction of lower withholding taxes. The tax treaty between the U.S. and the United Kingdom signed in 2001, for example, is the first time the U.S. has agreed to a zero withholding rate on dividends. We do not believe a shift by the U.S. from a credit to an exemption system would halt or reverse this trend.

10 See, for example, the discussion below of allocation of research and development expenses.

11 As we indicated earlier, we do regard shifting to an exemption system as a proper occasion to reconsider the scope of Subpart F with respect to active business income.

12 If current taxation of active business income is unacceptable, we would probably opt for expanding the scope of the exemption rather than establishing a third category of deferred income.

13 Three alternatives exist for allocating dividends between exempt and non-exempt income: pro rata allocation, treating dividends as paid out of exempt income first or treating exempt income as paid out last. Today's law applies a pro-rata approach for foreign tax credit purposes (i.e. dividends are allocated pro rata to each foreign tax credit limitation category). A pro rata rule seems the most equitable and appropriate rule, but also is the most complex rule. On the other hand, treating non-exempt income as paid out first seems unduly harsh, and stacking exempt income last may undermine the rules governing passive income and create too great an incentive to shift such income abroad. We believe that with an appropriate de minimis rule (as discussed above) and limiting the Subpart F definition of non-exempt income to passive income (as discussed above) applying a look-through rule on a pro rata basis is the best alternative if a look-through rule for dividends is needed.

14 We have no basis for assessing whether adequate information would be made available to corporate investors with smaller voting interests, 5 percent, for example. The 10 percent threshold is common throughout the OECD.

15 Because the dividend received deduction of § 243 of the Internal Revenue Code, in effect, exempts only 70 or 80 percent of dividends paid by U.S. companies to U.S. parents, there may be concern with providing full exemption for dividend payments by foreign subsidiaries to U.S. parents, notwithstanding the potential imposition of foreign taxes on dividends from abroad. If so, an exemption for 70 or 80 percent of foreign source dividends would respond to this concern without adding complexity.

16 If U.S. companies or other persons own more than 50 percent of the foreign corporation, a 5 or 10 percent threshold (rather than the 20 percent suggested in the text) could apply.

17 This raises the question whether foreign withholding taxes should be creditable to individual shareholders, including whether such credits should be flowed through mutual funds, as under current law. Reexamining this treatment of such portfolio investments by individuals is beyond the scope of our endeavor here.

18 Current law applies a "water's-edge" rather than worldwide allocation, and was adopted in the 1986 Tax Reform Act for revenue reasons. § 864(e) of the Internal Revenue Code. A worldwide allocation would generally allocate interest expense worldwide based either on gross income or assets. The "water's-edge" approach of current law excludes

borrowing from foreign subsidiaries in making the allocation of interest expense. Some commentators argue that "tracing" rules, similar to those used abroad, are appropriate (Shaviro, 2001). Virtually all commentators regard worldwide allocation as superior to water's-edge allocation (*e.g.*, Brumbaugh and Gravelle, 1999; Sullivan, 1999). Further discussion and analysis of interest allocation rules is not possible within the space limitations of this article.

19 We are assuming continuation of current law requirements that the use of intangible assets abroad requires a payment back to the U.S. owner (e.g., § 367(d) of the Internal Revenue Code). A comparable rule applicable to branches would become necessary under an exemption system along the lines we are discussing here.

20 Each of these expense allocation issues will exist not only for U.S. taxpayers earning exempt and/ or nonexempt foreign income, but also for foreign corporations that have U.S. corporate shareholders that may potentially receive exempt dividends. For such corporations, deductions would need to be allocated between exempt and non-exempt income. Presumably resolutions of these issues similar to those described in the text would be applied for purposes of determining the exempt income of such foreign corporations.

21 Rules for the transfer of substantial holdings of shares in a foreign corporation to another foreign corporation would not be necessary to the extent gain on the sale of the shares would be completely tax exempt. However, since, as discussed above, complete tax exemption is not likely to be the rule with respect to all sale of shares transactions, gain recognition agreements or other similar rules would likely be necessary with respect to transfers of shares where gain is not recognized.

22 The DISC regime, enacted in 1971, in effect exempted from U.S. tax a portion of profits from U.S. exports if earned by a qualifying domestic subsidiary of the U.S. exporter. The subsidiary was known as a DISC. Following a decision under CATI that DISC constituted an illegal subsidy to exports, Congress replaced the DISC regime with the FSC (Foreign Sales Corporation) regime, which Congress hoped would be acceptable because of the foreign nature of the FSC. The WTO held the FSC regime also to be an illegal export subsidy.

Chapter 7

Originally published as:

Michael J. Graetz, *Can a 20th Century Business Income Tax Regime Serve a 21st Century Economy?* 30 Australian Tax Forum (2015) Accepted for Publication.

1 Joint Comm. on Tax'n, *Present Law and Selected Policy Issues in the U.S. Taxation of Cross—Border Income*, JCX-51-15, March 16, 2015 at 37. ("The evidence on whether foreign investment and employment complements, or substitutes for, domestic investment and employment has been inconclusive.").

2 Eric Toder, Urban-Brookings Tax Policy Center, *International Competitiveness: Who Competes Against Whom and for What?* (2012), available at http://tpcprod.urban.org/UploadedPDF/412477-international-competitiveness.pdf.

3 Michael J. Graetz & Michael O'Hear, *The Original Intent of U.S. International Taxation*, 46 Duke L.J. 1021 (1997). *See also Historical Perspective on Subpart F in* 1 The NFTC Foreign Income Project: International Tax Policy for the 21st Century December 15, 2001, ch. 2, at 37–58 (Professor Graetz, who served as a special consultant on this project, was the principal author of this chapter).

4 Joint Comm. on Tax'n, *Choice of Business Entity: Present Law and Data Relating to C Corporations, Partnerships, and S Corporations*, JCX-71-15, April 10, 2015 at 37.

5 A so-called "Google tax" was subsequently announced in the form of an anti-avoidance measure in the Australian federal Budget on May 12, 2015.

6 *PWC Position Paper: The Case for Dividend Imputation in Australia* available at http://

pwc.docalytics.com/v/pwc-position-paper-dividend-imputation.

7 Internal Revenue Service, Mandatory Tax Treaty Arbitration, available at http://www.irs.gov/Businesses/International-Businesses/Mandatory-Tax-Treaty-Arbitration. *See also* Robert Stack, Opening Statement to Senate Committee on Foreign Relations, February 26, 2014 at 5-6, available at http://www.treasury.gov/resource-center/tax-policy/Documents/OTPTest-2014-1-26-Stack-SenFR.pdf.

8 Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 Colum. Law Rev. 347, 413-28 (2013).

9 On June 10, 2015, almost two months after this lecture, Robert Stack, U.S. Treasury Deputy Assistant Secretary (International tax affairs), told an OECD International tax conference in Washington D.C that the U.S. is "extremely disappointed in the output and our collective failure in the BEPS project to do more and do better work than we've done."

Chapter 8

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Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 Tax Law Review 537 (2003).

1 Some exceptions include Doron Herman, Taxing Portfolio Income in Global Financial Markets (2002); Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 Tex. L. Rev. 1301 (1996) [hereinafter *Structure*]; Yaron Z. Reich, *Taxing Foreign Investors' Portfolio Investments: Developments & Discontinuities*, 98 Tax Notes Int'l 119-16 (1998) (focusing on inbound foreign portfolio investment).

2 Elena L. Nguyen, *The International Investment Position of the United States at Yearend* 2002, Surv. Current Bus., July 2003, at 12, 20-21 tbl.2 (comparing lines 17 and 19); Douglas B. Weinberg & Patricia E. Abaroa, *U.S. International Transactions, First Quarter* 2003, Surv. Current Bus., July 2003, at 58-59 tbl.1 (comparing lines 14and 15); *see also* Avi Yonah, *supra* note 1, at 1315.

3 I.R.C. § 902.

4 *Id.* Obviously, one can quarrel with the 10% ownership threshold as establishing the division between direct and portfolio investment, but that number is commonly used throughout the OECD. *See, e.g.*, Robert H. Gordon & James R. Hines, Jr., International Taxation 42 (Nat'l Bureau of Econ. Research, Working Paper No. 8854, 2002) (defining foreign direct investment as 10% or more of total ownership), available at http://papers.nber.org/papers/w8854.pdf. Herman, *supra* note 1, at 72. Some countries, however, use a lower threshold-5% or even 1%–in classifying investment as direct. Richard J. Vann, *General Report, Trends in Company/Shareholder Taxation: Single or Double Taxation?*, 88a Cahiers de Droit Fisc. Int'l 21, 33 n.12 (2003). The precise dividing line between direct and portfolio investment may be controversial, but that is not important to us here, only that some dividing line exists.

5 I.R.C. § 901(a).

6 Revenue Act of 1918, ch. 18, §§ 222(a)(1), 238(a), 240(c), 40 Stat. 1057, 1073, 1080-82 (1919) (§ 222(a)(1) provided a foreign tax credit for individuals, § 238(a) provided a similar credit for domestic corporations, and § 240(c) allocated taxes paid by a foreign corporation in which a U.S. corporation had a direct investment).

7 Revenue Act of 1921, ch. 136, §§ 222(a)(5), 238(e), 42 Stat. 227, 249, 259 (§ 222(a)(5) provided limitation on credit for individuals and § 238(e) provided limitation on credit for corporations).

8 Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 Duke L.J. 1021, 1044-59 (1997).

9 Mitchell B. Carroll, The Double Taxation Conference 28-29 (Sept. 3, 1927), unpublished

manuscript, available in T.S. Adams Papers, Yale University, box 16, Sept. 1927 folder, (Carroll was an associate of T.S. Adams, then Tax Advisor to the Treasury Department), quoted in Graetz & O'Hear, *supra* note 8, at 1050. U.S. tax policy was relatively forward-looking; economic policy in the 1920's was generally protectionist.

10 For more on T.S. Adams' role in founding the modern U.S. international tax system, see Graetz & O'Hear, *supra* note 8.

11 *Id.* at 1036-41.

12 Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations, Doc. C.562.M.178. 1928 II (Oct. 31, 1928) [hereinafter League Report], reprinted in 4 Staff of Joint Comm. on Tax'n, Legislative History of United States Tax Conventions 4161-75 (1962).

13 OECD, Model Tax Convention on Income and on Capital, Jan. 28, 2003, art. 24(1), available at http://www.oecd.org/dataoecd/52/34/191 4467.pdf [hereinafter OECD Model Treaty] (proposing a model convention that includes a provision for eliminating double taxation); UN, Model Double Taxation Convention Between Developed and Developing Countries, Jan. 1, 1980, 1 Tax Treaties (CCH) ¶ 206 [hereinafter U.N. Model Treaty]; U.S. Model Income Tax Convention, Sept. 20, 1996, 1 Tax Treaties (CCH) ¶ 214 [hereinafter U.S. Model Treaty]; U.N. Conference on Trade and Development, U.N., World Investment Report 2002: Transnational Corporations and Export Competitiveness xv-xvi (2002).

14 League Report, *supra* note 12.

15 *See, e.g.*, Avi-Yonah, *Structure*, *supra* note 1, at 1305-06.

16 *See, e.g.*, I.R.C. §§ 871(a) (nonresident alien individuals), 882(a) (foreign corporations).

17 Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127, 98 Stat. 494, 648-52; I.R.C. §§ 871(h), 881.

18 *See, e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, Fr.-U.S., Aug. 31, 1994, art. 11(1), 2 Tax Treaties (CCH) ¶ 3001, at 27,005-8; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital Gains, U.K.-U.S., July 24, 2001, art. 11(1), 4 Tax Treaties (CCH) ¶ 10,900, at 44,505-11 [hereinafter U.S.-U.K. treaty].

19 U.S. Model Treaty, *supra* note 13, art. 10, 1 Tax Treaties (CCH) ¶ 214.10.

20 The 2001 U.S.-U.K. treaty allows a withholding rate of up to 15% on portfolio dividends. U.S.-U.K. treaty, *supra* note 18, art. 10, ¶ 2, 4 Tax Treaties (CCH), at 44,505-9. U.S. portfolio investors in the United Kingdom will not face any withholding tax only because the United Kingdom does not impose withholding tax on dividends, but instead negotiates withholding tax-equivalents through its tax treaties. There is no such equivalent in the new U.S.-U.K. treaty. *Id.*

21 Second Additional Protocol to the 1992 Mex.-U.S. Convention for the Avoidance of Double Taxation, Nov. 26, 2002, art. 11(2), 3 Tax Treaties (CCH) ¶ 5903A; Protocol to the 1982 Austl.-U.S. Convention for the Avoidance of Double Taxation, Sept. 27, 2001, art. 6(2), 1 Tax Treaties (CCH) ¶ 505. Like the new U.S.-U.K. treaty, the new protocols signed with Australia and Mexico preserve withholding taxes on foreign portfolio dividends.

22 *U.S., Netherlands to Revise Income Tax Treaty, Treasury Announces*, 94 Tax Notes 1111 (Mar. 4, 2002).

23 *See, e.g.*, Roy Culpeper, *Resurgence of Private Flows to Latin America: The Role of North American Investors*, *in* Coping With Capital Surges: The Return of Finance to Latin America 1, 32-33 (Ricardo Ffrench-Davis & Stephany Griffith-Jones eds., 1995) [hereinafter Capital Surges] (noting that "[m]ore complete, consistent, and prompt reporting of secondary market and derivative transactions would be beneficial to all participants (source and recipient countries, savers, investors, and borrowers alike)"); UN TDBOR, Commission on Investment, Technology and Related Financial Issues, Expert Meeting on Portfolio Investment Flows and Foreign Direct Investment, Provisional Agenda Item 3, Foreign Portfolio Investment (FPI) and Foreign Direct Investment (FDI):

Characteristics, Similarities, Complementarities and Differences, Policy Implications and Development Impact, U.N. Doc. TD/B/com.2/EM.6/2 and Corr.1 (1999), available at http://www.unctad.org/en/docs/c2em6d2&cl.en.pdf [hereinafter UNCTAD Report]; International Monetary Fund, Results of the 1997 Coordinated Portfolio Investment Survey 8, 12 tbl.1.1 (1999). Certain institutional characteristics of international financial markets make it difficult to accurately track flows of portfolio investment. For example, bearer bonds that allow buyers to remain anonymous are the most commonly traded bond instruments in the Eurobond markets. Anonymity of buyers means that a U.S. mutual fund purchasing Latin American debt in the London markets will not register as a transaction in which a U.S. taxpayer has purchased Latin debt. Rather, traditional government tracking mechanisms will treat the purchase as a flow of portfolio investment from Europe to Latin America. Stephany Griffith-Jones, European Private Flows to Latin America: The Facts and the Issues, in Capital Surges, *supra*, at 41. Recent efforts such as the IMF's 1997 coordinated portfolio investment survey and related efforts by Treasury to track FPI help to provide snapshots of the sources and destinations of international portfolio investment, but do not solve the problem of tracking flows of portfolio investment on an ongoing basis. *See* William L. Griever et al., *The U.S. System for Measuring Cross-Border Investment in Securities: A Primer With a Discussion of Recent Developments*, 87 Fed. Res. Bull., 633, 646 (2001) (discussing recommended changes to the U.S. data collection system for tracking flows of portfolio investments).

24 Russell Scholl, *The International Investment Position of the United States: Developments in 1971*, Surv. Current Bus., Oct. 1972, at 18, 21 tbl.3 (foreign securities).

25 Office of the Asst. Sec'y for Econ. Pol'y, Treasury Dep't, Summary of Report on Foreign Portfolio Investment in the United States as of December 31, 1997 tbl.2, available at http://www.treas.gov/tic/shl94sum.html [hereinafter Treasury FPI Summary].

26 Christopher L. Bach, *U.S. International Transactions, Revised Estimates for 1974-96*, Surv. Current Bus., July 1997, at 43, 46 tbl.2, available at http://www.bea.doc.gov/bea/articles/internat/bpa/1997/0797bp.pdf; Office of the Ass't Sec'y, Int'l Affairs, Treasury Dep't & Division of Int'l Finance, Board of Governors, Federal Reserve System, Report on U.S. Holdings of Foreign Long-Term Securities as of December 31, 1997, and December 31, 1999 (Apr. 2000), available at http://www.treas.gov/tic/flts.pdf [hereinafter Treasury FLTS Report].

27 Treasury FLTS Report, *supra* note 26, at 22 tbl.15.

28 Treasury FPI Summary, *supra* note 25, at tbls.1-3. Inbound FPI to the United States has grown rapidly as well, albeit at a slightly lower rate. Between 1984 and 1997, inbound FPI to the United States grew at a compound growth rate of 20%. That translated to a 10-fold increase in the stock of inbound FPI in the United States-from $268 billion in 1984 to $2.8 trillion in 1997. Even more impressive, between 1994 and 1997, inbound U.S. FPI in long-term securities more than doubled, from $1.2 trillion to $2.8 trillion. Treasury FPI Summary, note 25, at tbls.1-3. Over the 1994-1997 period, foreign holdings of U.S. equities increased 133%, while foreign holdings of debt securities increased 122%. Id. By March 31, 2000, the time of the last benchmark survey of foreign holdings of U.S. long-term securities, and a date near the peak of the U.S. stock market bubble, inbound foreign investors held almost $3.6 trillion in U.S. long-term securities. Griever et al., note 23, at 638 tbl.1 (2001).

29 Portfolio investment channeled through offshore financial centers was not included in the IMF's 1997 coordinated portfolio investment survey. Thus, this figure may under–or over-represent portfolio investment holdings by U.S. taxpayers. International Monetary Fund, *supra* note 23, at 132, 141-42 tbl.111.2.

30 Office of the Under Sec'y, Int'l Aff., Treasury Dep't, Securities Reports Division, Federal Reserve Bank of New York & Division of Int'l Finance, Board of Governors, Federal Reserve System, Report on U.S. Holdings of Foreign Securities as of Dec. 31, 2001, at 3 tbl.1 (May 2003), available at http://www.treas.gov/tic/shc2001r.pdf [hereinafter Treasury Report on Holdings].

31 Compound annual growth rate calculated based on $158 billion of outbound FPI in 1986 and $2.262 trillion for the stock of U.S. outbound FPI in 2001. *See* Bach, *supra* note

26, at 46 tbl.2 (1986); Treasury Report on Holdings, note 30, at 3 tbl.1.

32 Treasury FLTS Report, *supra* note 26, at 22 tbl.15.

33 Treasury Report on Holdings, *supra* note 30, at 5 tbl.2.

34 *Id.* Note that this figure is based on reported annual cash purchases for outbound FPI divided by 12. The figure likely underestimates the size of gross U.S. FPI due to the growing frequency of international mergers and acquisitions implemented through stock swaps. These stock swaps provide U.S. shareholders with in kind compensation of foreign stock holdings without any cash flow that would require reporting. Griever et al., *supra* note 23, at 641-42; Treasury Dep't, TIC Capital Movements: United States Transactions with Foreigners in Long-Term Securities charts CM-C, CM-D, available at http://www.treas.gov/tic/exhibitsc&d.pdf.

35 Compare text accompanying note 34 with text accompanying note 26. The churn rate suggested by these figures is extremely high and may be the result of problems with the TIC data collection system. For a discussion of the limitations of the current TIC system, see Griever et al., *supra* note 23.

36 Treas. Bull., Sept. 2003, at 88 tbl. CM-V-5, col.14 (Sept. 2003), available at http://fms.treas.gov/bulletin/b33cm5.doc.

37 Treasury FLTS Report, note 26, at 23 tbl.16. Authors' calculations based on raw data provided in the Treasury report.

38 GDP numbers used in this analysis are for 1997 in 1995 Dollars estimated via the Atlas Method. World Bank, World Development Indicators CD-ROM (2002), available at http://www.worldbank.org/data/onlinedatabases/onlinedatabases.html.

39 Treasury FLTS Report, *supra* note 26, at 23 tbl.16.

40 *See* Figure 3. When viewed through the lens of concentration of investment, Switzerland, the Netherlands, Canada, and Sweden become worthy of attention as nations into which the United States disproportionately directs portfolio investment. Meanwhile, Japan appears relatively underrepresented in the portfolios of U.S taxpayers. That country's prolonged recession may explain the relative paucity of U.S. FPI into Japan. Reliable data are not available for country-by-country U.S. outbound FPI in the late 1980's, before the Japanese downturn.

41 *See generally* Brian Aitken, *Have Institutional Investors Destabilized Emerging Markets?*, 16 Contemp. Econ. Pol'y 173 (1998) (examining impact of "positive feedback trading" by institutional investors on emerging stock markets); Culpeper, *supra* note 23. For example, the net shareholder tax rate on dividends for portfolio investments by U.S. tax payers through "collective investment institutions," such as a U.S. mutual fund, was historically 33.25% in the United Kingdom, compared to 46.6% for an investment in the United States. OECD, Taxation of Cross-Border Portfolio Investment: Mutual Funds and Possible Tax Distortions 114 tbl.Al.1.F (1999). This disparity may help explain the UK's position as the top recipient of U.S. outbound FPI British tax laws changed beginning in the year 2000. Thus, the net shareholder tax rate for investment by U.S. taxpayers in the United Kingdom in 2003 is higher than 33.25%. *See* Rev. Proc. 2000-13, 2000-1 C.B. 515; *see also* note 67 and accompanying text.

42 *See, e.g.*, I.R.C. § 902.

43 *See, e.g.*, Avi-Yonah, *Structure*, note 1, at 1308-10.

44 For instance, passive income is income that would be considered foreign personal holding company income as defined in § 954(c). I.R.C. § 904(d)(2)(A)(i). Passive income is put in a separate "basket" from other income under the FTC limitation system, thereby preventing cross-crediting of passive income foreign tax credits against credits on active income. I.R.C. § 904(d)(l)(A). Dividends, interest, royalties, rents, and annuities are all treated as passive income. I.R.C. § 954(c)(1)(A). The Code treats effectively connected income (active income), I.R.C. §§ 871(b), 882, differently from fixed or determinable annual or periodical income, I.R.C. §§ 871(a), 881 (passive income).

45 Section 902 provides that "a domestic corporation which owns 10 percent or more of the voting stock of a foreign corporation from which it receives dividends in any

taxable year shall be deemed to have paid" a ratable proportion of such foreign corporation's foreign income taxes. I.R.C. § 902(a).

46 I.R.C. § 901.

47 *See* OECD, Taxation of Cross-Border Portfolio Investment: Mutual Funds and Possible Tax Distortions 39, 42 tbl.2.7 (1999); *see also* notes 136-142 and accompanying text.

48 Centre for Tax Policy and Administration, OECD, OECD Tax Database tbl. 5 (July 23, 2002), available at http://www.oecd.org/EN/document10,,EN-document-99-3-no-1-32519-99,00.html; *see* David Carey & Economics Dep't, OECD, Tax Reform in Belgium, ECO/WKP (2003)8, at 33 & box 2 (May 15, 2003), available at http://www.oecd.org/eco (noting the Belgian government announced in 2002 it would reduce the corporate tax rate from 40.17% to 33.99% in order to restore the country's competitive position).

49 *See, e.g.*, Avi-Yonah, *Structure*, *supra* note 1, at 1306.

50 *See, e.g.*, Michael P. Devereux, *Issues in the Taxation of Income From Foreign Portfolio and Direct Investment* [hereinafter *Investment Income Taxation*], in Taxing Capital Income in the European Union 110, 131 (Sijbren Cnossen ed., 2000).

51 John H. Dunning, Multinational Enterprises and the Global Economy 568-70 (1993).

52 Gordon & Hines, *supra* note 4, at 43-49, 56-57.

53 Barry Eichengreen & Albert Fishlow, *Contending With Capital Flows: What Is Different About the 1990s?*, *in* Capital Flows and Financial Crises 23, 59 (Miles Kahler ed., 1998).

54 *See generally* UN Conference on Trade and Development, Comprehensive Study of the Interrelationship Between Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) 24-25 (1999).

55 Joel M. Dickson & John B. Shoven, *Ranking Mutual Funds on an After-Tax Basis* (Nat'l Bureau of Econ. Research, Working Paper No. 4393, 1993), available at http://papers.nber.org/papers/w4393.pdf.

56 *Id.* at 4-5. Two of the 150 largest funds were excluded for technical reasons related to unavailability of appropriate data, and one was excluded because it merged into another fund.

57 *Id.* at 12-16 and data referred to therein.

58 *Id.* at 1.

59 *Id.* at 2 (citing only one exception).

60 Disclosure of Mutual Fund After-Tax Returns, Securities Act of 1933 and Investment Company Act of 1940 Release Nos. 33-7941, 34-43857, 66 Fed. Reg. 9002 (Jan. 18, 2001).

61 Morningstar.com offers preliquidation, post-tax rates of return for all the mutual funds it rates on its highly popular "quicktake" reports. *See* http://morningstar.com.

62 Elizabeth Reed Smith, *Fund Strategies to Soothe Tax Pain*, N.Y. Times, Nov. 25, 2001, at C8.

63 *Id.*

64 J. Alex Tarquinio, *Tougher Path for Tax-Managed Funds*, N.Y. Times, Apr. 13, 2003, at C6.

65 Mutual funds play an increasingly important role in meeting the financial goals of U.S. portfolio investors, and are useful to study in attempting to understand the decisionmaking that drives the destination of portfolio investment more generally. Total assets of equity mutual funds increased from $83.1 billion at year-end 1984 to $3,962.3 billion at year-end 2000, representing a compound annual growth rate of 25.2% over the period. Investment Company Institute, 2001 Mutual Fund Fact Book 64 (May 2001), available at http://www.ici.org/ici_frameset.html (last visited July 6, 2003). In general, this reflects a relative shift away from direct household investment in equities to indirect ownership of equities through investment vehicles. The trend with respect

to FPI reflects the same relative shift. At the end of 1999, U.S. investors held over $700 billion in FPI through U.S.-based mutual funds, thereby accounting for almost 30% of total U.S. outbound FPI Lipper Analytical Services, World Equity Database (2000). Data assembled by Derek Lewis at authors' request and on file with authors. Mutual funds are now the single most commonly utilized vehicle for FPI for U.S. taxpayers.

66 Gordon & Hines, *supra* note 4, at 37.

67 *Id.*; Kenneth R. French & James M. Poterba, *Investor Diversification and International Equity Markets*, 81 Am. Econ. Rev. 222 (1991).

68 Gordon & Hines, *supra* note 4, at 39-40 & n.59 (citing studies).

69 Vann, *supra* note 4, at 24.

70 Gordon & Hines, *supra* note 4, at 39.

71 Roger H. Gordon & A. Lans Bovenberg, *Why Is Capital So Immobile Internationally? Possible Explanations and Implications for Capital Income Taxation*, 86 Am. Econ. Rev. 1057, 1073 (1996) (concluding that asymmetric information is a "promising explanation for the empirical evidence on the international mobility of capital").

72 Gordon & Hines, *supra* note 4, at 40.

73 *See, e.g.*, Eichengreen & Fishlow, *supra* note 53, at 59.

74 *See generally* Capital Flows and Financial Crises, *supra* note 53.

75 Rachel McCulloch & Peter A. Petri, *Equity Financing of East Asian Development*, *in* Capital Flows and Financial Crises, *supra* note 53, at 158, 166.

76 UNCTAD Report, *supra* note 23, at 15.

77 Treasury FLTS Report, *nsupra ote* 26; World Bank, World Development Indicators CD-ROM, note 38. Developing countries for purpose of this analysis were defined as countries with GDP/capita of less than $6,000, as measured by the World Bank. Brazil and Mexico top the list of countries influenced by U.S. investment. U.S. taxpayers held $64 billion and $52 billion respectively in investments in Brazil and Mexico in 1999. These two nations received 48% of U.S. outbound FPI to developing countries. Mexico was first in terms of dollars of U.S. outbound FPI received and second in U.S. FPI dollars received per capita. Brazil was second in U.S. FPI received and eleventh in FPI received per capita. Chile, Hungary, and Malaysia were the other reasonably large developing countries that received over $400/capita in FPI from the United States in the 1990's.

78 *See* Andres Velasco & Pablo Cabezas, *Alternative Responses to Capital Inflows: A Tale of Two Countries*, *in* Capital Flows and Financial Crises, *supra* note 53, at 128; Dorothy Meadow Sobol, *Central and Eastern Europe: Financial Markets and Private Capital Flows*, *in* Capital Flows and Financial Crises, *supra* note 53, at 186 (suggesting, inter alia, that Hungary was spared from the effects of the 1994 peso crisis because of the fact that portfolio investment had not yet entered the country).

79 Jeffrey Sachs et al., *Financial Crises in Emerging Markets: The Lessons From 1995*, at 147, 152 (Brookings Papers on Economic Activity, 1996).

80 *Id.*; *see also* Jeffrey Sachs et al., *The Collapse of the Mexican Peso: What Have We Learned?*, 22 Econ. Pol'y 13, 21, 25 (1996) (noting the Mexican banking system converted massive capital inflows, a significant part of which was short-term portfolio investment, into short-term peso debt, which was responsible in large part for the banking system's fragility).

81 *See generally* Roger Lowenstein, When Genius Failed: The Rise and Fall of LongTerm Capital Management (2000).

82 "Distinguished mainstream economists are questioning the wisdom of capital account liberalisation, the efficiency of international capital markets or the role of the IMF. Among them are Martin Feldstein, head of the National Bureau of Economic Research, Paul Krugman of the Massachusetts Institute of Technology, Jeffrey Sachs, director of the Harvard Institute for International Development and, with the official

institutions, Joseph Stiglitz, chief economist of the World Bank." Martin Wolf, *Ins and Outs of Capital Flows*, FIN. TIMES (London), June 16, 1998, at 25. (some of the affiliations of the people listed have changed since 1998.)

83 *See, e.g.*, GEORGE SOROS, GEORGE SOROS ON GLOBALIZATION (2002); JOSEPH STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS (2002).

84 Jeffrey D. Sachs, *Alternative Approaches to Financial Crises in Emerging Markets*, *in* CAPITAL FLOWS AND FINANCIAL CRISES, *supra* note 53, at 247, 259, 260-61; *see also* STEPHANY GRIFFITHJONES, GLOBAL CAPITAL FLOWS: SHOULD THEY BE REGULATED? (1998).

85 *See, e.g.*, *Policy Forum: Sand in the Wheels of International Finance*, 105 ECON. J. 160 (1995) (noting support of influential commentators for a tax on speculative transactions); R. Glenn Hubbard, *Securities Transactions Taxes: Tax Design, Revenue, and Policy Considerations*, 61 TAX NOTES 985, 986 & n.1 (Nov. 22, 1993) (offering brief introduction to the debate over securities transactions taxes); Lawrence H. Summers & Victoria P. Summers, *The Case for a Securities Transactions Excise Tax*, 48 TAX NOTES 879, 881 (Aug. 13, 1990) (discussing Tobin's concern over the diversion of human and capital resources into securities trading).

86 Barry Eichengreen et al., *Two Cases for Sand in the Wheels of International Finance*, 105 ECON. J. 160, 163-65 (1995).

87 The tax literature, however, has considered whether differences in enforcement issues suggest differences in taxation of FPI and FDI. *See, e.g.*, Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573, 1583-85 (2000) [hereinafter *Globalization*]; Hubbard, *supra* note 85; Summers & Summers, *supra* note 85.

88 *See Company Taxation in the Internal Market* 142-43 box 5, 150-52 box 6 (European Comm'n, Working Paper No. 582, 2001) [hereinafter EC Working Paper].

89 *Id.* at 142-43 box 5.

90 *Id.* at 215-38.

91 *Id.* at 223 box 10.

92 *See id.* at 142-43 box 5.

93 For example, a U.S. investor holding stock in a U.S. corporation faces identical tax consequences from dividends paid on her investment regardless of whether the dividends are paid out of income earned by the corporation in the United States or in Europe. Similarly, the U.S. investor pays the same capital gains tax on his sale of shares of a U.S. corporation regardless of where that corporation earns its income. *See supra* notes 136-44.

94 *See* EC Working Paper, *supra* note 88, at 142-43 box 5, 150-52 box 6.

95 *Id.* at 142-43 box 5.

96 Another important distinction between portfolio and direct investment is that locational decisions associated with FDI are likely to be affected by effective average tax rates. In contrast, locational decisions for portfolio investment, at most, are affected by the effective marginal tax rate. The difference is due to the fact that portfolio investment does not come with controlling influence. For this reason, portfolio investors expect to obtain only the required rate of return and not a share of the economic rent. If a project was expected to earn an economic rent, its price to new investors (the market price of the portfolio) would be higher. Therefore, a tax with a zero effective marginal rate but a positive effective average tax rate will affect the locational decisions for multinationals as contrasted to their pretax decision, but should not affect locational decisions for portfolio investments.

97 *See, e.g.*, OFFICE OF TAX POL'Y, TREASURY DEP'T, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY 23-54 (2000), available at http://www.ustreas.gov/offices/tax-policy/library/subpartf.pdf. For discussion of CEN see, e.g., DAVID F. BRADFORD & TREASURY DEP'T, BLUEPRINTS FOR BASIC TAX

Reform 89-90 (2d ed., rev. 1984); Staff of Joint Comm. on Tax'n, 102d Cong., Factors Affecting the International Competitiveness of the United States 5, 236 (Comm. Print 1991) [hereinafter JCT Competitiveness Report]; Staff of Joint Comm. on Tax'n, 106th Cong., Overview of Present-Law Rules and Economic Issues in International Taxation (Comm. Print 1999) [hereinafter JCT Economic Issues Report]; Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 26 Brook. J. Int'l Law 1357, 1363-71 (2001) [hereinafter *Inadequate Principles*].

98 *See, e.g.*, Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 Tax L. Rev. 565, 571-73 (1992); Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 Tax Notes 581, 582 (Apr. 30, 1990).

99 Richard E. Caves, Multinational Enterprise and Economic Analysis 190 (2d ed. 1996); Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q.J. Econ. 793, 793-94 n.3 (1980).

100 *See* Avi-Yonah, *Globalization*, *supra* note 87, at 1604.

101 *See, e.g.*, Caves, *supra* note 99, at 190; Frisch, *supra* note 98, at 582, 584-85.

102 *See, e.g.*, Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, *in* Taxation in the Global Economy 11, 39 (Assaf Razin & Joel Slemrod eds., 1990); Frisch, *supra* note 98, at 584.

103 Terrence R. Chorvat, *Ending the Taxation of Foreign Business Income*, 42 Ariz. L. Rev. 835 (2000); National Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21st Century, 1999 TNT 58-17, Mar. 26, 1999, available at LEXIS, TNT File; *see also* Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 Cornell L. Rev. 18, 63-70 (1993) (discussing alternative approaches for enhancing the stability of international income taxation).

104 JCT Competitiveness Report, *supra* note 97, at 5, 240-41.

105 *See, e.g.*, NFTC Foreign Income Project, *supra* note 103, ¶ 7.

106 Graetz, *supra* note 97, at 1371-77.

107 A new standard, capital ownership neutrality (CON), recently has been advanced as an alternative basis for developing international tax policy. Mihir A. Desai & James R. Hines, Jr., *Economic Foundations of International Tax Rules* (July 10, 2003) (paper prepared for the American Tax Policy Institute, on file with the Tax Law Review). A tax system satisfies CON if it does not distort ownership patterns. *Id.* at 23. CON maximizes the efficient allocation of capital if the productivity of capital depends on the identities of its owners. *Id.* Like CEN and CIN, CON does not provide a firm analytical foundation from which to establish international tax policy for FPI, as opposed to FDI. As Desai and Hines point out, the analytical force of CON depends upon ownership at a level that influences businesses' operational and investment decisions. *Id.* at 14-17, 34. This is not the case for FPI By definition, portfolio investment lacks this sort of influence on operational and investment decisions, see notes 40-42 and accompanying text; although, as both we and Desai and Hines point out, the 10% threshold that divides direct from portfolio investment for purposes of U.S. tax law may be somewhat arbitrary. Desai & Hines, *supra*, at 34; *see also* note 4.

108 *See* note 103.

109 Chorvat, *supra* note 103, at 845-59 (distinguishing between active foreign source income and other forms of income).

110 *See* the discussion at notes 178-88 and accompanying text.

111 *See* note 98.

112 Avi-Yonah, *Globalization*, *supra* note 87, at 1604.

113 *See* note 98.

114 Michael Keen, *The Welfare Economics of Tax Coordination in the European*

Community, *in* The Economics of Tax Policy 206 (Michael P. Devereux ed., 1996).

115 EC Working Paper, *supra* note 88.

116 *Id*. at 195-97, tbls.20-22.

117 *Id*. The EC Working Paper never calculates the EATR for a U.S. company engaging in domestic direct investment. As a result that data is not included here.

118 *Id*. at 194-99.

119 EC Working Paper, note 88, at 195 tbl.20, 196 tbl.21. The EATR was calculated by expressing the net present value of tax revenue from a given investment as a percentage of the net present value of the income stream produced by the investment. The pretax rate of return used to determine the EATR on these inframarginal investments was fixed at 20%. *Id*. at 194. In making these calculations, the EC Staff considered only the effect of corporate taxes because it assumed that companies engaged in cross-border investment would have access to the international financial market. *Id*. at 187.

120 EC Working Paper, *supra* note 88, at 195 tbl.20.

121 *Id*. at 196 tbl.21.

122 *Id*. at 197 tbl.22. A11alysis of the unweighted average of all the various EATRs for each of the EC countries across each of the forms of financing shows that the standard deviation of the EATR on U.S. FDI in the EC is 3.4%. *Id*. at 204 tbl.24. The standard deviation of the EATR on U.S. FDI in the EC rises to 3.9% when the most tax-efficient mechanism for financing direct investment into a subsidiary in each individual EC company is used. *Id*. at 208 tbl.26.

123 Using highest marginal tax rates, original calculations on file with authors.

124 Devereux, *supra* note 50.

125 Devereux uses a model in which there are two portfolio investors, each of which can invest in either of two identical companies. One of those two companies is domestic and the other is foreign. Devereux then considers two scenarios. In the first scenario, both of the hypothetical companies reside in countries with classical tax systems. *Id*. at 119-23. In the second scenario, one or both of the hypothetical companies reside in a country with an integrated tax regime that provides some relief from corporate-level withholding to nonresident portfolio investors. *Id*. at 123-26. Devereux speaks in terms of "production efficiency" rather than CEN. His definition of production efficiency, however, is equivalent with CEN so long as he is examining what he calls the "cooperative" case. *Id*. at 121-26. Devereux also considers the requirements for economically efficient taxation under a set of assumptions where countries are "non-cooperative." *Id*. at 126-28; *see also* Peter A. Diamond & James A. Mirrlees, *Optimal Taxation and Public Production I: Production Efficiency; II: Tax Rules*, 61 Am. Econ. Rev. 8-27; 261-78 (1971); *I: Production Efficiency* (in Errata), 62 Am. Econ. Rev. 238 (1972). By non-cooperative, Devereux means that the countries are neither interested in maximizing worldwide economic efficiency regardless of the consequences for their country nor willing to reallocate post-tax revenues between countries to solve distributional inequities resulting from tax systems that are more economically efficient but inequitably distribute income between countries. *Id*. at 116-17, 126. Devereux argues that a non-cooperative country should implement a policy of national neutrality with respect to both FDI and FPI. *Id. at 117.* For a discussion of national neutrality, see notes 141-152 and accompanying text.

126 Devereux, *supra* note 50, at 120.

127 *Id*. at 121.

128 *See id*. 120-21.

129 *Id*. at 122.

130 *Id*.

131 *See id*. at 122-23.

132 *See* notes 115-23 and accompanying text.

133 *See* Devereux, *supra* note 50, at 122.

134 *See id.*

135 EC Working Paper, *supra* note 88, at 73-74, 131-35.

136 Devereux, *supra* note 50, at 123-26.

137 *See* Ault, *supra* note 98, at 585.

138 Peter Andrew Harris, Corporate/Shareholder Income Taxation: And Allocating Taxing Rights Between Countries 69-72 (1996). Imputation relief is one of three major options available for providing dividend relief at the shareholder level. The other two are dividend exclusion and shareholder differentiation. *Id.* at 67-69. A dividend exclusion system excludes dividends from shareholder taxable income. *Id.* at 67-68. A shareholder differentiation system reduces the shareholder tax rate applicable to dividends received below shareholders' marginal income tax rates. *Id.* at 68-69. Additionally, relief of double taxation can be achieved in principle at the corporate level as well as at the shareholder level. *Id.* at 57.

139 Devereux, *supra* note 50, at 123-25.

140 *Id.* at 124-25.

141 *Id.* at 124-25.

142 *Id.* at 125. Finally, Devereux suggests that if integration credits were available only on portfolio investments in domestic economies, CEN still could be achieved if both the country of residence and country of source were to exempt all FDI from taxation. *Id.*

143 Harris, *supra* note 138, at 315; *see also* Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 Tax L. Rev. 565, 600 (1992).

144 As Devereux notes "the government in country A would need to set the personal tax rate on outward bound FPI lower than the personal tax rate on domestic portfolio investment, in order to offset the effect of the higher corporate tax in country B. This offsetting effect is clearly unlikely in practice." Devereux, *supra* note 50, at 122.

145 Case C-35/98, Staatssecretaris van Financien v. B.G.M. Verkooijen, 2000 E.C.R. I-4071, ¶ 62; Consolidated Version of the Treaty Establishing the European Community, art. 293, 2002 O.J. (C 325) 33.

146 H.R. 2, 108th Cong. §§ 116, 281 (2003). Under the proposal, to compute the dividends that could have been paid to shareholders without tax, a corporation would calculate an excludable dividend amount (EDA), which is essentially equivalent to taxable income less federal corporate income taxes paid and foreign tax credits used to offset U.S. tax liability. If a corporation's EDA exceeded the dividend it paid in a given year, each shareholder's basis in its stock would increase by the amount retained per share. Foreign corporations with income that was effectively connected with a U.S. trade or business or that receive excludable dividends could pay excludable dividends under the administration's proposal. Dividends paid out of EDA would be excludable from the income of both corporate and individual recipients.

147 H.R. 2, 108th Cong. § 284 (2003).

148 Treasury Dep't, Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once at ix (1992).

149 B.G.M. Verkooijen, 2000 E.C.R. I-4071, ¶ 62.

150 *See* notes 115-23 and accompanying text.

151 The Bush dividend exclusion proposal as described herein was not enacted. The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302, 117 Stat. 752, 758-64, reduced the tax rate applicable to dividend income, but did not create any preference for dividends paid by U.S. corporations or out of U.S.-source income so as to favor domestic over foreign portfolio investment. *See* I.R.C. § l(h)(ll). Nor did it tie the exclusion of dividends to the existence of foreign or domestic taxes paid at the

corporate level.

152 PEGGY B. MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME 134 (1969).

153 *Id.* at 99, 134.

154 JOINT COMM. ON TAX'N, 108TH CONG., THE U.S. INTERNATIONAL TAX RULES: BACKGROUND AND SELECTED ISSUES RELATING TO THE COMPETITIVENESS OF U.S. BUSINESSES ABROAD 20-21 (Comm. Print 2003); Frisch, *supra* note 98, at 583.

155 *See, e.g.*, Frisch, *supra* note 98, at 583-84.

156 Graetz, *supra* note 97, at 1382.

157 *See id.* at 1391.

158 *See generally* Graetz, *supra* note 97, at 1390-91.

159 Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX J. 771, 771 (2001); *see also* OECD, Taxation of Cross-Border Portfolio Investment: Mutual Funds and Possible Tax Distortions 30 tbl.2.1 (1999) [hereinafter OECD 1999 Report].

160 OECD 1999 Report, *supra* note 159, at 38.

161 *See, e.g.*, Graetz, note 97, at 1396; Herwig J. Schlunk, *I Come Not to Praise the Corporate Income Tax, But to Save It,* 56 TAX L. REV. 329, 335-36 (2003).

162 International Chamber of Commerce, Resolutions Unanimously Adopted by the Committee on Double Taxation 3 (Nov. 24, 1923) (statement of T.S. Adams, tax adviser to the U.S. Treasury), available in T.S. Adams Papers, Yale University, box 12, 1923-24 folder; Graetz & O'Hear, *supra* note 8, at 1036.

163 *See, e.g.*, Avi-Yonah, *supra* note 1, at 1336; *see also* Graetz & O'Hear, *supra* note 8, at 1056-59. We evaluate this claim separately in Section VI.

164 *See, e.g.*, Green, *supra* note 103, at 29.

165 *Id.*

166 Vann, *supra* note 4, at 34-35.

167 Some countries provide relief for the double tax through imputation credits and a few sometimes extend such credits to nonresidents, *see id.* at 50, n.27.

168 *See* notes 88-96 and accompanying text.

169 Underlying calculations on file with authors. Calculations do not reflect changes in the U.S. taxation of dividends enacted in 2003.

170 The 2003 Act, note 151, § 302, modified U.S. law to tax dividends at the same rate as capital gains—currently a top rate of 15%–for taxable years beginning after 2002 and before 2009. Under this law, the largest disparity in post-tax rates of return, with the cur rent foreign tax credit, between two identical investments, each with a 10% pretax rate of return and 100% of corporate earnings distributed as dividends, is 2.8 percentage points. This disparity arises between an investment in France, which produces an 8.5% after-tax return, and an investment in Germany, with a 5.7% after-tax return. A deduction for foreign income taxes instead of the foreign tax credit would slightly increase the difference in after-tax returns on these otherwise identical investments to 2.9 percentage points.

171 *See* text accompanying note 123. While substituting a deduction for foreign taxes for the FTC would create some disincentives to portfolio investment abroad, it is far from clear whether such a shift would have any substantial impact. As we have indicated, economists have discovered—but have yet to explain—a stubborn tendency of portfolio investors to invest in companies from their home country, notwithstanding economic advantages for investments abroad. *See* notes 67-72 and accompanying text. The economic effects from a change in the taxation of FPI could likely be significantly smaller than standard portfolio theory would predict, at least if foreign portfolio investors' decisions fail to conform to economic theory in the same way as domestic portfolio investors' decisions. *Id.*

When dividends from FPI are taxed similarly to capital gains under the 2003 Act, *supra* note 151, substituting a deduction for foreign taxes paid for the foreign tax credit would require structuring the deduction so that it offsets only such "qualified dividend income."

172 Since foreign withholding taxes on portfolio dividends are often imposed at a rate of 15% when received from countries with which the United States has entered into a bilateral income tax treaty, the current foreign tax credit, in those cases, will fully offset the 15% tax on dividend income when such dividends are taxed at the maximum 15% rate now applicable to capital gains. See 2003 Tax Act, *supra* note 151, § 302 (certain dividends paid by "qualified foreign corporations" taxed as capital gain for taxable years beginning after 2002 and before 2009). In these circumstances, replacing the FTC with a deduction for foreign taxes would allow the United States to collect some tax on income from U.S. investors' outbound FPI in those countries. We contend here, *see* note 163 and accompanying text, that residence countries should receive priority in taxing income derived from FPI.

173 Our preliminary calculations suggest that, under 2000 law and rates, moving to a deduction for foreign taxes paid with respect to corporate and individual foreign portfolio investors would provide approximately $350 million of additional revenue annually for the U.S. fisc. This estimate assumes no behavioral changes on the part of investors as a result of the change in the tax law. The estimate, however, is based on the value of individual FTC claimed on interest and dividend payments in 1996 (the most recent year for which data was available). Jeff Curry et al., *Individual Foreign-Earned Income and Foreign Tax Credit, 1996*, SOI Bull., Summer 1999, at 130, 147-48 tbl.3, also available at http://www.irs.gov/taxstats/article/0,,id=96621,00.html; Nick Ward, *Corporate Foreign Tax Credit, 1996: An Industry and Geographic Focus*, SOI Bull., Summer 2000, at 180, 209-11 tbl.2, also available at http://www.irs.gov/taxstats/article/O,,id=96337,00.html. The estimate also assumes that all individuals who claim the FTC are in the top individual tax bracket. Note that individuals outside the top tax bracket claimed at least 28% of the total individual FTC claimed in 1996. Furthermore, our calculation also ignores the exception for working capital investments discussed at note 176 and accompanying text. Finally, the estimate does not take into account changes in the taxation of dividends enacted, on a temporary basis, in 2003. For these reasons the estimated revenue gain from this preliminary calculation is probably high, but there seems to be some substantial revenue at stake. Gary Hufbauer, who assumes that a U.S. move to a deduction for foreign taxes paid with respect to outbound FPI and abolition of U.S. withholding taxes on inbound FPI would be accompanied by worldwide abandonment of withholding tax regimes, has calculated that moving to a deduction system would generate as much as $12 billion annually. Gary Clyde Hufbauer, U.S. Taxation of International Income: Blueprint for Reform 76 (1992). We are skeptical of Hufbauer's assumption that withholding tax rates would fall to zero in all countries that are important recipients of U.S. outbound FPI. *See* notes 178-88 and accompanying text.

174 Barbara Angus, Treasury Testimony at Foreign Relations Hearing on Pending Tax Treaties, ¶ 28 (Mar. 5, 2003), 2003 TNT 45-19, Mar. 7, 2003, available at LEXIS, TNT File (testimony of Barbara Angus, Int'l Tax Counsel, Treasury Dep't, Before the Senate Comm. on Foreign Relations).

175 *See, e.g.*, U.K.-U.S. Treaty, *supra* note 20, art. 10, ¶ 3, 4 Tax Treaties (CCH) ¶ 10,900.

176 For further discussion of the working capital issue, see Graetz & Oosterhuis, *supra* note 159, at 775 (recommending that the definition of working capital under Subpart F be based on a proportion of total gross income or total assets).

177 I.R.C. § 1(h)(11).

178 Hufbauer, *supra* note 173, at 67-68.

179 *Id.* at 65-68.

180 *Id.* at 68.

181 *Id.* at n.11 & 69 n.13.

182 *Id*. at 69 n.13.

183 *Id*. at 68.

184 *Id*.

185 OECD 1999 Report, *supra* note 159, at 42 tbl.2.7.

186 Another anecdotal example that often is mentioned in discussions regarding the effect of changes in U.S. tax policy on FPI patterns is the U.S. experience in the Eurobond market after the 1984 repeal of the 30% withholding tax on portfolio interest paid to foreign residents. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127(a), 98 Stat. 494, 648-50 (codified as amended at I.R.C. § 871(h)). The widespread utilization of Netherlands Antilles finance subsidiaries by U.S. corporate borrowers to access the Eurobond market prior to repeal of the 30% portfolio interest withholding tax and the subsequent transition to direct borrowing in the Eurobond market following the repeal of the withholding tax illustrate that U.S. multinational corporations will go to great lengths to obtain cheaper financing by providing tax-favorable investment vehicles to creditors. *See generally* Leslie E. Papke, *One-Way Treaty With the World: The U.S. Withholding Tax and the Netherlands Antilles*, 7 Int'l Tax & Pub. Fin. 295 (2000). Lessons from the Eurobond case principally concern the effect of tax policy changes on the actions of U.S. multinationals, and are of limited relevance in considering the responsiveness of U.S. outbound foreign portfolio investors to changes in U.S. tax policy.

187 UNCTAD Report, *supra* note 23, at 14. A strong interest in diversification, making overall levels of FPI inelastic, is consistent with speculative volatility. While small shifts in rates of return may encourage portfolio managers to shift their allocations between foreign portfolio investments, a desire for diversification will lead those managers to keep the capital in question in some form of foreign investment.

188 *Id*.

189 *See, e.g.*, Vito Tanzi, *Globalization, Technological Developments, and the Work of Fiscal Termites*, 26 Brook. J. Int'l L. 1261, 1262, 1274-75 (2001).

190 Graetz, *supra* note 97, at 1414-15.

191 Tanzi, *supra* note 189, at 1274-75.

192 Bureau of Economic Analysis, 1994 Benchmark Survey, U.S. Dep't of Commerce, Final Results, U.S. Direct Investment Abroad (1998); *see also* Treasury FLTS Report, note 26; Bach, *supra* note 26, at 46-48.

193 Bach, *supra* note 26, at 47.

194 *Id*. at 48.

195 *Id*. at 47.

196 Treasury FLTS Report, *supra* note 26, at 2.

197 Graetz, *supra* note 97, at 1414.

198 OECD, Harmful Tax Competition: An Emerging Global Issue 46-7, ¶¶ 114-17 (1998) [hereinafter OECD 1998 Report].

199 *Id*. at 37-43; Herman, *supra* note 1, at 223-38.

200 OECD 1998 Report, *supra* note 198, at 53-55, ¶¶ 140-48; Herman, note 1, at 238.

201 OECD 1998 Report, *supra* note 198, at 53-55, ¶¶ 140-48.

202 *Id.* at 37-59 (setting forth Forum's mandate).

203 Tanzi, note 189, at 1271 (citing UN, *Financial Havens, Banking Secrecy and Money Laundering* 71 (1998)).

204 Anne-Marie Berthault, *A French Perspective on Tax Havens and Bank Secrecy: Is the Future a Transparent One?*, 22 Tax Notes Int'l 3171, 3172-73 (June 18, 2001).

205 *See, e.g.*, OECD, *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report* 10, ¶¶ 28, 36-38 (2001) (hereinafter OECD *2001 Progress Report*], available at

http://www.sourceoecd.org/content/html/index.htm.

206 *Id.* at 11, ¶ 37.

207 *Id.*

208 *Id.*

209 *Id.* at 11, ¶¶ 37-38.

210 *Id.* at 11, ¶ 38.

211 OECD, *Improving Access to Bank Information for Tax Purposes* (2000), available at http://www.sourceoecd.org/content/html/index.htm. [hereinafter OECD 2000 Progress Report].

212 The OECD Forum also decided that it would create a List of Uncooperative Jurisdictions comprised of countries that met the tax haven criteria and chose not to eliminate their harmful tax practices after being put on notice by the OECD. The Forum's 2000 Progress Report suggested that OECD members could subject these states to coordinated defensive measures. *Id.* at 6-7. The OECD Forum published this list in 2002. *See* OECD, *List of Uncooperative Jurisdictions* (Apr. 18, 2002), available at http://www.oecd.org/EN/ document/O,EN-document-103-nodirectorate-no-12-28534-22,00.html.

213 OECD 2000 Progress Report, *supra* note 211, at 19, ¶ 21.

214 Berthault, *supra* note 204, at 3173.

215 *List of Uncooperative Jurisdictions*, *supra* note 212.

216 Some analysts believe that the OECD Forum process will ultimately fail. Peter Manyasz, *Tax Havens Outcome of OECD Meeting Disputed; Two Jurisdictions Drop Commitments*, Daily Tax Rep. (BNA) at G-8 (Oct. 16, 2003). Nevertheless, the sheer number of offshore jurisdictions involved in the OECD process shows the potential of that process to influence the information exchange practices of offshore jurisdictions.

217 OECD, Improving Access to Bank Information for Tax Purposes (2000), available at http://www.sourceoecd.org/content/html/index.htm. [hereinafter OECD 2000 Report]

218 *Id.* at 14.

219 Berthault, *supra* note 204, at 3172.

220 OECD 2000 Report, *supra* note 217, at 14-15.

221 OECD Model Treaty, *supra* note 13, at art. 27, ¶ 1.

222 *Id.* art. 27, ¶ 3.

223 Commentary on the OECD Model Tax Convention Proposed art. 27, ¶ 28.

224 Graetz, *supra* note 97, at 1415.

225 Bruce Zagaris, *Selected Aspects of U.S. International Exchange of Information*, 18 Tax Notes Int'l 1725 (Apr. 26, 1999).

226 *Id.*

227 *See* notes 190-97 and accompanying text.

228 Graetz, *supra* note 97, at 1415.

229 *Id.*; *see also* Iain Scoon & Sasha Carter, *EU Savings Tax Directive: Saved at Last?*, 30 Tax Notes Int'l 1179, 1179-82 (June 23, 2003) (describing the directive the ECOFIN Council of the EU adopted on June 3, 2003 regarding automatic exchange of information or the imposition of a withholding tax in the absence of automatic exchange of information (a transitory option available only to Austria, Belgium, and Luxembourg) with respect to interest payments to, or for the benefit of, resident individuals of EU member states).

230 Graetz, *supra* note 97, at 1415.

231 Stephen E. Shay et al., *The David R. Tillinghast Lecture - What's Source Got*

to Do With It?" Source Rules and U.S. International Taxation, 56 TAX L. REV. 81, 124-28 (2002).

232 *Id.* The United States also has taken some measures to improve its ability to provide information as part of exchanges of information with its tax treaty partners. *See, e.g.*, Prop. Regs. §§ 1.6049-6 & 1.6049-8(a), as amended by 67 Fed. Reg. 50386, 50388-50389 (Aug. 2, 2002) (requiring reporting of U.S. bank deposit interest paid to resident individuals of Australia, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, and the United Kingdom).

233 Tanzi, *supra* note 189, at 1271-72, 1274-75.

234 *Id.* at 1279.

235 *Id.* at 1271-74.

236 *Id.* at 1282.

237 *Id.* at 1272-73.

238 Vito Tanzi & Howell H. Zee, *Taxation in a Borderless World: The Role of Information Exchange*, *in* INTERNATIONAL STUDIES IN TAXATION: LAW AND ECONOMICS 321, 328-29 (Gustaf Lindencrona, Sven-Olof Lodin & Bertil Wiman eds., 1999).

239 Tanzi, *supra* note 189, at 1273.

240 *Id.*

241 *Id.*

242 *Id.* at 1272 (citing Howard Davies, *Creeping Growth of the Hedge Funds*, FIN. TIMES, Aug. 15, 2000, at 19).

243 *See, e.g.*, Herman, *supra* note 1, at 423 (noting that the United States could use its dominant role in the world's financial system to encourage multilateral cooperation in tax enforcement).

Chapter 9

Originally published as:

Michael J. Graetz & Alvin C. Warren, Jr., *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 The Yale Law Journal 1186 (2006).

1 Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11 (entered into force Jan. 1, 1958). The Treaty of Rome was itself a successor to the 1951 Treaty of Paris, Apr. 18, 1951, 261 U.N.T.S. 140, which established the European Coal and Steel Community, comprising the same six nations and eliminating tariffs on coal and steel.

2 ALEC STONE SWEET, THE JUDICIAL CONSTRUCTION OF EUROPE 46 (2004). Single European Act art. 13, Feb. 17, 1986, 1987 O.J. (L 169) 1. The Treaty Establishing the European Community, Nov. 10, 1997, 1997 O.J. (C 340) 3, incorporated the guarantees of the Single European Act: freedom of movement for workers, *id.* art. 39, freedom of establishment, *id.* arts. 43, 48, freedom to provide services, *id.* art. 49, and freedom of movement of capital, *id.* arts. 56, 58.

3 Single European Act art. 13, Feb. 17, 1986, 1987 O.J. (L 169) 1. The Treaty Establishing the European Community, Nov. 10, 1997, 1997 O.J. (C 340) 3, incorporated the guarantees of the Single European Act: freedom of movement for workers, *id.* art. 39, freedom of establishment, *id.* arts. 43, 48, freedom to provide services, *id.* art. 49, and freedom of movement of capital, *id.* arts. 56, 58.

4 Article I-4 of the Treaty Establishing a Constitution for Europe states: "The free movement of persons, services, goods and capital, and freedom of establishment shall be guaranteed within and by the Union, in accordance with the Constitution." Treaty Establishing a Constitution for Europe, art. I-4, Oct. 29, 2004, 2004 O.J. (C 310) 1.

5 The EU expanded to fifteen members by adding Austria, Finland, and Sweden in 1995.

The Treaty of Amsterdam in 1997 consolidated and renumbered the articles of the EU and the EC treaties, and in 2001 the Treaty of Nice somewhat revised the EU's governance in anticipation of its expansion to at least twenty-five members. *See* Treaty of Amsterdam Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Oct. 2, 1997, 1997 O.J. (C 340) 1; Treaty of Nice Amending the Treaty on European Union, the Treaties Establishing the European Communities and Certain Related Acts, Feb. 26, 2001, 2001 O.J. (C 80) 1. For subsequent citations to articles in the European treaties, we refer to the Consolidated Version of the Treaty Establishing the European Community, Dec. 24, 2002, 2002 O.J. (C 325) 33 [hereinafter EC Treaty]. For further background, see RUTH MASON, PRIMER ON DIRECT TAXATION IN THE EUROPEAN UNION 1-3 (2005). The European treaties (and Europe's proposed constitution) can be amended (or adopted) only through the unanimous vote of the member states, typically followed by ratification at the national level either by the national legislature or by a referendum.

6 *See, e.g.,* Martin Feldstein, *The Euro and the Stability Pact* (Nat'l Bureau of Econ. Research, Working Paper No. 11,249, 2005).

7 *E.g.,* Robert O. Keohane & Stanley Hoffmann, *Institutional Change in Europe in the 1980s, in* THE NEW EUROPEAN COMMUNITY 1, 7 (Robert O. Keohane & Stanley Hoffmann eds., 1991).

8 *E.g.,* Robert O. Keohane & Stanley Hoffmann, *Institutional Change in Europe in the 1980s, in* THE NEW EUROPEAN COMMUNITY 1, 7 (Robert O. Keohane & Stanley Hoffmann eds., 1991).

9 *E.g.,* James A. Caporaso, *The European Union and Forms of State: Westphalian, Regulatory or Post-Modern?,* 34 J. COMMON MKT. STUD. 29 (1996); Alberta M. Sbragia, *The European Community: A Balancing Act,* PUBLIUS, Summer 1993, at 23.

10 Case 26/62, N.V. Algemene Transport–en Expeditie Onderneming van Gend & Loos v. Nederlandse administratie der belastingen, 1963 E.C.R. 1.

11 The Parliament's 732 members serve five-year terms. MASON, *supra* note 5, at 4-6.

12 *See* Tracy A. Kaye, *Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches,* 7 FLA. TAX REV. (forthcoming 2006) (manuscript at 11, on file with authors).

13 STONE SWEET, *supra* note 2, at 47.

14 MASON, *supra* note 5, at 7 n.57.

15 An early draft of the proposed European Constitution would have allowed majority voting on corporate income tax provisions, but the final draft retained the unanimity requirement, on which the United Kingdom and Ireland insisted. Brian Groom & Peter Norman, *EU Leaders Draw Up Outline Deal on Treaty Revisions,* FIN. TIMES, Dec. n, 2000, at 1. On other issues, Council decisions are made by simple majority, qualified majority, or unanimous vote, depending on the subject matter. The most common procedure is a qualified majority vote, which requires both a majority of member states (or in some cases, a two-thirds majority) and a minimum of 72.3% of total votes. Any member state may also insist that the vote represent 62% of the EU population in order to take effect. MASON, *supra* note 5, at 7; STONE SWEET, *supra* note 2, at 47. Votes in the Council are weighted, generally by the country's size. There are a total of 321 votes. For example, Germany, Italy, and the United Kingdom have 29 votes each, while Slovenia has 4. The presidency of the Council rotates every six months among the member states.

16 EC Treaty art. 257.

17 *E.g., Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Tax Policy in the European Union-Priorities for the Years Ahead,* COM (2001) 260 final (May 23, 2001) [hereinafter *Communication on Tax Policy Priorities*].

18 There are a few directives applicable to the taxation of corporate income. *E.g.,* Council Directive 2003/49, 2003 O.J. (L 157) 49 (concerning interest and royalty payments between related companies); Council Directive 90/434, 1990 O.J. (L 225) 1, as amended by Council Directive 2005/19, 2005 O.J. (L 58) 19 (concerning mergers); Council Directive

90/435, 1990 O.J. (L 225) 6, as amended by Council Directive 2003/123, 2004 O.J. (L 7) 41 (concerning parent-subsidiary taxation); *see also* Council Directive 2003/48, 2003 O.J. (L 157) 38 (concerning savings); Council Directive 77/799, 1977 O.J. (L 336) 15, as amended by Council Directive 79/1070, 1979 O.J. (L 331) 8, and Council Directive 92/12, 1992 O.J. (L 76) 1 (concerning mutual assistance).

19 EC Treaty art. 213.

20 For a comparison of French, U.S., and ECJ decisions, see Mitchel de S.-O.-L'E. Lasser, Judicial Deliberations: A Comparative Analysis of Judicial Transparency and Legitimacy (2004).

21 Stone Sweet, *supra* note 2, at 1.

22 *Id.* Miguel Poiares Maduro goes further to argue that the ECJ engages in "majoritarian activism" and "judicial harmonisation" to reach a regulatory balance that normally corresponds to the view of the Commission and to legislation in the majority of member states. Miguel Poiares Maduro, We the Court: The European Court of Justice and the European Economic Constitution 68 (1998). Maduro writes: "The conclusion to be drawn is that what is taking place in the Court is a kind of Community legislative process, with the Court trying to harmonise national rules in accordance with an 'ideally drafted' representation of all States' interests." *Id.* at 78. As will become apparent later in this Article, we do not find that Professor (now Advocate General) Maduro's description is apt in the context of the ECJ's income tax decisions. *See infra* Parts III-IV.

23 Eric Stein, *Lawyers, judges and the Making of a Transnational Constitution,* 75 Am. J. Int'l L. 1, 1 (1981); *cf.* J.H.H. Weiler, *The Transformation of Europe,* 100 Yale L.J. 2403 (1991) (arguing that the transformation of Europe must also be understood as a political process).

24 *See infra* Section IV.A.

25 *See, e.g.,* James R. Hines Jr., *Taxation and U.S. Multinational Investment,* 2 Tax Pol'y & Econ. 33 (1988).

26 For a fuller discussion of these possibilities, see Alvin C. Warren, Jr., *Income Tax Discrimination Against International Commerce,* 54 Tax L. Rev. 131 (2001).

27 Multilateral Agreements on Trade in Goods, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex lA, Legal Instruments - Results of the Uruguay Round, 33 I.L.M. 1125, 1154 (1994); General Agreement on Trade in Services, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, Legal Instruments-Results of the Uruguay Round, 33 I.L.M. 1125, 1167 (1994); Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, Legal Instruments—Results of the Uruguay Round, 33 I.L.M. 1125, 1197 (1994); General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, 55 U.N.T.S. 194.

28 *See, e.g.,* Paul R. McDaniel, *Trade Agreements and Income Taxation: Interactions, Conflicts, and Resolutions,* 57 Tax L. Rev. 275 (2004) (tracing the history of the GATT and WTO decisions holding that U.S. tax preferences were impermissible export subsidies under the trade treaties).

29 The more recent GATT treaties provide exceptions from trade treaty obligations for income tax and tax treaty provisions. *See* Reuven S. Avi-Yonah, *Treating Tax Issues Through Trade Regimes,* 26 Brook J. Int'l L. 1683 (2001); Servaas van Thiel, *General Report, in* Wto and Direct Taxation 13, 17-25 (Michael Lang et al. eds., 2005).

30 *See* Articles of the Model Convention with Respect to Taxes on Income and on Capital art. 24 (Org. for Econ. Cooperation & Dev. 2005) [hereinafter OECD Model Convention], *available at* http://www.oecd.org/dataoecd/50/49/35363840.pdf. There are more than 2500 bilateral tax treaties in effect, mostly between developed countries. These treaties generally have in common the key structural features of the OECD Model Convention. *See* Kees van Raad, Nondiscrimination in International Tax Law (1986); Mary Bennett, *Nondiscrimination in International Tax Law: A Concept in Search of a Principle,* 59 Tax L. Rev. (forthcoming 2006) (manuscript at 5, on file with authors).

31 Because the focus of this Article is income taxation, it is natural to think of tax discrimination against foreign persons as being against foreign producers. Other kinds of tax discrimination against foreign persons are, however, conceivable. For example, a country might impose a special tax on domestic hotel rooms rented by foreign persons, whether the hotel was owned by domestic or foreign interests.

32 A third possibility emerges from the concept of "national neutrality," which argues for a deduction for foreign taxes, rather than a credit or exemption, to alleviate international double taxation. The key idea here is that domestic and foreign taxes are different because a country benefits only from the taxes it collects. From this perspective, domestic income before taxes should be compared with foreign income after taxes, so a deduction for the latter is appropriate. If equal treatment after deduction for foreign taxes (and national neutrality) were considered the appropriate baseline, the credit and exemption methods of alleviating double taxation would favor foreign over domestic production. From the perspective of those two methods, however, alleviating double taxation by a deduction for foreign taxes, which is not acceptable under the typical tax treaty, would discriminate against foreign production. Although not explicitly framed as a nondiscrimination requirement, the treaty requirement of either a credit or exemption could, from this perspective, be considered such a requirement. *See* Peggy Brewer Richman, Taxation of Foreign Investment Income: An Economic Analysis (1963).

33 *E.g.,* I.R.C. § 904 (West Supp. 2005).

34 For more on capital export and import neutrality, as well as a critical evaluation of the role these concepts play in the analysis of international taxation, see Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies,* 54 Tax L. Rev. 261 (2001).

35 I.R.C. § 199 (West Supp. 2005).

36 *E.g.,* I.R.C. § 168(b), (g)(1)(A), (g)(2) (West 2002 & Supp. 2005) (providing slower depreciation for tangible property used outside the United States).

37 EC Treaty art. 12.

38 *Id.* art. 90.

39 *Id.* art. 87.

40 For classifications of the cases by Treaty freedom, see, for example, Matiias Dahlberg, Direct Taxation in Relation to the Freedom of Establishment and the Free Movement of Capital 71-83 (2005); Adolfo J. Martin Jimenez, Towards Corporate Tax Harmonization in the European Community: An Institutional and Procedural Analysis 205-257 (1999); and Mason, *supra* note 5, at 37-92.

41 In European parlance, "discrimination" sometimes refers only to discrimination on the basis of nationality, and "restriction" to other cases in which cross-border income is taxed more heavily than domestic income. This distinction maps roughly, but not exactly, onto our distinction between discrimination against foreign producers (incoming investment) and foreign production (outgoing investment). *See, e.g.,* Dahlberg, *supra* note 40, at 107-13, 327-29.

42 *See, e.g.,* Michel De Wolf, Souveraineté Fiscale et Principe de Non Discrimination 453- 54 (2005); Hans-Jörgen Aigner et al., *General Report, in* CFC Legislation, Tax Treaties and EC Law 13, 38-43 (Michael Lang et al. eds., 2004); Axel Cordewener et al., *The Tax Treatment* of *Foreign Losses:* Ritter, M & S, *and the Way Ahead (Part Two),* 44 Eur. Tax'n 218 (2004).

43 Case C-446/03, Marks & Spencer plc v. Halsey, ¶ 37 (Apr. 7, 2005) (opinion of Advocate General Maduro), http://www.curia.eu.int/en/contentjjuris/index.htm (search for "Case C- 446/03"). Advocate General Maduro also stated that the different criteria established by the ECJ for application of the Treaty freedoms, such as market access and nondiscrimination based on nationality, "all spring from the same source of inspiration which appears to me to be to prevent Member States from creating or maintaining in force measures promoting internal trade to the detriment of intra-community trade."

Id. ¶ 39.

44 Case 120/78, 1979 E.C.R. 649.

45 *See also* Case 8/74, Procureur du Roi v. Dassonville, 1974 E.C.R. 837 (holding that Belgium could not exclude Scotch whisky already in circulation in France on the ground that the French exporter did not have a U.K. certificate of authenticity that would be required for direct importation into Belgium from the United Kingdom).

46 Case 18/84, 1985 E.C.R. 1339.

47 Case C-118/96, Safir v. Skattemyndigheten i Dalarnas Lan, 1998 E.C.R. I-1897. The court rejected the argument that the tax was not discriminatory because Swedish insurance companies were subject to Swedish taxation, while foreign companies were not.

48 Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, 1999 E.C.R. I-7447. The court rejected the argument that the provision was not discriminatory because German lessors would be subject to taxation in Germany.

49 Case C-55/98, Skatteministeriet v. Vestergaard, 1999 E.C.R. I-7641.

50 Case C-422/01, Försakringsaktiebolaget Skandia (publ) v. Riksskatteverket, 2003 E.C.R. I- 6817.

51 Case C-42/02, *In re* Lindman, 2003 E.C.R. I-13,519. The court rejected the argument that the provision was not discriminatory because the organizers of Finnish lotteries could be subject to Finnish taxation. In addition to the cases discussed in the text, the ECJ has decided a number of other cases involving imported products and services. *See, e.g.,* Case C-334/02, Comm'n v. France, 2004 E.C.R. I-2229 (rejecting a policy allowing French holders of French debt to elect a lower tax rate, whereas French holders of foreign debt could not); Case C-17/00, De Coster v. College des bourgmestre et échevins de Watermael-Boitsfort, 2001 E.C.R. I-9445 (invalidating Belgium's tax on satellite dishes when Belgian broadcasters, but not foreign broadcasters, had the option of using untaxed cable systems as an alternative); Case C-478/98, Comm'n v. Belgium, 2000 E.C.R. I-7587 (invalidating Belgium's exclusion of noninstitutional Belgian investors from a Eurobond issuance by the Belgian government in German marks through German financial institutions); C-439/97, Sandoz GmbH v. Finanzlandesdirektion fur Wien, Niederosterreich und Burgenland, 1999 E.C.R. I-7041 (invalidating an Austrian stamp tax due on foreign borrowing when there was no written loan agreement and when no such tax would be due on borrowing from an Austrian lender).

52 *Skatteministeriet,* 1999 E.C.R. at I-7644.

53 Case 270/83, Comm'n v. France, 1986 E.C.R. 273. These shareholder credits were part of an imputation system eliminating the double taxation of corporate income. We discuss such systems in Section II.A.

54 Case C-324/00, 2002 E.C.R. I-11,779.

55 *E.g.,* I.R.C. § 163(j) (West 2002 & Supp. 2005).

56 Case C-330/91, The Queen v. Inland Revenue Comm'rs, 1993 E.C.R. I-4017.

57 Case C-311/97, Royal Bank of Scotland pk v. Greece, 1999 E.C.R. I-2651.

58 Joined Cases C-397 & C-410/98, Metallgesellschaft Ltd v. Comm'rs of Inland Revenue, 2001 E.C.R I-1727. The "advance corporate tax" was a component of an imputation system intended to reduce double taxation of corporate income. We discuss such systems in Subsection II.A.I. For additional cases involving source-country discrimination against incoming investment, see, for example, Case C-253f03, CLT-UFA SA v. Finanzamt KölnWest (Feb. 23, 2006), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-253/03"), which invalidated a higher German tax on a branch of a foreign company than on a German subsidiary of a foreign company; Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161, which struck down tax relief for foreign investments that was available for German companies, but not for such investments by foreign companies operating in Germany; and Case C-1/93, Halliburton Servs. BV v. Staatssecretaris

van Financien, 1994 E.C.R. I-1137, which invalidated a Dutch transfer tax exemption available only if both the transferor and transferee were Dutch companies.

59 Case C-446/03 (Dec. 13, 2005), http://www.curia. eu.int/en/content/juris/index.htm (search for "Case C-446/03").

60 *E.g.,* Cordewener et al., *supra* note 42; Gerard T.K. Meussen, *Cross-Border Loss Relief in the European Union Following the Advocate General's Opinion in the* Marks & Spencer *Case,* 45 Eur. Tax'n 282 (2005); Lee A. Sheppard, *Dowdy Retailer Set To Destroy European Corporate Tax,* 104 Tax Notes 16 (2004); Christian Wimpissinger, *Beyond* Marks & Spencer: *Cross Border Losses and EC Law,* 38 Tax Notes Int'l 923 (2005).

61 Marks & Spencer plc v. Halsey, No. SPC 00352 (Dec. 17, 2002) (opinion of Special Comm'rs Jones & Gammie) (on file with authors).

62 Case C-446/03, Marks & Spencer plc v. Halsey (Apr. 7, 2005) (opinion of Advocate General Maduro), http://www.curia.eu.int/enfcontent/juris/index.htm (search for "Case C-446/03"). As indicated above, *see supra* text accompanying note 43, Advocate General Maduro suggested that Treaty freedoms should be considered related means to prevent measures promoting internal trade to the detriment of intracommunity trade. *Id.* ¶¶. 37, 39- 40.

63 The court stated its holding ("ruling" in ECJ parlance) as follows:

As Community law now stands, Articles 43 EC and 48 EC do not preclude provisions of a Member State which generally prevent a resident parent company from deducting from its taxable profits losses incurred in another Member State by a subsidiary established in that Member State although they allow it to deduct losses incurred by a resident subsidiary. However, it is contrary to Articles 43 EC and 48 EC to prevent the resident parent company from doing so where the nonresident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods and where there are no possibilities for those losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party.

Marks & *Spencer,* ¶ 61 (Dec. 13, 2005). The United Kingdom has announced plans to modify its legislation to allow foreign losses falling within the second sentence of the court's ruling, but only if the losses are not part of a tax-motivated transaction. Press Release, HM Revenue & Customs, Changes to Company Tax Relief Following European Court of Justice (ECJ) Judgment (Feb. 20, 2006), *available at* http://www.gnn.gov.uk/Content/Detail.asp?ReleaseID=188162&NewsAreaID=2.

64 *Marks* & *Spencer,* ¶¶ 32-34 (Dec. 13, 2005).

65 Case C-264/96, Imperial Chemical Industries plc v. Colmer, 1998 E.C.R. I-4695.

66 Case C-254/97, Société Baxter v. Premier Ministre, 1999 E.C.R. I-4809.

67 Case C-35/98, Staatssecretaris van Financiën v. B.G.M. Verkooijen, 2000 E.C.R. I-4071 (deciding the case on the basis of a Commission directive implementing Treaty freedoms).

68 Case C-315/02, Lenz v. Finanzlandesdirektion fiir Tirol, 2004 E.C.R. I-7063.

69 Case C-319/02, *In re* Manninen, 2004 E.C.R. I-7477. Additional cases involve discrimination against outgoing investment or transfers. *See, e.g.,* Case C-471/04, Finanzamt Offenbach am Main-Land v. Keller Holding GmbH (Feb. 23, 2006), http://www.curia. eu.int/en/content/juris/index.htm (search for "Case C-471/04") (invalidating a German disallowance of financing costs for foreign, but not domestic, second-tier subsidiaries); Case C-268/03, De Baeck v. Belgium, 2004 E.C.R. l-5961 (invalidating a Belgian capital gains tax on shares transferred to foreign, but not domestic, buyers); Case C-9/02, De Lasteyrie du Saillant v. Ministere de l'Économie, des Finances et de l'Industrie, 2004 E.C.R. I-2409 (invalidating a French tax on the transfer of stock abroad); Case C-168/01, Bosal Holding BV v. Staatssecretaris van Financiën, 2003 E.C.R. I-9409 (invalidating a Dutch deduction for financing costs for domestic subsidiaries, but not for foreign subsidiaries unless they produced income in Holland); Case C-436/00, X

v. Riksskatteverket, 2002 E.C.R. I-10,829 (invalidating a provision under which transfer of shares to foreign companies or companies with foreign parents for less than market value was taxable to Swedish shareholders when the transfer to Swedish companies without foreign parents was not); Case C-141/99, Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v. Belgium, 2000 E.C.R. I-11,619 (holding that Belgian operating losses could not be carried forward against Belgian income if those losses could have been offset against income of a foreign affiliate exempt under a tax treaty); Case C-251/98, Baars v. Inspecteur der Belastingdienst Particulieren/Ondernemingen Gorinchem, 2000 E.C.R. l-2787 (invalidating a Dutch exemption from wealth tax for shares in domestic, but not foreign, companies); Case C- 200/98, X AB v. Riksskatteverket, 1999 E.C.R. I-8261 (invalidating a provision granting Swedish tax relief for transfers within corporate groups but not for transfer to a Swedish subsidiary partially owned by a controlled foreign company).

70 Press Release, PricewaterhouseCoopers LLP, PricewaterhouseCoopers Study Shows All 25 EU Countries' Tax Systems To Be in Breach of EU Law (Oct. 14, 2004), *available at* http://www.ukmediacentre.pwc.comfcontent/detail.asp?ReleaselD=1026&NewsArealD=2. For an earlier analysis, see *European Union: Fundamental Freedoms for Citizens, Fundamental Restrictions on National Tax Law,* 40 Eur. Tax'n (Special Issue) 3 (2000) (identifying provisions of national law that are arguably contrary to ECJ jurisprudence).

71 One exception is Case 81/87, The Queen v. HM Treasury, 1988 E.C.R. 5483 (upholding the U.K. requirement of government consent if a U.K. company moved its business headquarters abroad, removing it from U.K. tax jurisdiction).

72 *See* Mason, *supra* note 5, at 93-114.

73 *Id.* at 110.

74 Case C-475/03, Banca Popolare di Cremona v. Agenzia Entrate Ufficio Cremona (Mar. 17, 2005) (opinion of Advocate General Jacobs), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-475/03") (considering whether a regional tax on production levied in Italy is compatible with the prohibition of national turnover taxes other than a value-added tax); *see also* Michael Lang, *The* Marks & Spencer *Case-The Open Issues Following the ECJ's Final Word,* 46 Eur. Tax'n 54, 67 (2006) (arguing that the ECJ's decision in *Marks* & *Spencer* might have been motivated by revenue considerations).

75 For further discussion of the issues involved in designing an integrated tax system, see U.S. Dep't of the Treasury, Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992); Alvin C. Warren, Jr., Am. Law Inst., Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration (1993); and Michael J. Graetz & Alvin c. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction,* 84 Tax Notes 1767 (1999). The foregoing are collected in Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports (Michael J. Graetz & Alvin C. Warren, Jr. eds., 1998) [hereinafter Treasury and Ali Integration Reports].

76 Consider a corporation that earns $200, pays $60 in corporate taxes at a rate of 30%, and distributes half of the remaining $140 each to shareholders *A* and *B,* whose tax rates are 25% and 35%. *As* shown in the table below, full imputation converts the corporate tax into a withholding tax, with each shareholder ultimately receiving the same after-tax return he would have received if his share of the corporate income had been taxed at his individual tax rate:

SHAREHOLDERS	A(25%)	B(35%)
1. Shareholder cash dividend	$70	$70
2. Shareholder taxable income	$100	$100
3. Preliminary shareholder tax	$25	$35

4. Tax credit	($30)	($30)
5. Final shareholder tax (3-4)	($5)	$5
6. Net shareholder cash (1-5)	$75	$65

To avoid confusion, it is worth noting that an imputation shareholder credit is entirely distinct from the foreign tax credit discussed above. The former is aimed at reducing double taxation of corporate income (often called economic double taxation) that can occur in a single country, whereas the latter is aimed at reducing international double taxation (that involves taxation by more than one country). The two forms of multiple taxation converge when a corporation is taxed in one country and its shareholders in another.

77 A third option, deduction of dividends, is usually rejected because it would automatically extend the benefits of integration to exempt and foreign shareholders. *See* Treasury and ALI Integration Reports, *supra* note 75, at 251-53, 641.

78 *See, e.g.,* Richard J. Vann, *General Report,* 88A Cahiers De Droit Fiscal International [Stud. Int'l Fiscal L.] 21 (2003).

79 *See* Peter A. Harris, Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries (1996); Treasury and ALI Integration Reports, *supra* note 75, at 12-14, 183-98, 735-63; Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices,* 47 Tax L. Rev. 565 (1992);

80 *See Commission Staff Working Paper, Company Taxation in the Internal Market,* SEC (2001) 1681 (Oct. 23, 2001), *available at* http://europa.eu.int/comm/taxation_customs/resources/documents/company_tax_study_en.pdf [hereinafter *Working Paper on Company Taxation]* (finding rate differences the most important corporate tax distortion within the EU, but recommending harmonization of the tax base); Comm'n of the Eur. Communities, *Report of the Committee of Independent Experts on Company Taxation* (Ruding Committee Report) (Mar. 1992) (recommending staged steps to reduce corporate tax distortions, including a minimum base and rate, as well as extension of imputation credits to foreign income); *Commission Proposal for a Council Directive Concerning the Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends,* 1975 O.J. (C 253) 2 (recommending a common imputation system); A.J. van den Tempel, *Corporation Tax and Individual Income Tax in the European Communities* (EEC Comm'n, Approximation of Legislation Series No. 15, 1970) [hereinafter van den Tempel Report] (recommending a common system of separate corporate and individual income taxation); EEC Comm'n, *The Development of a European Capital Market* (Segre Report) (Nov. 1966), *available at* http://europa.eu.int/comm/economy_finance/emu_history/documentation/chapter1/19661130en382develeurocapitm_a.pdf (recommending imputation credits be extended to foreign income or foreign shareholders); EEC Comm'n, Fiscal and Fin. Comm., *Report on Tax Harmonization in the Common Market* (Neumark Report) July 8, 1962), *reprinted in* Tax Harmonization in the Common Market 7 (Commerce Clearing House, Inc. ed. & trans. 1963) (recommending a common system of split-rate corporate taxation under which preferential rates would apply to distributed earnings).

81 Case C-35/98, Staatssecretaris van Financién v. B.G.M. Verkooijen, 2000 E.C.R. I-4071.

82 *Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Dividend Taxation of Individuals in the Internal Market,* COM (2003) 810 final (Dec. 19, 2003).

83 Case C-319/02, *In re* Manninen, 2004 E.C.R. I-7477; *see also* Case E-1/04, Fokus Bank ASA v. Norway, [2005] 1 C.M.L.R. 10 (Eur. Free Trade Area Ct. Nov. 23, 2004), *available at* http://www.dinesider.no/customer/770660/archive/files/Decided%20Cases/2004/e_1_04decision-e.pdf (holding that Norway's failure to grant imputation credits to German and U.K. shareholders of a Norwegian company violated the free movement of capital provisions of the European Economic Area Agreement, which extends certain

aspects of the EU internal market to Iceland, Liechtenstein, and Norway).

84 *See* Klaus Eicker, *EC Tax Scene: Germany Introduces a 'Classical' System of Corporate Taxation in Order To Meet European Requirements,* 28 Intertax 453 (2000); Stephan Eilers & Holger Hauselmann, *German Tax* Reform *2001*, Derivatives Rep., Oct. 2000, at l; Dieter Endres & Andreas Oestreicher, *2001 Tax Reform in Germany-Planning for a New Era,* 28 Intertax 408 (2000); Klaus Sieker, *The German Reduction Tax Act* 2001, 30 Tax Mgmt. Int'l J. 115 (2001).

85 *See* Malcolm Gammie, *UK Imputation, Past, Present and Future,* 52 Bull. Int'l Fiscal Documentation 429 (1998).

86 *See* Vann, *supra* note 78, at 50.

87 Eric Berengier, *France Amends Treatment of Dividend Distributions,* 38 Tax Notes Int'l 467 (2005); Gianluca Qgeiroli, *Italy's Dividends Tax Treatment: A Chance of Harmonization,* 35 Tax Notes Int'l 535 (2004).

88 Austria, Malta, Spain, and the United Kingdom retain some version of imputation. European Tax Handbook 2005, at 56, 464, 613, 725 Juhani Kesti ed., 16th ed. 2005). In 2003, the United States extended the preferential tax rate on capital gains to dividends, which has the same effect as a partial exclusion. *See* I.R.C. § 1(h)(11) (West Supp. 2005).

89 Case C-319/02, *In re* Manninen, 2004 E.C.R. I-7477, ¶ 80 (Mar. 18, 2004) (opinion of Advocate General Kokott). For a recent discussion of methods to reduce bias against international investment in the context of the Australian imputation system, see C. John Taylor, *Alternative Treatments for Foreign Source Income in Australia's Dividend Imputation System,* 20 Austl. Tax F. 189 (2005).

90 In previous work relating to the U.S. corporate tax, one of us has favored credits, while the other has favored exclusions. *See* Treasury and Ali Integration Reports, *supra* note 75, at 7-8, 77-96, 637-90.

91 Sophie Fay & Francrois Grosrichard, *67 pôles de compétitivité pour dessiner une nouvelle France industrielle,* Le Monde, July 13, 2005, at 8.

92 Case C-39/04, Laboratoires Fournier SA v. Direction des verifications nationales et internationales, 2005 E.C.R. I-2057; *see also* Case C-242/03, Ministre des Finances v. Weidert, 2004 E.C.R. I-7379 (invalidating a Luxembourg tax deduction for the foundation or expansion of domestic, but not foreign, corporations).

93 Press Release, European Comm'n, Why Europe Needs Research Spending Oune 9, 2005), *available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=MEMO/05/199; *see also* Laszlo Kovacs, European Comm'r for Taxation and Customs, EU Tax Policy and Its Implications for Ireland, Speech to European Movement Ireland 12 (Feb. 24, 2006), *available at* http://europa.eu.int/commjcommission_barrosojkovacs/speeches/speech_dublin.pdf ("The Commission will issue a communication . . . proposing a common framework relating to R&D tax incentives [that] will set out the constraints of Community law and identify best practices.").

94 Press Release, European Comm'n, Direct Taxation: Commission Requests Spain To Amend Laws Incompatible with the EC Treaty July 14, 2005), *available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/933.

95 Press Release, European Comm'n, Commission Decides To Refer Germany to Court Concerning Tax Deductions for School Fees July 15, 2005), *available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/946; *see also* Press Release, European Comm'n, Commission Refers Sweden to Court over Discriminatory Rules on Capital Gains Tax Relief on Home Sales (Dec. 16, 2005), *available at* http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/05/1621 (concluding that the deferral of gain on the sale of a home violated the treaty freedoms because it was conditioned on the purchase of another home in Sweden).

96 EC Treaty art. 87; *see also* Raymond H.C. Luja, Assessment and Recovery of Tax Incentives in the EC and the WTO 77-80 (2003).

97 *See, e.g.,* Case C-156/98, Germany v. Comm'n, 2000 E.C.R. I-6857 (sustaining the Commission's rejection of a post-unification regional tax concession in certain former

territories of East Germany on the ground that the state aid violated the freedom of establishment because the aid was limited to taxpayers headquartered in the region).

98 *Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation,* 1998 O.J. (C 384) 3, ¶ 13 (providing examples of general provisions including tax rates, measures to prevent double taxation or tax avoidance, and measures pursuing general economic policy objectives such as research and development). The distinction between general provisions and exceptions is based on language in Article 87 of the EC Treaty that prohibits state aid "favouring certain undertakings or the production of certain goods." *See* Wolfgang Schon, *Taxation and State Aid Law in the European Union,* 36 Common Mkt. L. Rev. 911, 916-17 (1999) (comparing the scope of the four freedoms with that of the state-aid provisions). This distinction between general provisions and exceptions also is typically used to construct "tax expenditure" budgets, which, although published by many countries, remain controversial. *See, e.g.,* Michael J. Graetz & Deborah H. Schenk, Federal Income Taxation: Principles and Policies 41-56 (5th ed. 2005).

99 Press Release, European Comm'n, State Aid: Commission Opens Formal Investigation into Luxembourg's 1929 Tax-Exempt Holdings (Feb. 8, 2006), *available at* http://europa.eu.int/ rapid/pressReleasesAction.do?reference=IP/06/1 32; Letter from Neelie Kroes, European Comm'n, to Michel Barnier, Foreign Minister, France ¶¶ 14, 32 Jan. 19, 2005), *available at* http://europa.eu.int/comrnfsecretariat_generaVsgb/state_aids/comp-2004/n407-04.pdf (regarding the "*[r]*égime *d'aide que la France envisage de mettre* à *exécution enfaveur des projets de* R&D *dans les pöles de compétitivité*"*).* The reductions for social security were approved because they fell within a limited exception for research and development.

100 *E.g.,* I.R.C. subpt. F (2000).

101 *E.g.,* Case C-196/04, Cadbury Schweppes plc. Comm'rs of Inland Revenue (filed Apr. 29, 2004).

102 *See, e.g.,* CFC Legislation, Tax Treaties EC Law (Michael Lang et al. eds., 2004); Birgitta Glad, *New Challenges to CFC Legislation in Norway–Developing EC Law,* 34 Tax Notes Int'l 843 (2004); Marjaana Helminen, *Is There a Future for CFC-Regimes in the EU?,* 33 Intertax 117 (2005); Raymond H.C. Luja, *Tax Treaties and State Aid: Some Thoughts,* 44 Eur. Tax'n 234 (2004); Anders Rubinstein & Nikolaj Bjornholm, *News Analysis: Do the* Lenz *and* Manninen *Decisions Invalidate Danish Dividend and CFC Taxation?,* 36 Tax Notes Int'l 286 (2004).

103 *E.g.,* Malcolm Gammie, *The Role of the European Court of Justice in the Development of Direct Taxation in the European Union,* 57 Bull. Int'l Fisc. Doc. 86, 96 (2003).

104 *See* Peter J. Wattel, *Home Neutrality in an Internal Market,* 36 Eur. Tax'n 159 (1996) (arguing that the foreign tax credit is inconsistent with the idea of a common market). *But see* Case C-336/96, Gilly v. Directeur des services fiscaux du Bas-Rhin, 1998 E.C.R. I-2793 (refusing to invalidate a foreign tax credit limitation in a French-German tax treaty, as applied to labor income of frontier workers).

105 Lee A. Sheppard, *Responding to* Marks & Spencer, *or Not,* 104 Tax Notes 1489, 1490-92 (2004) (reporting comments of Malcolm Gammie).

106 Graetz, *supra* note 34, at 272 n.36.

107 *See* Wattel, *supra* note 104.

108 *See, e.g.,* Jimenez, *supra* note 40, at 283 (concluding that only source-country taxation is consistent with the Treaty freedoms).

109 *See* Ian Roxan, *Assuring Real Freedom of Movement in EU Direct Taxation,* 63 Moo. L. Rev. 831, 873 (2000) (suggesting that freedom of movement would, if anything, give preference to residence taxation); *see also* Cordewener et al., *supra* note 42, at 224-26 (suggesting that an exemption may be invalid because it would preclude the deduction of foreign losses); Howard M. Liebman & Olivier Rousselle, *Discriminatory Treatment of Dividends in the European Union: Is the End Near?,* 39 Tax Notes Int'l 143 (2005) (explaining that a foreign tax credit is required for foreign withholding taxes to

ensure that total taxes on incoming dividends are not higher than taxes on domestic dividends); Luja, *supra* note 102, at 235 (suggesting that the exemption may be invalid as a form of state aid if it is only made available under a tax treaty).

110 Case 120/78, Rewe-Zentral AG v. Bundesmonopolverwaltung fur Branntwein, 1979 E.C.R. 649; *see also* Case C-250/95, Futura Participations SA v. Administration des contributions, 1997 E.C.R. I-2471 (citing *Cassis de Dijon* and holding that subjecting non-Luxembourg companies operating in Luxembourg to the same accounting requirements as Luxembourg companies was unduly burdensome and violated the Treaty freedoms); Case 8/74, Procureur du Roi v. Dassonville, 1974 E.C.R. 837.

111 *Commission Non-Paper to Informal Ecofin Council, Home State Taxation for Small and MediumSized Enterprises* July 7, 2004), *available at* http://europa.eu.int/comm/taxation_customs/resources/documents/HST_Non-Paper_EN.pdf. As presently formulated, home state taxation would apply the home state tax base, but not its tax rate. A company's total EU income would be computed under home state legislation and then allocated to the member states on the basis of a formula, such as the company's payroll in each country, with the tax rate of each member state then applied to its allocation.

112 *See Commission Proposal for a Directive of the European Parliament and of the Council on Services in the Internal Market,* COM (2004) 2 final/3 (Mar. 5, 2004). In spite of limitations on the country of origin principle, this proposal played a role in the campaign against the EU Constitution in France, where it was said that foreign service providers, symbolized by a Polish plumber, would work in France without having to comply with French regulations.

113 It has also been argued that exemption of foreign income may violate the provisions of the trade treaties that prohibit export subsidies. Reuven S. Avi-Yonah, *Treating Tax Issues Through Trade Regimes,* 26 Brook. J. Int'l L. 1683, 1688 (2001).

114 *Cf.* Frans Vanistendael, *Marché interne et souveraineté fiscale, in* Regards Critiques et Perspectives sur le Droit et la Fiscalité 255, 267 (Cyrille David ed., 2005) (arguing that the simultaneous existence of credit and exemption systems is incompatible with the single market mandated by the EC Treaty, but that the ECJ does not have the authority to choose between the two systems).

115 Since the 1920s, the standard compromise found in tax treaties with respect to corporate source income is that residence countries defer to source countries with respect to corporate business income by means of a foreign tax credit or an exemption for foreign income, while source countries defer to residence countries with respect to shareholder dividend income by reducing or eliminating withholding taxes on dividends paid to foreign shareholders. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation,* 46 Duke L.J. 1021 (1997); *see also* Richard M. Bird & J. Scott Wilkie, *Source- vs. Residence Based Taxation in the European Union: The Wrong Question?, in* Taxing Capital Income in the European Union 78 (Sijbren Cnossen ed., 2000) (arguing that source and residence are not particularly useful principles for assigning tax jurisdiction).

116 *See* Roxan, *supra* note 109 (proposing a cross-migration framework for identifying prohibited taxation of transborder income); Wolfgang Schon, *Tax Competition in Europe—the Legal Perspective,* 9 EC Tax Rev. 90, 97-99 (2000) (arguing that the EC Treaty requires only that a country establish capital import neutrality within its borders and "not unreasonably hinder" exportation of capital, whether monetary, real, or human); Servaas van Thiel, The Future of the Principle of Non-Discrimination in the EU: Towards a Right to Most-Favoured-Nation Treatment and a Prohibition of Double Burdens? (Oct. 21, 2005) (unpublished manuscript, on file with authors).

117 van den Tempel Report, *supra* note 80, at 37; *see also* van Thiel, *supra* note 116, at 12 ("[T]he question of how to address discrimination, i.e. neutrality within one tax system, should be distinguished from the question how to address disparities between two tax systems . . . ."). Professor van Thiel criticizes our conclusion that the logic of the ECJ's jurisprudence involves an impossible quest to eliminate discrimination based on both origin and destination of economic activity, because he sees the court's decisions as remaining "within one tax system." As we indicate in the text, that view fails to account

for much of the ECJ's jurisprudence.

118 In a recent opinion, Advocate General Geelhoed formulated the obligations of source and residence countries under the EC Treaty as nondiscrimination. Although he did not discuss the impossibility of fully eliminating discrimination based on both origin and destination, his interpretation of those obligations did lead him to reject or restrict some of the court's prior decisions finding treaty violations. Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue (Feb. 23, 2006) (opinion of Advocate General Geelhoed), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-374/04").

119 Case C-446/03, Marks & Spencer pk v. Halsey (Dec. 13, 2005), http://www.curia.eu.int/enjcontent/juris/index.htm (search for "Case C-446/03").

120 Case C-319/02, *In re* Manninen, 2004 E.C.R. I-7477. There are several other cases in which the *ECJ* has considered not only the tax law in the member state subject to litigation, but also the tax law in another member state. *E.g.*, Case C-4031'03, Schempp v. Finanzamt Miinchen V, 2005 ECJ CELEX LEXIS 329 July 12, 2005) (upholding German legislation that conditioned deductibility of maintenance payments to a former spouse on taxability in the spouse's country); Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 ECJ CELEX LEXIS 349 July 5, 2005) (upholding wealth tax differences due to differences in tax treaties); *cf.* Case C-336/96, Gilly v. Directeur des services fiscaux du Bas-Rhin, 1998 E.C.R. I-2793 (holding that a residence country's limitation of foreign tax credit to the domestic tax rate did not violate the EC Treaty in the context of labor income).

121 *See, e.g.,* Michael Lang, Double Taxation and EC Law (Oct. 21, 2005) (unpublished manuscript, on file with authors); van Thiel, *supra* note u6. Quite apart from the four freedoms, Article 293 of the EC Treaty provides that member states will eliminate double taxation. That Article was to be eliminated in the proposed constitution. For a critical view of the potential elimination, see Moris Lehner, *A Significant Omission in the Constitution for Europe?,* 2005 B.T.R. 337.

122 We are grateful to Hugh Ault for bringing this possibility to our attention.

123 Org. for Econ. Cooperation and Dev., Ctr. for Tax Policy & Admin., The OECD's Project on Harmful Tax Practices: The 2004 Progress Report (2004), *available at* http://www.oecd.org/dataoecd/60/331'30901115.pdf; *Resolution of the Council and the Representatives of the Governments of the Member States, Meeting Within the Council of 1 December 1997 on a Code of Conduct for Business Taxation,* 1998 O.J. (C 2) 1 (Annex 1), *available at* http://europa.eu.int/comm/taxation_customs/resources/documents/COC_EN.pdf. Not all non-EU OECD countries have agreed to this constraint.

124 *See supra* text accompanying note 98.

125 The OECD is presently studying possible changes to the nondiscrimination article in its model tax treaty. *See* Bennett, *supra* note 30 (manuscript at 3 n.4, on file with authors).

126 *Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee: Towards an Internal Market Without Tax Obstacles—A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities,* COM (2001) 582 final (Oct. 23, 2001) [hereinafter *Communication on Consolidated Corporate Tax Base]; EU Summarizes November Meeting of Harmonized Tax Base Working Group,* Worldwide Tax Daily, Jan. 21, 2005, 2005 WTD 18-16 (LEXIS).

127 *E.g.,* Johnathan Rickman & Charles Gnaedinger, *European Commission Rebuffs FrenchGerman Initiative To Harmonize Corporate Tax,* Worldwide Tax Daily, May 14, 2004, 2004 WTD 94-3 (LEXIS). There are undoubtedly some member states that are skeptical of the future steadfastness of the opposition to rate harmonization on the part of a Commission committed to reduction of economic distortions within the EU. *See, e.g., Working Paper on Company Taxation, supra* note 80 (finding that different national tax rates are the single most important difference between national and transnational investment, a conclusion that would be strengthened by the proposed harmonization of tax bases).

128 The exceptions are cases eliminating incentives for domestic production, unless the country decides to extend the incentive to foreign production.

129 Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11,779, ¶ 36 ("It is settled law that reduction in tax revenue does not constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to a fundamental freedom."); *see also* Joined Cases C-397 & C-410/98, Metallgesellschaft Ltd v. Comm'rs of Inland Revenue, 2001 E.C.R I-1727; Case C-307/97, Compagnie de Saint Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161.

130 Press Release, Court of Justice of the Eur. Communities, Advocate General Tizzano Proposes that the German Tax Legislation Should Be Declared Incompatible with Community Law, but that the Effect of Such Incompatibility Should Be Limited in Time (Nov. 10, 2005), *available at* http://curia.eu.int/en/actu/communiques/cp05/aff/cp050096en.pdf (discussing Case C-292/04, Meilicke v. Finanzamt Bonn-Innenstadt, ¶ 34 (Nov. 10, 2005) (opinion of Advocate General Tizzano), http://curia.eu.int/en/content/juris/index.htm (search for "Case C-292/04")). Advocate General Tizzano suggested, for the first time, limiting the retroactivity of an ECJ decision. The case concerned dividends paid in 1995 through 1997 under the German imputation system, which favored dividends paid by domestic German companies over those paid to German individuals by companies resident elsewhere in the EU-a scheme held invalid by the *ECJ* in *Verkoojijen*. *See supra* Subsection II.A.1. The Advocate General denied relief in *Meilicke,* holding that Germany was responsible to issue refunds only for claims filed after the date of the *Verkoojijen* decision. It remains to be seen whether the *ECJ* will follow Advocate General Tizzano's opinion in this regard. *See* Alexander F. Peter, *ECJ Advocate General Breaks New Ground in German Tax Case,* Worldwide Tax Daily, Dec. 8, 2005, 2005 WTD 235-3 (LEXIS). See *supra* note 74 for additional discussion of revenue considerations.

131 *See, e.g.,* Case C-319/02, *In re* Manninen, 2004 E.C.R. I-7477; Case C-9/02, De Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie, 2004 E.C.R. I-2409.

132 *Lankhorst-Hohorst GmbH,* 2002 E.C.R. I-11,779.

133 *See, e.g.,* Feldstein, *supra* note 6.

134 *See* Graetz & Schenk, *supra* note 98, at 332-33, 338.

135 *E.g.,* Lawrence H. Summers, *Taxation and Corporate Investment: A q-Theory Approach,* 1981 Brookings Papers on Econ. Activity 67, 118. Some economists go further to argue that the biggest bang for the buck is obtained with tax incentives for machinery and equipment. *See, e.g.,* J. Bradford De Long & Lawrence H. Summers, *Equipment Investment and Economic Growth,* 106 Q.J. Econ. 445 (1991) (presenting empirical evidence that economic growth is greater in countries that invest more heavily in equipment). *But see* Alan J. Auerbach et al., *Reassessing the Social Returns to Equipment Investment,* 109 Q.J. Econ. 789 (1994) (arguing that, over the long run, capital intensity should not matter for economic growth).

136 *See, e.g.,* Wolfgang Schon, *Tax Issues and Constraints on Reorganizations and Reincorporations in the European Union,* 34 Tax Notes Int'l 197 (2004) (analyzing the legality of corporate exit taxes under the EC Treaty); *see also supra* text accompanying note 102.

137 The Growth and Stability Pact requires the budget deficits of member states to be below three percent of gross domestic product. *Qualified Majority Voting, in* Encyclopedia Of The European Union 395 (Desmond Dinan ed., 2000).

138 Jimenez, *supra* note 40, at 107, 109-11.

139 *Id.* at 110.

140 *Id.* at 115.

141 For the long story, see *id.* at 115-24.

142 *Id.*

143 For our purposes, it is not necessary to rehearse in great detail the Commission's ongoing efforts to harmonize member states' corporate income taxes. In 1990, the Commission issued a somewhat schizophrenic communication (1) urging harmonization on the ground that disparate member state tax systems inhibit the "development of the

internal market" and, at the same time, (2) insisting that the member states should have the freedom to fashion their own tax systems except when this might cause "major distortions" in the operation of the internal market. *Commission Communication to Parliament and the Council, Guidelines on Company Taxation,* SEC (90) 601 final (Apr. 20, 1990); JIMENEZ, *supra* note 40, at 127. The Commission considered the 1992 Ruding Committee Report as generally supportive of its 1990 conclusions. JIMÉNEZ, *supra* note 40, at 131-35. The Council responded to both the Commission and the Ruding Report in November 1992, by emphasizing the centrality of taxation to member state sovereignty and by treating the principle of "subsidiarity"—minimum EU-level action—as a foregone conclusion. *Id.* at 136; *see also* ANTONIO ESTELLA, THE EU PRINCIPLE OF SUBSIDIARITY AND ITS CRITIQUE (2002). The European Parliament issued its views nearly two years later. It endorsed some of the Commission's conclusions, but it complicated the Commission's task by making clear its belief that any changes recommended by the Commission '"should have regard to the general fiscal environment linked to"' (1) '"the establishment of the European Monetary Union,"' (2) member states' "'budget constraints,'" (3) "'implications for other forms of taxation of any changes in company tax bases or rates,"' and (4) the "'wider role of company taxation as an instrument of economic policy."' JIMENEZ, *supra* note 40, at 137 (quoting the Cox Report, which conveyed the European Parliament's response to the Commission).

144 EUROPEAN TAX HANDBOOK 2005, *supra* note 88, at 185.

145 KMPG, CORPORATE TAX RATE SURVEY 2005, at 2-3, *available at* http://kpmg.com.om/PDF/212792%20Global%20Tax%20Rate_fin.pdf (including effects of subnational taxes on corporate income).

146 For a description of qualified majority voting, see *supra* note 15.

147 *Communication on Consolidated Corporate Tax Base, supra* note 126, at 5; *Communication on Tax Policy Priorities, supra* note 17, at 6; *Working Paper on Company Taxation, supra* note 80, at 384. The European Parliament recently endorsed the idea of a common company tax base. *European Parliament Adopts Report on Harmonized Tax Base,* WORLDWIDE TAX DAILY, Dec. 13, 2005, 2005 WTD 239-18 (LEXIS).

148 Press Release, PricewaterhouseCoopers, *supra* note 70.

149 In the United States, harmonization of the tax base has occurred because the states piggyback on the federal corporate tax and simply use that tax base as a starting point. In fact, there are some relatively minor variations among the states. *See* 1 JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION ch. 7 (3d. ed. 1998 & Supp. 2005).

150 For further discussion of formulary apportionment, see *infra* text accompanying notes 200-207. The Commission seems to be recognizing some of these difficulties. For example, in a December 8, 2005 speech, Laszlo Kovacs, the European Commissioner for Taxation and Customs, emphasized that even the harmonized tax base would be optional for member states. Laszlo Kovacs, European Comm'r for Tax'n and Customs, The Future of EU Taxation Policy, Speech to Tax Directors' Institute and Pricewaterhouse Coopers 5 (Dec. 8, 2005), *available at* http://europa.eu.int/comm/commission_barroso/kovacs/speeches/51201TDI.pdf.

151 *See* Moorman Mfg. Co. v. Blair, 437 U.S. 267, 280 (1978) ("It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income.").

152 *See* George R. Zodrow, *Tax Competition and Tax Coordination in the European Union,* 10 INT'L TAX & PUB. FIN 651 (2003).

153 *See, e.g.,* Kovacs, *supra* note 150, at 6; *see also* Chuck Gnaedinger, *EU Proposes Code of Conduct for Transfer Pricing Documentation,* 40 TAX NOTES INT'L 688 (2005).

154 Michel Aujean, Dir. of Analysis & Tax Policies, EU Comm'n, Conference Presentation: The Future of Nondiscrimination—Direct Taxation in Community Law (Oct. 21, 2005) (on file with authors).

155 The EC Treaty provides for "enhanced cooperation" whenever at least eight member states agree. *See* EC Treaty art. 11; Otmar Thoemmes, *A Europe* à Deux: Vitesses *for*

Enterprise Taxation?, 32 INTERTAX 536 (2004).

156 Aujean, *supra* note 154; Kovacs, *supra* note 150, at 12 ("One of the main tasks of the Commission under the EC Treaty is to ensure that member states respect their Treaty obligations, including, where necessary, by launching infringements proceedings against the Member States.").

157 Kovacs, *supra* note 150, at 13.

158 CONG. BUDGET OFFICE, CORPORATE INCOME TAX RATES: INTERNATIONAL COMPARISONS 14-5 (2005); Chris Edwards, Dir. of Tax Policy, Cato Inst., A Proposal for a Dual-Rate Income Tax, Testimony to the President's Advisory Panel on Tax Reform (May 11, 2005) (accompanying presentation available at www.taxreformpanel.gov/meetings/docs/edwards_052005.ppt).

159 *See, e.g.,* Timothy Lyons, *A Drive To Curb the Power of the ECJ,* 2005 B.T.R. 449.

160 *Cf* Donald H. Regan, *The Supreme Court and State Protectionism: Making Sense of the Dormant Commerce Clause,* 84 MICH. L. REV. 1091 (1986) (arguing that the U.S. Supreme Court should be concerned only with preventing purposeful protectionism in applying the dormant Commerce Clause).

161 A step in this direction has been suggested by the opinion of the Advocate General in *Meilicke*. Case C-292/04, Meilicke v. Finanzamt Bonn-Innenstadt (Nov. 10, 2005) (opinion of Advocate General Tizzano), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-292/04"). The ECJ may also curb the revenue impact of its holdings by narrowing their scope. *See* Case C-446/03, Marks & Spencer plc v. Halsey (Dec. 13, 2005), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-446/03"); *see also supra* notes 74, 130, 134 and accompanying text.

162 *See supra* notes 54-55, 132 and accompanying text.

163 Susannah Camic, State Responses to Adverse Supreme Court Tax Decisions (May 2004) (unpublished manuscript, on file with authors).

164 Chris Giles, *UK Seeks To Curb European Tax Rules,* FIN. TIMES, June 20, 2005, at 1.

165 *Compare* Case C-204/90, Bachmann v. Belgium, 1992 E.C.R. I-249 (holding that the denial of a deduction to Belgian purchasers of foreign insurance was justified because proceeds would not be taxed in Belgium), *with* Case C-80/94, Wielockx: v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2493 (holding that the denial of a deduction by the Netherlands for pension contributions by a nonresident was not justified even though receipts from the pension plan would not be taxable under the Netherlands-Belgium tax treaty). *See generally Marks & Spencer* (Dec. 13, 2005); MASON, *supra* note 5, at 94-101 (discussing the scope of fiscal cohesion).

166 Case C-475/03, Banca Popolare di Cremona v. Agenzia Entrate Ufficio Cremona (Mar. 17, 2005) (opinion of Advocate General Jacobs), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-475/03").

167 Case C-292/04, Meilicke v. Finanzamt Bonn-Innenstadt (Nov. 10, 2005) (opinion of Advocate General Tizzano), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-292/04"); *see also* Case C-374/04, Test Claimants v. Comm'rs of Inland Revenue (Feb. 23, 2006) (opinion of Advocate General Geelhoed), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-374/04") (criticizing the court's decisions in *Bosal Holding* and *Marks & Spencer).*

168 Case C-376/03, D. v. Inspecteur van de Belastingdienst, 2005 ECJ CELEX LEXIS 349 (July 5, 2005).

169 Servaas van Thiel, *A Slip of the European Court in the* D *Case (C-376/03): Denial of the MostFavoured-Nation Treatment Because of Absence of Similarity?,* 33 INTERTAX 454 (2005).

170 For two possibilities, see, for example, text accompanying notes 116-125.

171 Thoemmes, *supra* note 155, at 536 (observing that a "coalition of the willing" for greater harmonization could be formed under the "[e]nhanced [c]ooperation" provisions of the EC Treaty, which requires agreement of eight member states).

172 Charles E. Lindblom, *The Science of "Muddling Through,"* 19 Pub.Admin. Rev. 79 (1959).

173 U.S. Const. art. I, § 10, cl. 2 ("No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports . . . .").

174 *Id.* cl. 3 ("No State shall, without the Consent of Congress, lay any Duty of Tonnage . . . .").

175 *Id.* art. I, § 8, cl. 3 ("[Congress shall have power] [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.").

176 *Id.* art. IV, § 2, cl. 1 ("The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States.").

177 *Id.* amend. XIV, § 1 ("[N]or shall any State . . . deny to any person within its jurisdiction the equal protection of the laws."). The Due Process Clause of the Fourteenth Amendment has also been important in state tax cases involving issues of jurisdiction to tax and extraterritorial taxation, but it is not germane to issues of nondiscrimination.

178 Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977). The other three requirements to satisfy the *Complete Auto* test are that (1) the activity taxed has a substantial nexus with the taxing state; (2) the tax is fairly apportioned to reflect the degree of activity that occurs within the taxing state; and (3) the tax is fairly related to benefits provided by the state. *Id.*

179 Walter Hellerstein, The U.S. Supreme Court's State Tax Jurisprudence: A Template For Comparison 11 (Oct. 21, 2005) (unpublished manuscript, on file with authors) [hereinafter Hellerstein, State Tax Jurisprudence]; *see also* Walter Hellerstein, *Is "Internal Consistency" Foolish?: Reflections on an Emerging Commerce Clause Restraint on State Taxation,* 87 Mich. L. Rev. 138 (1988) [hereinafter Hellerstein, *Internal Consistency*]; Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives,* 81 Cornell L. Rev. 789 (1996).

180 Hellerstein, State Tax Jurisprudence, *supra* note 179, at 10 (quoting *In re* State Tax on Ry. Gross Receipts, 82 U.S. (15 Wall) 284, 296 (1872)).

181 *See supra* note 149.

182 Additionally, the fact that state corporate income taxes are deductible in determining federal taxable income typically reduces their financial impact by about one-third. *See* I.R.C. § 164 (West 2002 & Supp. 2005).

183 For elaboration of these distinctions, see, for example, Walter Hellerstein & Charles E. McLure, Jr., *Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission's Company Taxation Proposals,* 58 BULL. Int'l Fiscal Documentation 86 (2004).

184 West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 193 (1994).

185 Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984). *As* discussed earlier, the categories of foreign products, producers, and production can overlap. Although some commentators, including Hellerstein, have classified this case as a tax incentive for in-state production, Hellerstein, State Tax Jurisprudence, *supra* note 179, at 22, 29, we believe it is better analyzed as a barrier to out-of-state products, because the provision seems primarily aimed against importation of non-Hawaii products, rather than against non-Hawaii production by Hawaiian taxpayers.

186 New Energy Co. of Ind. v. Limbach, 486 U.S. 269 (1988).

187 The Court itself viewed the Ohio regime as erecting '"an economic barrier against competition' that was 'equivalent to a rampart of customs duties."' *Limbach,* 486 U.S. at 275 (quoting Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511, 527 (1935)). The taxes at issue in these cases were taxes on consumption, not income, but it is unclear whether or how that would affect the Court's analysis.

188 Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318 (1977).

189 ARMCO v. Hardesty, 467 U.S. 638 (1984).

190 Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 U.S. 232, 232 (1987).

191 *Id.*

192 *Id.* at 244, 248; *see also* Hellerstein, *Internal Consistency, supra* note 179, at 144 (noting that, if one assumes that every state adopts this kind of arrangement, cross-border activity gets taxed twice, while the taxpayer who confines its activity to a single state is taxed only once).

193 West Lynn Creamery, Inc. v. Healy, 512 U.S. 186 (1994).

194 This is generally due to the U.S. states' use of formulary apportionment for allocating corporate taxes among the states, which reduces the role of residence taxation because the allocation factors generally relate to source or consumption. *See infra* text accompanying notes 200-207. There are more state cases involving this type of discrimination. *E.g.,* R.J. Reynolds Tobacco Co. v. City of New York Dep't of Finance, 667 N.Y.S.2d 4 (App. Div. 1997) (holding that an accelerated depreciation limited to in-state property discriminates against interstate commerce). *See generally* Hellerstein, State Tax Jurisprudence, *supra* note 179, at 24-28 (discussing state court precedents). Discrimination against non-U.S. source income under a state income tax would violate the Foreign Commerce Clause. *See, e.g.,* Kraft Gen. Foods, Inc. v. Iowa Dep't of Revenue & Fin., 505 U.S. 71, 79 (1992) (invalidating a dividends-received deduction for income from domestic but not foreign corporations and asserting that "a state's preference for domestic commerce over foreign commerce is inconsistent with the Commerce Clause").

195 Westinghouse Elec. Corp. v. Tully, 466 U.S. 388 (1984).

196 Maryland v. Louisiana, 451 U.S. 725, 731 (1981).

197 *Id.* at 757.

198 Fulton Corp. v. Faulkner, 516 U.S. 325, 327 (1996) (internal quotation marks omitted).

199 *See, e.g.,* Charles E. McLure, Jr., *The Long Shadow of History: Sovereignty, Tax Assignment and Judicial Decisions on Corporate Income Taxes in the US and the EU* 10 (unpublished manuscript, on file with authors) ("[T]he conflict between state tax sovereignty and the dormant Commerce Clause has been nowhere near as great as the analogous conflict in the EU.").

200 Most states define business income under the Uniform Division of Income for Tax Purposes Act or a substantially similar statute as "income arising from transactions and activity in the regular course of the taxpayer's trade or business." Unif. Div. Income Tax Purposes § 1(a), 7A U.L.A. 147 (2002). "Nonbusiness income" is typically allocated to a particular state or states based either on the situs of the property giving rise to the income (e.g., rents from real property) or on the taxpayer's commercial domicile (e.g., interest and dividends not related to the taxpayer's trade or business).

201 The ECJ also has more difficulty limiting its decisions in this manner because of the Treaty's prohibition against state aid. *See supra* text accompanying notes 96-99. It is worth recalling that the Supreme Court, unlike the ECJ, has considerable discretion regarding which cases it will hear.

202 *E.g.,* Austan Goolsbee & Edward L. Maydew, *Coveting Thy Neighbor's Manufacturing: The Dilemma of State Income Apportionment,* 75 J. Pub. Econ. 125 (2000); Charles E. Mclure, Jr., *The State Corporate Income Tax: Lambs in Wolves' Clothing, in* The Economics of Taxation 327 (Henry J. Aaron & Michael J. Boskin eds., 1980).

203 Kirk J. Stark, *The Quiet Revolution in U.S. Subnational Corporate Income Taxation,* 23 St. Tax Notes 775, 780-82 (2002).

204 *Id.* at 780.

205 437 U.S. 267 (1978).

206 Georgia, Illinois, Massachusetts, Nebraska, and Oregon have adopted single-factor sales formulas, and about half the states have formulas that double-weigh sales in their apportionment formulas. Jerome R. Hellerstein & Walter Hellerstein, State and Local Taxation: Cases and Materials 610-11 (8th ed. 2005); *see also* Stark, *supra* note 203, at 780-82.

207 *Moorman,* 437 U.S. at 283-84 (Powell, J., dissenting). We do not question Justice Powell's characterization of Iowa's sales-only formula as a subsidy to exports (when compared to the three-part formula), but since sales of both Iowa and out-of-state products enter equally into Iowa's tax calculation, we do not agree that its formula necessarily operates as a tariff. *See also* Charles E. Mclure, Jr. & Walter Hellerstein, *Does Sales-Only Apportionment of Corporate Income Violate International Trade Rules?,* 25 St. Tax Notes 779 (2002) (arguing that a single sales factor formula may be an illegal export subsidy under the international trade treaties).

208 386 F.3d 738 (6th Cir. 2004), *cert. granted sub nom.* DaimlerChrysler Corp. v. Cuno, 126 S. Ct. 36 (2005) (No. 04-1704).

209 The court stated:

[A]s between two businesses, otherwise similarly situated and each subject to Ohio taxation, the business that chooses to expand its local presence will enjoy a reduced tax burden, based directly on its new in-state investment, while a competitor that invests out-of-state will face a comparatively higher tax burden because it will be ineligible for any credit against its Ohio tax. *Cuno,* 386 F.3d at 743.

210 One analyst claims that forty-six states offer more than 330 statutory income or franchise tax credits. Timothy H. Gillis, *Sixth Circuit Bans Ohio Tax Credit Under the Commerce Clause, Casting a Pall on Incentives,* 101 J. Tax'n 359, 360 (2004). Another survey of forty-eight states found that only Wyoming had not enacted at least one location incentive between 1991 and 1993· Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business,* 110 Harv. L. Rev. 377, 383-84 (1996); *see also* Chris Micheli, *A 50-State Comparison of Tax Incentives for Manufacturing Equipment Purchases,* 12 St. Tax Notes (1997) (explaining that nearly all states provide tax and other economic incentives for local economic activity).

211 The Supreme Court may refuse to reach the merits in this case on the ground that Cuno and the other plaintiffs lack standing. *See* DaimlerChrysler Corp. v. Cuno, 126 S. Ct. 36, 36 (2005) (granting certiorari and directing the parties to brief the question of "[w] hether respondents have standing to challenge Ohio's investment tax credit").

212 Hellerstein, State Tax Jurisprudence, *supra* note 179, at 29-34.

213 Another example would be states' piggybacking on the domestic manufacturing provision of § 199 of the Internal Revenue Code. I.R.C. § 199 (West Supp. 2005).

214 A further reason to avoid striking down Ohio's investment tax credit is the fact that direct subsidies to encourage in-state production have been permitted by the Supreme Court's interpretations of the U.S. Constitution. *See* Edward A. Zelinsky, Cuna v. DairnlerChrysler: *A Critique,* 34 St. Tax Notes 37 (2004); Edward A. Zelinsky, *Restoring Politics to the Commerce Clause: The Case for Abandoning the Donnant Commerce Clause Prohibition on Discriminatory Taxation,* 29 Ohio N.U.L. Rev. 29 (2002). Europe does not have the same discontinuity between tax incentives and direct expenditures because of the Treaty's prohibitions against state aid. *See supra* text accompanying notes 96-99.

215 H.R. 2471, 109th Cong. (2005); S. 1066, 109th Cong. (2005). These bills are identical.

216 *See* Walter Hellerstein, *Cuno* and Congress: An Analysis of Proposed Federal Legislation Authorizing State Economic Development Incentives 3 (2005) (unpublished manuscript, on file with authors) ("Congress must act with surgical precision if it is to perform the operation without killing the patient.").

217 *See, e.g.,* Vicki C. Jackson, *Constitutional Comparisons: Convergence, Resistance, Engagement,* 119 Harv. L. Rev. 109 (2005); Jeremy Waldron, *Foreign Law and the Modem* Ius Gentium, 119 Harv. L. Rev. 129 (2005); Ernest A. Young, *Foreign Law and the Denominator Problem,* 119 Harv. L. Rev. 148 (2005).

218 *See supra* text accompanying note 183.

219 *See also* Bennett, *supra* note 30 (manuscript at 2-3, 31-32).

220 I.R.C. § 163U) (West 2002 & Supp. 2005).

221 *See* Bennett, *supra* note 30 (manuscript at 19).

222 Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, 2002 E.C.R. I-11,779.

223 *See* Case C-9/02, De Lasteyrie du Saillant v. Ministere de l'Economie, des Finances et de l'Industrie, 2004 E.C.R. l-2409 (striking down a French tax for transfer of stock abroad). The United States, in contrast, believes that it is consistent with its treaty obligations to apply a toll charge under I.R.C. § 367(e)(2) (2000) when appreciated assets are transferred to foreign parents. I.R.S. Notice 87-66, 1987-2 C.B. 376 (rendered obsolete, but not repealed by, Rev. Rul. 2003-99, 2003-2 C.B. 388). Bennett, *supra* note 30 (manuscript at 42-43), concludes that a member state provision such as § 367(e)(2) would be struck down by the ECJ.

224 *See* OECD Model Convention, *supra* note 30, art. 24; Bennett, *supra* note 30 (manuscript at 54-55).

225 *See* Bennett, *supra* note 30 (manuscript at 53-55).

226 *See supra* text accompanying note 32.

227 *See* Bennett, *supra* note 30 (manuscript at 3 n.4).

228 I.R.C. § 199 (West Supp. 2005).

229 *See, e.g.,* Ruth Mason, U.S. Tax Treaty Policy and the European Court of Justice (Oct. 21, 2005) (unpublished manuscript, on file with authors) (arguing for a multilateral tax treaty between the United States and the EU member states).

230 *See, e.g.,* Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161; Case C-336/96, Gilly v. Directeur des services fiscaux du Bas-Rhin, 1998 E.C.R. I-2793.

231 *E.g., Saint-Gobain,* 1999 E.C.R. I-6161.

232 Case C-475/98, Comm'n v. Austria, 2002 E.C.R. I-9797; Case C-471/98, Comm'n v. Belgium, 2002 E.C.R. I-9681; Case C-467/98, Comm'n v. Denmark, 2002 E.C.R. I-9519; Case C-476/98, Comm'n v. Germany, 2002 E.C.R. I-9855; Case C-472/98, Comm'n v. Luxembourg, 2002 E.C.R. I-9741; Case C-468/98, Comm'n v. Sweden, 2002 E.C.R. I-9575; Case C-466/98, Comm'n v. United Kingdom, 2002 E.C.R. I-9427; *see also* Georg W. Kofler, *European Taxation Under an 'Open Sky': LoB Clauses in Tax Treaties Between the U.S. and EU Member States,* 35 Tax Notes Int'l 45 (2004).

233 No intra-European bilateral transport agreements have, however, been entered into since the *Open-Skies* decisions.

234 *See, e.g.,* U.S. Model Income and Capital Tax Convention Treaty art. 22 (1996) (U.S. Dep't of the Treasury).

235 Tax Convention, U.S.-Neth., art. 26, ¶ 4, Dec. 18, 1992, S. Treaty Doc. No. 103-6 (1993).

236 *Compare* Tax Convention, U.S.-F.R.G., art. 28, Aug. 29, 1989, S. Treaty Doc. No. 101-10 (1990) (establishing limitations on benefits), *with* Tax Convention, *supra* note 235, art. 26, ¶ 4.

237 Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161; Hans van den Hurk, *Is the Ability of the Member States To Conclude Tax Treaties Chained Up?,* 13 EC Tax Rev. 17 (2004).

238 Case C-376/03, D. v. Inspecteur van de Belastingdienst (Oct. 26, 2004) (opinion of Advocate General Colomer), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-376/03").

239 *Id. pp.* 97, 101 (emphasis added).

240 Case C-376/03, D. v. lnspecteur van de Belastingdienst, 2005 ECJ CELEX LEXIS 349 July 5, 2005); *see also* Case C-374/04, Test Claimants v. Comm'rs of lnland Revenue ¶¶ 97-103 (Feb. 23, 2006) (opinion of Advocate General Geelhoed), http://www.curia.eu.int/en/content/juris/index.htm (search for "Case C-374/04") (declining to extend bilateral tax treaty benefits to third-country residents).

241 *Inspecteur van de Belastingdienst,* 2005 ECJ CELEX LEXIS ¶ 34.

242 *Id.* ¶¶. 48, 63.

243 *Id.* ¶ 56 (citing Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, 1999 E.C.R. I-6161).

244 *Id.* ¶ 61.

245 *See* Marcel Buur, *ECJ Rejects 'Most Favored Nation' Argument in Dutch-German Tax Case,* Worldwide Tax Daily, July 7, 2005, 2005 WTD 129-2 (LEXIS).

246 *See, e.g.,* van Thiel, *supra* note 169, at 455-57.

247 *See* Mason, *supra* note 229 (arguing for a multilateral tax treaty between the EU and the United States as a response to the ECJ decisions).

248 *See* U.S. Dep't of the Treasury, *supra* note 75. The United States currently taxes dividends at a fifteen percent rate. *See* I.R.C. § 1(h)(11) (West Supp. 2005). President Bush had proposed a one hundred percent exclusion for dividends from earnings on which corporate taxes had already been paid.

249 *See supra* note 102.

250 We have already seen something of the way the debate will unfold in the controversy over Treasury's issuance of I.R.S. Notice 98-11, 1998-1 C.B. 433, which responded to certain tax planning techniques reducing corporate taxes in Europe. In that Notice, the IRS attacked transactions that reduced taxes of U.S. corporations in foreign countries. That unleashed an "explosion of criticism" attacking the Treasury and the IRS for attempting to use U.S. taxes as a "backstop" for "the tax systems of other countries." *See* H. David Rosenbloom, *International Tax Arbitrage and the "International Tax System,"* 53 Tax L. Rev. 137, 157 (2000).

251 The discussion in the text assumes the continuing existence of a corporate income tax in the United States. Some analysts, however, have urged substituting some form of consumption tax for the current U.S. corporate income tax. President's Advisory Panel on Fed. Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System 151-90 (2005). Such a development would, of course, put pressure on the Europeans either to protect or eliminate their own corporate income taxes.

252 *See, e.g.,* Thomas Ferenczi, *La Cour de justice est accusée d'outrepasser ses compétences,* Le Monde, Jan. 13, 2006, at 8 (reporting the view of several member states that the ECJ had exceeded its judicial role in cases involving the role of women in the German army and the access of foreign students to Austrian universities.

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PRAISE FOR *FOLLOW THE MONEY*

This collection of Michael Graetz's writings reminds me of the feat achieved by Mark Twain in his Innocents Abroad, or a New Pilgrim's Progress. Of greatest value, perhaps, is Michael's foresight in highlighting the most treacherous parts of the terrain we face. Graetz's peripatetic journeys across disciplines and topics provide the best possible antidote to the parochialism we are susceptible to and will surely provide the foundation for whatever comes next.

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This collection of influential articles by one of the most respected tax lawyers in the nation addresses today's most important and difficult international tax policy issues. Michael Graetz masterfully critiques guiding principles, resulting in insights that have changed how we approach international tax policy and guided the conversation on reform. These essays are valuable to anyone interested in tax policy in the 21st century and demonstrate clearly why we should "follow the money" and follow Michael Graetz.

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