

# Northwestern Journal of International Law & Business

---

Volume 30

Issue 3 *Summer*

---

Summer 2010

## International Tax Reform Should Begin at Home: Replace the Corporate Income Tax with a Territorial Expenditure

William B. Barker

Follow this and additional works at: <http://scholarlycommons.law.northwestern.edu/njilb>



Part of the [International Law Commons](#), and the [Tax Law Commons](#)

---

### Recommended Citation

William B. Barker, International Tax Reform Should Begin at Home: Replace the Corporate Income Tax with a Territorial Expenditure, 30 Nw. J. Int'l L. & Bus. 647 (2010)

This Article is brought to you for free and open access by Northwestern University School of Law Scholarly Commons. It has been accepted for inclusion in Northwestern Journal of International Law & Business by an authorized administrator of Northwestern University School of Law Scholarly Commons.

# International Tax Reform Should Begin at Home: Replace the Corporate Income Tax with a Territorial Expenditure Tax

*William B. Barker\**

## PREFACE

*The present U.S. system of international taxation is riddled with problems because it does not satisfy critical principles of economics, justice, or common sense. It fails to accomplish the most important goals that an international system should achieve—that is, protecting the domestic tax base in a way that fosters domestic economic development and the creation of jobs. This paper explores alternatives to the present system to see if they do a better job. Some of the alternatives fail for the same reasons as the present system because they are predicated on the same outmoded theories. Some are clearly an improvement, but at the same time raise other significant issues. There is one system, however, that consistently overcomes these defects in a way that would promote domestic business activity and job growth. That system is a destination-based, territorial consumption tax for all corporations.*

## I. INTRODUCTION

Every nation faces the same problem. Economic forces unleashed by free trade, open capital markets, and the enhanced mobility of many of the factors of production, have led to intense tax competition among nations and, as a result, have tested nations' ability to tax business income. The common principles of international taxation, derived one hundred years ago in simpler times, are inadequate to overcome the challenges brought about by dramatic changes in world production and consumption. The United States hangs on to an illusive principle of residence taxation of business income through a hodgepodge of complex, conflicting approaches—deferral of business and equity capital income (territorial approach), anti-avoidance provisions (residence approach), and a liberal foreign tax credit system (residual residence approach). Though the U.S. system is nominally

---

\* Professor of Law, The Dickinson School of Law of Pennsylvania State University.

a residence system, it is in fact a hybrid; it hardly taxes the foreign business income of corporations, and it regularly results in the under-assessment of the U.S. business income of both U.S. and foreign-owned enterprises.

International tax rules must reflect the world in which multinationals produce goods and services both within and without the borders of their “own” country for sale to customers both within and without their “own” country.<sup>1</sup> To get a sense of corporate dominance of trade, U.S. multinationals and their foreign affiliates accounted for 57% of total U.S. exports and 37% of U.S. imports in 2003.<sup>2</sup> Forty-one percent of multinational exports were to foreign affiliates, 44% of imports were from related affiliates.<sup>3</sup> Only a small part of U.S. owned foreign affiliates’ activities are involved with U.S. imports; 11% of sales of U.S. foreign affiliates are imports into the United States.

The picture would be incomplete, however, without considering the role of foreign-owned U.S. affiliates. In recent years, foreign multinationals and their U.S. affiliates accounted for 20% of total U.S. exports and 30% of U.S. imports.<sup>4</sup> The majority of this trade involved intercompany trade, approximately 50% of exports and 80% of imports.<sup>5</sup>

The U.S. tax system is designed to tax the income from exports as they leave the United States, but to exempt the income from imports when they come in.<sup>6</sup> Sales by U.S. domestic corporations are included in income, purchases from foreign affiliates are deductible, and those foreign affiliates’ income is deferred until repatriation as a dividend to the United States. This is the same pattern for foreign-owned multinationals and their U.S. affiliates. U.S. affiliates are treated as U.S. corporations; foreign parents are non-resident entities taxed only on the basis of U.S. source income.

Globalization and tax competition have placed intense pressure on the present U.S. international tax system’s “ability to apply transaction-based tax and intercompany transfer pricing rules to a range of common transactions.”<sup>7</sup> For many years, Congress has been content with incremental change. Congress sometimes patches the existing system in

---

<sup>1</sup> See discussion *infra* accompanying notes 52–54 for a discussion of the problems of conceptualizing the residence of a firm that is engaged in business in many countries.

<sup>2</sup> Raymond J. Mataloni, Jr., *U.S. Multinational Corporations: Operations in 2003*, DEP’T OF COMMERCE, SURVEY OF CURRENT BUSINESS, July 2005, at 9, 9–10.

<sup>3</sup> Bureau for Workers’ Activities, Int’l Labour Org., *Multinational Corporations* (1995), [http://actiav.ilo.org/action\\_english/telearn/globalilo/multinat/multinat.htm](http://actiav.ilo.org/action_english/telearn/globalilo/multinat/multinat.htm).

<sup>4</sup> William J. Zeile, *U.S. Affiliates of Foreign Companies: Operations in 2003*, DEP’T OF COMMERCE, SURVEY OF CURRENT BUSINESS, Aug. 2005, at 208.

<sup>5</sup> *Id.*

<sup>6</sup> See I.R.C. § 861 (2006) (resident companies), I.R.C. § 871 (2006) (nonresident companies engaged in a trade or business with the United States).

<sup>7</sup> American Bar Association Section on Taxation, *Report of the Task Force on International Tax Reform*, 59 TAX LAW. 649, 658 (2006) [hereinafter *ABA Task Force Report*].

order to close loopholes and raise additional revenue. Other times, Congress elevates the tax expenditure function over the tax revenue function and increases the tax benefits for overseas operations.<sup>8</sup> The result is a system that raises little revenue from foreign operations and sometimes reduces substantially the domestic tax base.<sup>9</sup>

Over the years, there have been many proposals for significant change to the international tax system. One proposal would end the deferral of the tax obligation for the foreign affiliates of U.S. corporations.<sup>10</sup> A second proposal would exempt foreign active business income of U.S. taxpayers.<sup>11</sup> A third proposal would exempt foreign economic rents.<sup>12</sup> A fourth would adopt a territorial allocation of worldwide income based on formulary apportionment.<sup>13</sup> At the same time, there has been considerable discussion that targets the overhaul of our entire income tax system by replacing it with a consumption tax model.<sup>14</sup> This paper seeks to examine those international tax reform proposals in terms of several types of inquiry. The first is the need to evaluate tax systems in terms of the societal goals and optimum conditions for appropriate, successful taxation. The second is the need to face the lessons from experience that have identified the principal problems in international taxation. The third is the need to determine why the present system, which is the product of a hundred years of intense self-examination, still does not work well. Finally is the need to test reform proposals against these factors to see if any present a superior solution. The object is to reach some conclusions on the efficacy of both income tax solutions and consumption tax solutions in providing international tax solutions.<sup>15</sup>

---

<sup>8</sup> See, e.g., American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004). For further discussion see text *infra* accompanying notes 41–47.

<sup>9</sup> See Zeile, *supra* note 4, at 692–716 (reviewing the present state of U.S. international tax law).

<sup>10</sup> See, e.g., J. Clifton Fleming, Robert J. Peroni & Stephen E. Shay, *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299 (2001).

<sup>11</sup> See, e.g., PRESIDENT’S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA’S TAX SYSTEM 103 (2005) [hereinafter PRESIDENT’S ADVISORY PANEL].

<sup>12</sup> See William B. Barker, *An International Tax System for Emerging Economies, Tax Sparing and Development: It Is All About Source!*, 29 U. PA. J. INT’L L. 349 (2007).

<sup>13</sup> See, e.g., Joan M. Weiner, *Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level* (U.S. Dep’t of Treasury, OTA Paper 83, 1999), available at <http://www.ustreas.gov/offices/tax-policy/library/ota83.pdf>.

<sup>14</sup> See, e.g., DAVID F. BRADFORD, *UNTANGLING THE INCOME TAX* (1986); William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974).

<sup>15</sup> Only reforms that the U.S. could practically adopt unilaterally will be analyzed. Formulary apportionment will not be addressed since practical implementation requires a

## II. AN INTRODUCTION TO CURRENT INTERNATIONAL TAX PROVISIONS

International taxation must deal with a complex situation. It involves the power of nation states to assess and tax economic events that have direct consequences outside the nation's borders. By the time income taxation became an important tax for most countries in the early twentieth century, there were two distinct approaches to international taxation. The first, and clearly the dominant approach, was source or territorial taxation. The second, adopted principally by the United States and the United Kingdom, was residence or domiciliary taxation.<sup>16</sup>

Source tax is based on the proposition that a country has the right to tax income that has "arisen" in that country.<sup>17</sup> It links taxation with power over the subject matter of the tax. It is a direct method of assigning a tax base to a nation. Practically, it must draw lines between those transactions and economic events that occur in a country and those that do not. It relies on its ability to place income and expenditures based on factors happening in that country. Its premise is that income so sourced belongs to a particular country. In principle, once a source system determines its appropriate tax base, it freely taxes it according to its own principles without concern as to any other country's tax regime.

Residence taxation is an indirect method of assigning a tax base to a nation.<sup>18</sup> Initially, it ignores the focus of the activity or factors that give rise to the income; instead, it looks to the person or entity that earns the income—that is, the taxpayer. Thus, residence taxation is a personal jurisdiction approach; a nation seeks to tax its residents on income irrespective of source. The personal relationship between nation and resident gives that nation the right and the power to tax that person on her worldwide income.

Unlike source taxation, resident taxation must directly confront the problem of international double taxation. There are two generally accepted models for mitigating double taxation: the exemption and the foreign tax credit approach.<sup>19</sup> The exemption system is not truly a residence-based approach because it removes foreign income from the tax base. It can be justified in a residence system as a practical measure where there is reason to believe that the incidence of foreign tax is almost the same or higher than

---

high degree of international coordination. See Weiner, *supra* note 13.

<sup>16</sup> See generally William B. Barker, *Optimal International Taxation and Tax Competition: Overcoming the Contradictions*, 22 NW. J. INT'L. L. & BUS. 161, 180 (2002); Michael J. Graetz, & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1050 (1997).

<sup>17</sup> Barker, *supra* note 16, at 181.

<sup>18</sup> *Id.*

<sup>19</sup> See Articles of the OECD Model Tax Convention on Income and on Capital, art. 23 (2003).

that found in the residence state. The second method, the foreign tax credit, permits a credit for foreign taxes as an offset to the residence country tax.<sup>20</sup> Tax credit systems limit the credit to the amount of domestic tax that would otherwise be due.<sup>21</sup> Thus, worldwide tax coupled with the credit allows the source country the primary position of taxation while granting the residence country the residual tax, if any.

The present U.S. system contains a further distinction concerning income earned by a corporation. A resident corporation is taxed on its worldwide income.<sup>22</sup> Foreign corporations, including those owned by a resident, are taxed, if at all, only on income connected with the United States. Owner-residents of foreign corporations are taxed on sales of their shares and on dividends. In general, income earned by U.S. owned foreign corporations is deferred until repatriation.<sup>23</sup> Corporate owners are entitled to an indirect foreign tax credit on taxable foreign dividends with regard to the underlying tax on the foreign corporation's earnings.<sup>24</sup> Deferral of controlled foreign corporation income reduces the present value of the residual tax to the United States.<sup>25</sup>

### III. THE GOALS OF INTERNATIONAL TAX REFORM

Clear consensus on the goals of the U.S. tax system must be the starting point for successful reform. The first and most obvious function of taxation is raising revenue.<sup>26</sup> Today, with the ever-increasing problem of tax competition,<sup>27</sup> governments are looking for new, dependable sources of revenue.<sup>28</sup>

More effective taxation internationally is primarily a question of the tax base.<sup>29</sup> There are three inter-related aspects or perspectives on the tax

---

<sup>20</sup> See, e.g., I.R.C. § 901 (2006) (allowing a credit against U.S. tax for income taxes paid to a foreign government).

<sup>21</sup> See, e.g., I.R.C. § 904 (2006) (limiting the amount of the foreign tax credit to the amount of U.S. tax due on the foreign income).

<sup>22</sup> See I.R.C. § 11 (2006). See generally PAUL R. MCDANIEL, HUGH J. AULT, & JAMES R. REPETTI, *INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION* 35–56 (5th ed. 2005).

<sup>23</sup> The exception to this rule is for certain income earned by Controlled Foreign Corporations (Subpart F). I.R.C. § 951 (2006).

<sup>24</sup> I.R.C. § 902 (2006).

<sup>25</sup> See *infra* note 65.

<sup>26</sup> Adam Smith was the first to recognize that taxation should be the primary method governments use to raise revenue for their operations. See ADAM SMITH, *THE WEALTH OF NATIONS*, bk. 5, ch. 2, pt. 1 (1904).

<sup>27</sup> See Barker, *supra* note 16, at 165–71.

<sup>28</sup> *ABA Task Force Report*, *supra* note 7, at 654. A 2006 American Bar Association Task Force recognized that the American Job Creation Act of 2004 continued a trend of lower taxes on business income. *Id.* Even this study suggested that the U.S. needed a new direction that required a more effective and intensive taxation of foreign income. *Id.* at 674–76.

<sup>29</sup> Additional revenue is also raised where the economy generates additions to the tax

base. First is the U.S. domestic source tax base for all corporations, U.S. and foreign. Second is the foreign source tax base for U.S. residents. The third is the foreign source tax base for non-resident corporations owned by U.S. residents. The first base targets effective territorial taxation of business enterprises. The second and third bases target effective extraterritorial taxation of the income of our resident companies.

While the second and third goals may be appropriate objectives of policy in some situations, the primary goal of international tax rules and their reform must be the first concern. Unless the principles of fair and efficient taxation for domestic activities and foreign activities were one and the same, which they are not, the inescapable conclusion is that the primary focus should be on establishing and protecting the domestic tax base from erosion that is caused by mischaracterizing and misvaluing foreign and domestic income.<sup>30</sup> A critical reason behind the international trend toward the alternative of a foreign business income (territorial) exemption system is that territorial exemption is perceived to be a more effective way of identifying and preserving the domestic tax base.<sup>31</sup> Economic projections, to the effect that an exemption system is expected to substantially raise revenue as compared to present law, seem to confirm this.<sup>32</sup> The apparent reason for the increase in projected revenue from a system that exempts business income is the more effective taxation of capital income to resident taxpayers.<sup>33</sup>

Tax reform must also confront the real tax system, which is grounded in the dynamic process of politics. "Governments have long recognized the vast power of tax law to influence human conduct. Tax law has taken an interventionist approach, using the structure of taxation to achieve social goals outside the inherent policy choices of taxation. . . . The aims and purposes of taxation include the purposeful use of the forms of taxation to promote economic and social results that are deemed to be politically

---

base.

<sup>30</sup> See *ABA Task Force Report*, *supra* note 7, at 659 ("While changes to international tax rules generally have not been a source of revenue, changes that redress incursions into the U.S. tax base would indeed raise revenue.").

<sup>31</sup> Until quite recently, Japan, the United Kingdom, and the United States were the principal nations which still adopted a worldwide tax regime for corporations. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-934, INTERNATIONAL TAXATION: STUDY COUNTRIES THAT EXEMPT FOREIGN-SOURCED INCOME FACE COMPLIANCE RISKS AND BURDENS SIMILAR TO THOSE IN THE UNITED STATES 2 (2009). Both Japan and the United Kingdom have now adopted provisions for the exemption of foreign active business income. *Id.* at 37.

<sup>32</sup> *ABA Task Force Report*, *supra* note 7, at 658 n.17 (noting that dividend exception has been estimated by the Staff of the Joint Committee on Taxation to increase revenue by \$54.8 billion over a 10-year period).

<sup>33</sup> Rosanne Altshuler & Harry Grubert, *Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations*, 54 NAT'L TAX J. 787, 798 (2001).

desirable.”<sup>34</sup> There is obviously a direct relation between the foreign operations of U.S. taxpayers and their domestic operations. Some have argued that increased foreign investment can have a beneficial impact on growth and domestic production.<sup>35</sup> The evidence is sketchy for this proposition; there are many reasons for foreign activities that promote offsetting results.<sup>36</sup> Foreign activities relating to intra-firm exports do promote domestic production. Multinationals also expand foreign operations to reallocate production to foreign locations thus replacing U.S. jobs.<sup>37</sup> However these tradeoffs are assessed, studies show that low foreign taxes and tax preferences can significantly effect locational decisions.<sup>38</sup>

Enacting tax preferences to increase the benefit of domestic over foreign production can also be problematic. The purpose of the American Jobs Creation Act (“AJCA”)<sup>39</sup> was to promote domestic welfare and domestic job growth. The AJCA provided a temporary tax deduction for U.S. corporations repatriating cash dividends. Evidence suggests that it was a tremendous success in promoting the repatriation of approximately \$300 billion in dividends.<sup>40</sup> But evidence also shows that the extra cash primarily was used for acquisitions and additional management compensation.<sup>41</sup> Dividend flows to the United States were dramatically curtailed

---

<sup>34</sup> William B. Barker, *The Concept Of Tax: A Normative Approach*, in *THE CONCEPT OF TAX*, 21, 27–28 (Bruno Peeters et al. eds., 2005).

<sup>35</sup> See generally Mihir A. Desai, C. Fritz Foley & James R. Hines, *Domestic Effects of the Foreign Activities of U.S. Multinationals* (Ross Sch. of Bus. Paper No. 1020, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=825264](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=825264) (estimating that 10% greater foreign investment is associated with 2.6% greater domestic investment, and 10% greater foreign employee compensation is associated with 3.7% greater domestic employee compensation).

<sup>36</sup> See Martin A. Sullivan, *Will Obama's International Proposals Kill U.S. Jobs?*, 123 TAX NOTES 1063, 1064 (2009) (arguing that the positive effect of foreign investment on U.S. activity reported in the Desai-Foley-Hines study is overstated due to statistical bias).

<sup>37</sup> For an account of tax's effect on jobs, see Francesco Daveri & Guido Tabellini, *Unemployment Growth and Taxation in Industrial Countries*, 15 ECON. POL'Y 48, 52 (2000) (concluding that about 4% points out of 10.5% unemployment was attributable to the large incidence of the tax on labor).

<sup>38</sup> See Harry Grubert, *Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location*, 56 NAT'L TAX J. 221, 221–24 (2003); James R. Hines, Jr. & Eric M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, 109 Q. J. ECON. 149 (1994).

<sup>39</sup> American Jobs Creation Act of 2004, *supra* note 8.

<sup>40</sup> See Melissa Redmiles, *The One Time Received Dividend Deduction*, IRS STATISTICS OF INCOME BULLETIN, Spring 2008, at 102, 103, available at <http://www.irs.gov/pub/irs-soi/08codivdeductbul.pdf>.

<sup>41</sup> Jennifer L. Blouin & Linda K. Krull, *Bringing It Home: A Study of the Incentives Surrounding the Repatriation of Foreign Earnings Under the American Jobs Creation Act of 2004*, 47 J. ACCT. RES. 1027 (2009) (stock repurchase); Thomas J. Brennan, *Cash-Flow and Market Response to Repatriation* 24 (May 24, 2008), <http://ssrn.com/abstract=1134040> (cash may have been used for other purposes).



immediately after the sunset of the provision, with the result that net repatriations were substantially negative over a four-year period.<sup>42</sup> Experiments with tax incentives rarely achieve goals worth their costs.<sup>43</sup> The consequence of granting tax incentives in this case was substantial revenue loss without any appreciable increase in U.S. investment.<sup>44</sup>

It is often hard to predict exactly what effect a tax incentive will have. Tax systems do things differently and tax incentives can have quite different effects on economic activity. Consideration instead should be given to systemic provisions rather than to piecemeal incentive provisions which have the capacity to promote the objectives of welfare in an even-handed manner. Systemic tax reform must speak in terms of those economic conditions that promote fair and efficient taxation.

#### IV. ECONOMIC AND SOCIAL CONDITIONS (OR ASPIRATIONS) FOR OPTIMAL TAXATION

Neither tax systems nor tax reform can accomplish the goals of taxation without addressing certain important elements of good taxation. These elements are efficiency, fairness, and ability to administrate. These elements, moreover, take on quite different aspects when one considers how an open international system bears on the efficacy of taxation.

##### A. Efficiency

The ideal of taxation begins with the approach of positive economics where the most normative prescription for tax is that of efficiency. Tax should be imposed so as to minimize the social costs inherent in collection and spending. In general, an efficient tax is a neutral tax—that is, the incidence of the tax should not change the relative prices of goods and services in the public sector. Taxes are considered to be efficient if resources are used in a way that maximizes their output.<sup>45</sup>

A tax can be inefficient when its incidence distorts economic decision-making from a tract that would have been followed in the absence of tax.<sup>46</sup> This ideal of efficiency is linked to a general goal that is variously described as the maximization of total wealth, or the maximization of total

---

<sup>42</sup> Thomas J. Brennan, *What Happens After a Holiday?: Long-Term Effects of the Repatriation Provision of the AJCA*, 5 NW. J. L. & SOC. POL'Y 1, 2, 16–17 (2010).

<sup>43</sup> See G.A. MACKENZIE, DAVID W.H. ORSMOND & PHILLIP R. GERSON, *THE COMPOSITION OF FISCAL ADJUSTMENT AND GROWTH: LESSONS FROM FISCAL REFORMS IN EIGHT ECONOMIES* 8 (IMF Occasional Paper No. 149, 1997) (recounting the experience of emerging economies with tax incentives).

<sup>44</sup> Brennan, *supra* note 42, at 17.

<sup>45</sup> Norman B. Ture, *Taxing Foreign-Source Income*, in U.S. TAXATION OF AMERICAN BUSINESS ABROAD 37, 38 (AEI-Hoover Policy Study 16, 1975).

<sup>46</sup> See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 193 (Jack R. Crutchfield ed., 1973).

wealth or utility.<sup>47</sup> Thus, the government should design its tax laws and institutions in a way that promotes this condition.

In the international setting, the problem of neutrality takes on a unique aspect. Tax rules or regimes are not neutral where tax rules or regimes affect locational decisions.<sup>48</sup> Tax incidence is an important factor in determining the location of an enterprise or investment any time when factors of production are mobile. Such mobile factors include moneyed capital—both tangible assets and intangible assets like technologies and trademarks. It also can include labor, especially in the case of highly skilled labor. The importance of tax to locational decisions is well-documented.<sup>49</sup> Nations compete in many ways to attract value producing activities to their countries. Tax incentives are oftentimes their principle enticement. Targeted tax incentives are not neutral and are inefficient.

### 1. Capital Export Neutrality and Capital Import Neutrality

Taxation faces unique problems of efficiency and neutrality in open settings where production and values flow freely and each nation is free to set its own rules. Traditionally, the debate over principles of efficiency has been structured in terms of the principle that international tax law should result in the efficient allocation of capital.<sup>50</sup> Neutral taxation of business income has been subsumed under the principles of capital income taxation.

Two approaches to neutrality still form the basis of the debate today. These are Capital Export Neutrality (CEN) and Capital Import Neutrality (CIN).<sup>51</sup> Both CEN and CIN assume general taxation of capital income and

---

<sup>47</sup> See generally, Francesco Parisi, *Positive, Normative and Functional Schools in Law and Economics*, 18 EUR. J.L. & ECON. 259, 269–70 (2004).

<sup>48</sup> See Barker, *supra* note 16, at 189.

<sup>49</sup> See, e.g., Rosanne Altshuler, Harry Grubert & T. Scott Newlon, *Has U.S. Investment Abroad Become More Sensitive to Tax Rates?*, in INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY 9 (James Hines Jr. ed., 2001); COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION 115 (1992); ALEX EASSON, TAXATION OF FOREIGN DIRECT INVESTMENT: AN INTRODUCTION 17 (1999); Barker, *supra* note 12, at 365; Barker, *supra* note 16, at 178; James R. Hines Jr. & Eric M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, 109 Q.J. ECON. 149 (1994).

<sup>50</sup> For one of the earliest accounts, see R.A. Musgrave, *Criteria for Foreign Tax Credit*, in TAXATION AND OPERATIONS ABROAD 83 (1960). For the leading economic analysis, see Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q.J. ECON. 793 (1980). For a general analysis of the issues, see Barker, *supra* note 16, at 188–95.

<sup>51</sup> Barker, *supra* note 16, at 189–90. These are, of course, new forms of the old debate. One version is ownership neutrality, where tax law should not prevent ownership by the most efficient owner. See Mahir A. Desai, *New Foundations for Taxing Multinational Corporations*, 82 TAXES 39 (2004). This is a CIN compatible theory. This author has suggested a new take on the old debate suggesting that the proper principles should be a reconciliation of CEN and CIN principles described as Value Export Neutrality and Value Import Neutrality. The proscription is that “the country that is the source of the assets that

source countries' legitimate power to tax the income from capital provided by non-residents. Both theories recognize that it is the home countries' response that will determine whether capital is efficiently allocated worldwide. The theories differ as to what the resident countries' response should be. CIN provides that capital should be taxed only at the same rate as domestic capital in the host country. CIN results in source taxation only. CEN provides that capital should be taxed at the same rate whether it is utilized in the country of residence or elsewhere. CEN requires residence taxation with appropriate double taxation relief.<sup>52</sup>

In a world with tax harmonization and the effective sharing of information among governments, either approach would be an "efficient" solution.<sup>53</sup> In a world of tax competition, however, most economists and legislators favor CEN because a nation that taxed only the domestic income from capital would experience a large capital drain with economic stagnation as a consequence.<sup>54</sup> Indeed, CIN principles do not lead to effective source taxation of capital income. CIN's premise is that capital will flow to the country where it achieves the highest return. CIN, however, is post tax. The highest foreign return is tax free, or, alternatively, any tax must be charged to the borrower and added on to the interest rate.<sup>55</sup> This result holds true unless countries can agree on harmonized tax bases and rates.<sup>56</sup> Today source countries exempt from income taxation much of the return from debt and other forms of capital.<sup>57</sup> The worldwide adoption of CIN principles would mean the nontaxation of debt capital and many

---

provides the income-producing value should get the exclusive right to tax." Economic rents should be taxed exclusively in the country of source. Barker, *supra* note 16, at 202. M. Desai and J. Hines have challenged the usefulness of CEN and CIN and have proposed instead the theory of ownership neutrality. They assert that tax rules should be evaluated by the degree to which they insure that the identities of capital owners are unaffected by tax rate differences, thereby allowing the market to allocate ownership rights to where they are most productive. See Mihir A. Desai & James R. Hines, Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT. TAX J. 937 (2004); Mihir A. Desai, *New Foundations for Taxing Multinational Corporation*, 82 TAXES 39, 46 (2004).

<sup>52</sup> See Barker, *supra* note 12, at 377–78.

<sup>53</sup> Capital Importing countries would most likely favor CIN because it would provide them with cheaper capital. Capital Exporting Nations would likely favor CEN because it would protect their supplies of capital.

<sup>54</sup> Assaf Razin & Efraim Sudka, *International Tax Competition and Gains from Tax Harmonization*, 37 ECON. LETTERS 69, 75 (1991).

<sup>55</sup> Charles R. Irish, *International Double Taxation Agreements and Income Taxation at Source*, 23 INT'L & COMP. L.Q. 292, 303 (1974); *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, League of Nations Doc. E.F.S.73.F.19, at 8 (1923).

<sup>56</sup> Razin & Sudka, *supra* note 54, at 71, 75.

<sup>57</sup> Mitsuhiro Fukao & Mesaharu Hanazaki, *Internationalisation of Financial Markets and the Allocation of Capital*, 8 J. ECON. STUD. 35 (1987) (Countries hosting EUROBOND market do not tax interest.).

forms of equity capital.<sup>58</sup>

Thus, the only practical and effective economic approach to the taxation of income from capital is CEN.<sup>59</sup> The traditional view is that CEN theory supports residence-base, worldwide taxation of all income.<sup>60</sup> This broad formulation is misleading, however, because both CEN and CIN only address the taxation of income from capital. To the extent that income is produced by factors other than capital, CEN and CIN are silent.

Consider this in terms of the four principle economic concerns of international tax law: appropriate tax significance of domestic business income, exports and imports, foreign capital investment, and resident's foreign business income. CEN and CIN are principles of the efficient allocation of capital income worldwide, that is, the use abroad of capital owned by U.S. persons, and the use in the United States of the capital owned by non-resident taxpayers. Though these theories provide critical insights on neutral international tax principles, they are not designed to provide all the answers.

To begin, capital income viewed from an international perspective takes two forms. The first examines capital flows derived from private investors. This investment is called Foreign Portfolio Investment (FPI) which can be defined as all private, non-Foreign Direct Investment (FDI) made by nonresidents.<sup>61</sup> The second examines capital flows associated with business activity. FDI can be defined as foreign investment undertaken by a taxpayer where the investor owns 10% or more of the equity of the business activity conducted.<sup>62</sup>

Under most approaches to sourcing income, capital income is sourced where it is used or where the transaction takes place and not in the country from which the capital was derived.<sup>63</sup> Though some nations in the past followed principles of strict territorial taxation, most nations today implement a system of taxing FPI of their residents.<sup>64</sup> On the other hand, where FPI is "sourced" in a country, it has always been a generally recognized principle of international taxation that the source state has the right to tax that income. The exercise of this right, however, is becoming less common.

---

<sup>58</sup> See Barker, *supra* note 12, at 373.

<sup>59</sup> See PEGGY BREWER RICHMAN, *TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS* 8 (1963) (supporting CEN approach).

<sup>60</sup> See Barker, *supra* note 16, at 163.

<sup>61</sup> See GARY C. HUFBAUER, *UNITED STATES TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM* 63 (1992); see also Barker, *supra* note 16, at 163.

<sup>62</sup> HUFBAUER, *supra* note 61, at 63 n.1.

<sup>63</sup> See Hugh S. Ault & David F. Bradford, *Taxing International Income: An Analysis of the United States System and its Economic Premises*, in *TAXATION IN THE GLOBAL ECONOMY* 33 (Assaf Razin & Joel S. Slemrod eds., 1990).

<sup>64</sup> See Barker, *supra* note 16, at 194 nn.205–07.

The U.S. has led the way in establishing the nontaxation of much of the return from FPI provided by non-resident taxpayers.<sup>65</sup> Ineffective source taxation attracts foreign capital and encourages domestic capital flight. Nations experiencing capital flight can forego taxation of all income from capital (thus converting a tax on all income into a tax solely on labor income),<sup>66</sup> or they can seek ways to effectively tax the worldwide investment income of their residents. The world trend is in the direction of resident taxation of capital income,<sup>67</sup> and most developed countries are exploring measures to increase the effectiveness of their tax regimes. Moreover, in light of the strong evidence that any source-based tax on interest income is added to the cost of borrowing by the creditors, the optimal solution would be a deduction for foreign taxes as opposed to the allowance of a windfall foreign tax credit against resident taxes because the foreign tax credit would overcompensate for the economic cost of foreign taxes and continue the tax incentive for foreign investment as compared to domestic.

Foreign Direct Investment and the taxation of business income present a much different problem. The words themselves suggest both a more active engagement of resources by the resident country and a more intimate involvement of the foreign enterprise in the source country.

Countries hosting the economic activities of foreign taxpayers witness the whole process of income production. Even though in some cases it may be appropriate to view the income produced as a return on capital, as, for instance, when business income is paid as dividends and interest to resident taxpayers, when produced by a corporation or enterprise the income is the consequence of many factors of production under the general categories of capital and labor. Income is also attributed to the conditions extant in a particular country (such as infrastructure and superstructure). Governments provide many benefits to taxpayers and firms benefit from these inputs, which aid income production.<sup>68</sup> These benefits justify taxation.<sup>69</sup>

---

<sup>65</sup> See I.R.C. § 871(h) (2006) (referring to individual portfolio interest), I.R.C. § 871(i) (referring to individual deposits), I.R.C. § 881(c) (2006) (referring to foreign corporation portfolio interest).

<sup>66</sup> See VITO TANZI, *TAXATION IN AN INTEGRATING WORLD* 14 (1995).

<sup>67</sup> One of President Obama's recent tax proposals is aimed at strengthening the system of withholding and information gathering. See U.S. DEP'T OF THE TREASURY, *GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS* 41–42 (2009), available at <http://www.ustreas.gov/offices/tax-policy/library/grmbk09.pdf>.

<sup>68</sup> See John D. Wilson & David E. Wildasin, *Capital Tax Competition: Bane or Boon*, 88 J. PUB. ECON. 1065, 1069 (2004).

<sup>69</sup> It was Adam Smith who first linked the justification for taxation to the benefits taxpayers receive from the state. See ADAM SMITH, *THE WEALTH OF NATIONS*, bk. 5, ch. 2, pt. 2 (1904). See also Herwig J. Schlunk, *Double Taxation: The Unappreciated Ideal*, 102 TAX NOTES 893 (2004) (stating that income can be a reasonable proxy for benefits a corporation receives from a nation).

Consequently, business income has a more complex make-up, and it would be a daunting task to try to analyze the exact factor makeup of any return. In general, most factor costs (with the exception of a normal return on equity) are deducted in some manner from the tax base in determining net income.<sup>70</sup> Since governments do not directly charge for public goods and services, these do not reflect actual costs and are, consequently, not deductible.

The complex makeup of business income is largely ignored, however. Business income is instead treated as a whole. Once assigned to a national location, that country has the primary right to tax. But, contrary to the consensus on FPI that resident taxation is appropriate, there is no consensus on the residence country's right to tax foreign business income.<sup>71</sup> This anti-resident attitude is now reflected in the fact that most nations exempt the foreign active business income of their corporations.<sup>72</sup> Moreover, the deferral of the tax on the income of U.S. owned foreign affiliates can approximate the results of exemption depending on the length of the exemption because it reduces the present discounted value of the tax obligation.<sup>73</sup>

Three American scholars, however, have argued against this worldwide trend. They have suggested instead worldwide taxation of corporate income without deferral.<sup>74</sup> They argue that the present system creates excess avoidance possibilities, distorts economic decisions, and is unfair to other American taxpayers. They illustrate their concerns with the following example. Assume a U.S. company has 100 to invest either in the United States or abroad. Assume that two investments were uncovered, a U.S. investment with a pretax return of 20% and a foreign investment with a pretax return of 15%. Assuming that the foreign nation does not impose an income tax, and the United States would exempt (or defer) that income, the U.S. company would prefer the less profitable foreign investment. The conclusion is that this leads to capital flight and loss of American jobs.

---

<sup>70</sup> The exception is the cost of equity.

<sup>71</sup> See Klaus Vogel, *Worldwide v. Source Taxation of Income—A Review and Reevaluation of Arguments (Part II)*, 16 *INTERTAX* 310, 311–12 (1988) (stating that government benefits should result in exclusive source taxation of multinational corporation's income).

<sup>72</sup> See *supra* note 31 for the recent examples of Japan and the United Kingdom.

<sup>73</sup> Assume a tax obligation of \$100 that does not have to be paid for 20 years. The present value of the obligation to pay \$100 at the end of 20 years at a discount rate of 8% would be \$21.50. Assuming a 50 year deferral, the present value of the obligation to pay \$100 at the end of 50 years at a discount rate of 8% would be \$2.13. The formula is  $p = A/(1 + r)^n$  with  $p$  = present price,  $A$  = amount, and  $r$  = interest rate. See MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS*, 449–50 (2009).

<sup>74</sup> See, e.g., Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, *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 (2002).

Table 1 illustrates the consequences.

Table 1 – Comparison of Equity Investment

United States and Foreign – 100 Investment

United States (Taxed)	Foreign (Exempt)
20% Return Pretax	15%
7% Tax (35% x 20% return)	0 tax (exempt or deferred)
13 % (after tax return)	15%

Though the example is useful in conveying some basic truths, it is too simple to convey the subtleties of business income. It does illustrate the CEN principle that exemption of foreign capital income creates a substantial capital drain and/or higher domestic cost of capital. Thus, the authors are correct in recognizing that an income exemption system (like the deferral system) tips the competitive scales in favor of foreign investment. The CEN principle, however, is concerned with the efficient allocation of a nation's capital; thus its only application would be to the element of business income that represents the normal return on capital. To see the difference in the example where CEN principles are faithfully followed, begin by reworking the example assuming that the investments are both debt financed instead of equity financed.

Table 2 – Comparison of Debt Financed (8% Interest)

100 Investment – United States and Foreign

United States (Taxed)	Foreign (Exempt)
20% Pretax Gross Return	15%
<u>8% Interest Ded.</u> <sup>75</sup>	<u>8%</u> <sup>76</sup>
12 Pretax Net	7%
<u>4.2% Tax (35% x 12)</u>	<u>0 Tax (Exempt)</u>
7.8 % Post Tax Return	7% Post Tax Return

Comparing Table 1 and Table 2 shows that a critical problem of a

---

<sup>75</sup> Eight percent was arbitrarily chosen as a market value return on a debt investment. Changing the rate would change the absolute calculations but not the point of the illustration.

<sup>76</sup> The tax on the interest paid on the debt is not reflected in the Table because it could be paid to anyone, who might or might not be a U.S. taxpayer.

deferral or exemption system is the deferral on the exemption of the return on equity capital. Whereas in Table 1, the return from equity capital was not included in the U.S. tax base, the comparative tax advantage created a huge incentive for the foreign location. Where both investments were debt financed, however, the balance changed significantly. There the normal return from debt, which was arbitrarily assigned an 8% return, was excluded from both the United States and the foreign tax base.

This suggests an alternative to deferral or the exemption of active business income. This alternative is the foreign exemption of true profit or economic rents. Economic rents are the return that is left when the normal cost of capital is accounted for.<sup>77</sup> Taxation of economic rents is generally accomplished by a cashflow or expenditure tax.<sup>78</sup> Exemption of economic rents requires a different approach. One way to determine the exempt amount for purposes of foreign exclusion would be to begin with the foreign active income base and impute a normal capital return on equity as an interest payment from foreign corporation to U.S. parent.<sup>79</sup> This is illustrated in Table 3. The difference between Tables 2 and 3 is that in Table 2, any investor could have earned the actual interest charge and taxation of that amount depends on the residence of the investor. In Table 3, the beneficiary of the equity return is the U.S. parent and that return should be currently included in its income.

Table 3 – Comparison of Equity Financed

100 Investment with an 8% Normal Return Imputed

United States (Taxed)	Foreign (Tax normal return only)
20% Pretax	15%
<u>7% Tax (35% x 20%)</u>	<u>2.8% U.S. tax on 8% return (35% x 8%)</u>
13% Post tax return	13.2% Post tax return

Treating the equity capital component of FDI the same as FPI makes sense because, to the owner of capital, every investment should make at least a normal return. Corporations, however, seek to employ their own capital in a venture in order to make a net present value investment; that is a return that exceeds the net cost of capital.<sup>80</sup> Table 2 illustrates the result that both investments produce a net present value return. In the case of the

---

<sup>77</sup> RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 280 (2006).

<sup>78</sup> Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does it Matter?* 47 TAX L. REV. 377 (1992).

<sup>79</sup> This is illustrated in Table 3.

<sup>80</sup> See BREALEY, MYERS & ALLEN, *supra* note 77, at 17.



foreign enterprise, this is 15% pre-tax and 7% post-tax. In the case of the U.S. enterprise, it is 12% pretax and 7.8% post tax. These figures illustrate that in all likelihood, the multinational will wish to make both investments. That is, both investments yield a net present value return. The multinational will be encouraged to raise additional capital in the market because both of these investments yield returns greater than the cost of capital.

The distortions created by the exemption or deferral of equity income can also change a marginal pre-tax return into a positive post-tax return and a sub-marginal pre-tax return into a positive post-tax return. Take the example of a U.S. taxpayer with 100 of equity to invest, which that taxpayer could lend at 8% interest. Thus, 8% would be the opportunity cost of capital.

Table 4: Comparison of 100 Equity Financed U.S. v. Foreign

United States (taxed)	Foreign Exempt
8% Pretax	8%
<u>2.8% Tax (.35% - 8%)</u>	<u>0 Tax</u>
5.2% Post Tax Return	8 %

Table 4 illustrates what happens when the investment yields no more than a normal return on capital. The after-tax disparity is large. Table 4 demonstrates that the U.S. investor would not invest at any lower pre-tax rate because it would have both a pre- and post-tax return that would be lower than if it simply lent the money. In terms of the foreign investment, however, this would not be the case. The pretax return could be dropped from 8% to as low as 5.3% and still have a greater after-tax return than the U.S. investment by the U.S. taxpayer. Due to the tax incentive, the foreign enterprise could earn a sub-marginal return. This is an inefficient result from the U.S. perspective.

A territorial cash flow exemption system, which results in the exemption of economic rents, does not share this error.

Table 5 – Comparison of 100 Equity Investment  
(Normal Return Imputed to Foreign Investment)

United States (taxed)	Foreign (Exempt w/ 8% Interest Imputed)
8% (Pretax)	8%
2.8% (Tax 35% x 8%)	2.8% (Tax 35% of 8%)
5.2 Post Tax	5.2 Post Tax

Here, there is no advantage. Moreover, the foreign enterprise would not invest at a sub-marginal rate because it would create a subnormal return as follows.

Table 6 – Comparison of 100 Equity Investment  
(Normal Return Imputed to Foreign Investment)

United States (Taxed)	Foreign (Exempt w/ 8% Interest Imputed)
8% (Pre Tax)	7% (Pre tax)
<u>2.8% (Tax 35% x 8%)</u>	<u>2.8% (Tax 35% x 8%)</u>
5.2% Post Tax	4.2% Post Tax

Systems that exempt or defer business income must face the clear, inefficient consequence that they distort the location of business activity due to their treatment of equity capital. The U.S. taxpayer's business can utilize three kinds of equity capital: money, exported physical assets, and exported intangible assets. These are all mobile assets. Though CEN is typically described in terms of money capital, its underlying premise is applicable to all forms of capital. Where capital is mobile, countries will compete for that capital through lower tax rates.

The present U.S. income tax system addresses the flight of some mobile capital by requiring that the return from intangibles used abroad be currently taxed.<sup>81</sup> Either the value of the intangible is reflected in the price of property sold, or, when the intangible is transferred as an equity investment to a controlled foreign corporation it will be treated as transferred on the basis of an arm's length royalty commensurate with the productivity of that asset.<sup>82</sup> In addition, actual interest payments are also taxed. This scheme is also suggested for proposed territorial exemption systems.<sup>83</sup> These provisions that reflect the home taxation of the income from money or intangible capital derived or produced in the U.S. reflect CEN principles because they result in home taxation of the income from capital wherever it is used. What these systems do not address is the income attributed to equity, which includes transferred equity and retained earnings. To the extent that the income derived from equity capital escapes the tax net, CIN principles, not CEN principles, control. Thus, both deferral and exemption systems follow CIN principles with regard to equity capital.

Thus a foreign active business income exemption system creates the

---

<sup>81</sup> I.R.C. § 367(d) (2006) (noting that most transfers of intangible assets are taxable regardless of whether they are used in a foreign business).

<sup>82</sup> *Id.*

<sup>83</sup> See Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT'L TAX. J. 771, 775 (2001).

same kind of economic problem that the present system of deferral creates. Whereas a system of deferral defers the tax on the income from the normal return on equity capital, an exemption system eliminates the tax altogether. Nations compete for mobile factors of production, including capital in all of its forms with tax incentives, thus diminishing the effect of source taxation.<sup>84</sup> This treatment of equity capital as one reason why there is little effective taxation of the foreign income of multinationals.

### B. Fairness

Both FDI and FPI involve the proper taxation by the nation from which the capital was derived. Though this right is usually thought of in terms of a nation's right to tax the income of its residents, this right can also be fairly seen in terms of the territorial right of a nation to tax the value it has added to the world.<sup>85</sup>

Since FPI is solely a matter of the taxation of capital income, it is appropriate to focus on home taxation by the country of residence where the capital value was created. FDI, however, is different because it involves business income which is produced by many factors in addition to capital. Unlike the weak economic justification that source countries have for the taxation of imported capital, source countries have a paramount claim to the taxation of noncapital business income.

Thus, any claim by a home nation to tax the noncapital portion of FDI is a residual claim of residence. Since only corporations get the benefit of deferral, corporations are the only practical vehicle for foreign business operations. Thus, worldwide taxation of noncapital business income is essentially a question of corporate residence. In many cases, questions of corporate residence are immaterial. Since corporations can easily divvy up their operations in separate corporate entities, subsidiary corporations can minimize the effect of residence classification and residence-based taxation by carefully limiting the activity of a "resident" corporation (no matter what the definition) to those activities that would normally be sourced and taxed in that "resident" country. Ultimately, however, parent organizations must deal with countries that assert, in principle, worldwide taxation based on a corporation's residence.

Nations adopting resident taxation have always taxed, in principle, the worldwide income of their corporations.<sup>86</sup> There is no general consensus, however, as to what makes a corporate resident. Nations have adopted quite different jurisdictional classifications, including place of

---

<sup>84</sup> This has been particularly true in the case of emerging economies. *See generally* Barker, *supra* note 12, at 363–67 (discussing how emerging economies relinquish much of their source tax base through tax preferences and incentives).

<sup>85</sup> *See* Barker, *supra* note 16, at 195–97 (demonstrating that the primary economic right to tax the income from capital in all of its forms is the state where the capital was created).

<sup>86</sup> Fewer nations today follow the worldwide principle with respect to business income.

incorporation, place of central management and control, and principle place of business.<sup>87</sup> For new corporations, there is considerable choice in choosing residence. For existing corporations, though tax is a strong incentive to change residence, changing residence is difficult without adverse tax and political consequences.

David Tillinghast has called corporate residence a “crude, if not naive, criterion.”<sup>88</sup> A concept that originally conceptualized the legal status of individuals is quite difficult to apply to corporations. Though corporations are legal persons, it is arbitrary to apply the unitary legal concept of residence to what are essentially economic enterprises conducted throughout the world and identified by far flung assets, personal activities, owners, and different legal persona. Though it has been suggested that the residence of the owners is a better approach to corporate residence, that approach also lacks the capacity to capture the full dynamics of a firm.<sup>89</sup> Since all approaches to corporate residence lack either theoretical justification or practical merit, there is no compelling case for worldwide tax on the basis of corporate residence. Since there is no special relationship between a nation and its corporations sufficient to justify non-arbitrary taxation, commentators turn to fundamental fairness as a guide to deciding what should be done.<sup>90</sup>

Fair allocation of taxes among taxpayers is a significant normative goal of a system of taxation. Adam Smith’s first canon of taxation was that taxes should be equal or equitable.<sup>91</sup> The classic view was that the allocation of the tax burden was fair where each person contributed in accordance with the benefits he or she receives from government services.<sup>92</sup>

The exchange or benefit principle of taxation is the primary theory that underlies source-based international taxation.<sup>93</sup> The modern theory that supports resident-based, comprehensive income taxation has shifted from benefit received to ability to pay.<sup>94</sup> Ability to pay switches the focus from an exchange principle where tax is justified on the basis of benefit received to a system of obligation based on status; that is, the special relationship between the taxpayer and a state. This status justifies worldwide taxation

---

<sup>87</sup> HUGH L. AULT & BRIAN J. ARNOLD, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 349–50 (2004).

<sup>88</sup> David R. Tillinghast, *A Matter of Definitions: “Foreign” and “Domestic” Taxpayers*, 2 INT’L TAX AND BUS. LAW. 237, 260 (1984).

<sup>89</sup> See Michael J. Graetz, *The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261, 323 (2001) (arguing that shareholder residence is not a practical solution).

<sup>90</sup> See, e.g., J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Perspectives on the Worldwide vs. Territorial Taxation Debate*, 125 TAX NOTES 1079, 1091–93 (2009).

<sup>91</sup> See ADAM SMITH, *THE WEALTH OF NATIONS*, bk. 5, ch. 2, pt. 2 (1904).

<sup>92</sup> Barker, *supra* note 34, at 24.

<sup>93</sup> DAVID R. TILLINGHAST, *TAX ASPECTS OF INTERNATIONAL TRANSACTIONS* 3 (1984).

<sup>94</sup> Barker, *supra* note 16, at 187.

without regard to actual benefits received by the taxpayer. Ability to pay is also linked to comprehensive taxation, progressivity, and assessment of each individual's personal circumstances. The requirement that a taxpayer contribute in accordance with her ability to pay is primarily societal equity. It is also individual equity when viewed from the perspective of the taxpayer as a social being, treated as a whole with all of the burdens and benefits of social life.<sup>95</sup>

This individual approach to equity is not, however, a useful paradigm for corporations. This personalized, highly nuanced concept of ability to pay has nothing to do with corporations even though it has everything to do with corporate shareholders.<sup>96</sup> It is acknowledged even by those who advocate for worldwide taxation of corporations that these entities "pose perplexing issues in evaluating fairness concerns."<sup>97</sup> These scholars shift from a dynamic conception of fairness to a mechanical one; they justify comprehensive taxation on the basis that taxation of income is justified by a taxpayer's command over these resources. Command translates into ability.<sup>98</sup>

A second important aspect of fairness is taxpayer fairness. Undoubtedly, this is one of the most important issues in international taxation.<sup>99</sup> It is a matter of international consensus that residents' countries must do something to mitigate the problem of international double taxation, either by exempting foreign source income or by providing a foreign tax credit.<sup>100</sup> The claim of individual taxpayer equity, however, necessarily suppresses the claims of resident taxpayer equality because the claim to tax by the resident country is either abandoned in an exemption system or is offset by foreign taxes paid in a credit system. A tax paid to a foreign government is not the same as a tax paid to one's own government since these funds are not available to provide goods and services to resident taxpayers.<sup>101</sup>

A third important aspect of fairness is fairness between governments. Governments have conflicting claims to the same tax base. The result of exempting active business income is that the income sourced or attributed to a particular nation is solely taxable by that nation. This results in

---

<sup>95</sup> *Id.* at 188.

<sup>96</sup> See Reuven S. Avi-Yonah, *Corporations, Society and the State: A Defense of the Corporate Tax* 38–39 (Univ. of Mich. Law, Olin Ctr. for Law & Econ., Working Paper No. 04-006, 2004), available at <http://ssrn.com/abstract=516202> (advocating that corporate taxation is a regulatory measure aimed at restricting corporate (or management) power). This supports taxation of corporations based on benefit received, not ability to pay.

<sup>97</sup> See Fleming, Peroni & Shay, *supra* note 90, at 1092.

<sup>98</sup> *Id.* at 1093.

<sup>99</sup> See ABA Task Force Report, *supra* note 7, at 659.

<sup>100</sup> See Articles of the OECD Model Tax Convention on Income and on Capital, art. 23 (2003) (outlining the credit and exemption method for the elimination of double taxation).

<sup>101</sup> Barker, *supra* note 16, at 185–86.

exclusive territorial taxation of active business income. Worldwide taxation with foreign tax credit relief merely defers to the source country acknowledging the source country's primary right to tax. To the extent that the source country's effective rate is not as high as the resident country's effective rate, the resident country captures the residual. In the United States, this is not a current tax; it is a deferred tax when the income is earned by a controlled foreign corporation.<sup>102</sup> A deferred tax has a smaller present value to the government and a smaller present cost to the taxpayer.<sup>103</sup>

There is a profound difference in the concept of entitlement advanced by the resolution of the different claims of fairness contained in the different approaches to international taxation. Territorial taxation is based on the generally accepted principle that a nation has the right to tax income where that country is the source of the economic activity. Resident countries assert that residence is an independent basis for taxation. Worldwide taxation's focus is on the taxpayer whose relation to a nation is such that it is fair to tax that person according to her means. International equity in a residence system is a nonnegotiable deal—the resident country will relinquish its tax claim if and only to the extent that the source country taxes.<sup>104</sup> The benefit of the resident country's deferral flows to the taxpayer because there would be no effect if the source country applied the same effective rates to the income.

Though this may appear to be a fair resolution from the point of view of the residence country, it may not be fair from the point of view of the source country. A source country has only one choice with respect to the tax base that has been assigned to it where the taxpayer is subject to another country's worldwide tax. Assuming a source country does not discriminate, it may be very difficult for it to tax the business income of foreign taxpayers where only some of those taxpayers are residents of worldwide taxing countries and the majority are not residents of such countries. These countries cannot be in total control of their tax policies.<sup>105</sup>

These fiscal policies include the right of a source nation to forego taxes in order to achieve certain social or economic goals. The choice not

---

<sup>102</sup> Subpart F of the Code provides an exception to the rule of deferral for certain types of income earned by controlled foreign corporations. *See generally* I.R.C. § 951 (2006).

<sup>103</sup> *See supra* note 73.

<sup>104</sup> Some countries that have adopted worldwide tax principles have adopted limited exemptions for their multinationals for business activities in emerging nations. This practice is known as tax sparing. *See* ORG. FOR ECON. CO-OPERATION & DEV., TAX SPARING: A RECONSIDERATION 12–13, 68–69 (1998) [hereinafter OECD, TAX SPARING]. Though the United States has considered tax sparing and other incentives for providing aid to emerging economies over the years, none have ever been adopted. For a detailed history, *see* Robert Hellawell, *United States Income Taxation and Less Developed Countries: A Critical Appraisal*, 66 COLUM. L. REV. 1393, 1406 (1966).

<sup>105</sup> *See* Barker, *supra* note 12, at 385–86.

to tax is just as much a part of fiscal sovereignty as the choice to tax. Worldwide tax limits that choice of source countries, especially for emerging economies.

In addition, to the extent that the tax base that is the subject of territorial tax is attributable to value that is added to the world by the source country, a case can be made that the source country should have the exclusive right to tax. Income can represent such value where the ability to earn such income is attributable to the benefits provided by the source country and that country's special endowments. An exemption system solves this problem of intergovernmental equity by assigning the potential to tax this income exclusively to the country that added this value to the world. However, full exclusion of active business income goes farther than necessary. The value that the source nation added to the world does not include the normal income return from imported capital. Thus, it is the portion of income which is the income over and above the normal return on capital—economic rents—which is the appropriate amount to exclude.<sup>106</sup> Source countries, especially emerging economies, have a fairness claim to economic rents worthy of special consideration. On the other hand, resident countries have a fairness claim to the value derived from the use of capital exported from their countries.

The claims of fairness represent conflicting issues of philosophy and politics. The resolution of these issues can easily take a pro-resident form when applied to individuals. But when considering fairness issues in regard to corporate business income, one should question whether the ties a corporation has to a particular jurisdiction are sufficient to tax foreign economic rents in the light of the factors of source country contribution.

### C. Tax Competition and Business Competitiveness

Tax competition is a nation's relinquishment, in whole or part, of its right to tax an economic activity, with the result that the effective tax is less than that of other countries.<sup>107</sup> Due to the increasing mobility of capital, economic activity, financial services, and skilled labor, many developed nations see certain practices of other countries as unfairly attracting economic activity that otherwise would have taken place within the developed countries, causing an erosion "of the tax base of these countries and distorting the location of such economic activity."<sup>108</sup>

There are many cost factors that influence the decision as to the location of business operations. Though a foreign direct investment in a

---

<sup>106</sup> See *id.* at 383–85.

<sup>107</sup> See Barker, *supra* note 16, at 172.

<sup>108</sup> ORG. FOR ECON. CO-OPERATION & DEV., TOWARDS GLOBAL TAX COOPERATION: REPORT TO THE 2000 MINISTERIAL COUNCIL MEETING AND RECOMMENDATIONS BY THE COMMITTEE ON FISCAL AFFAIRS 5 (2000). See also Barker, *supra* note 16, at 165.

country would rarely be made solely for tax considerations, today tax is one of the most important factors.<sup>109</sup> As long as countries provide tax incentives for nonresidents, multinational enterprises will take advantage of the incentives.<sup>110</sup> Indeed, business argues that in the world of tax competition, business must take advantage of low tax jurisdictions in order to remain competitive with the multinationals from other developed countries.<sup>111</sup>

The competitive posture of U.S. enterprises should be a matter of importance to U.S. lawmakers. Though multinational corporations assert that residence tax makes them less competitive,<sup>112</sup> direct evidence is sparse and inconclusive.<sup>113</sup>

The U.S. Treasury Department has referred to the success of U.S. enterprises as evidence that U.S. enterprises are quite successful overseas.<sup>114</sup> The literature also cites to the lack of significant evidence as to the competitive disadvantage of U.S. multinationals.<sup>115</sup> There is even indirect evidence that the present system can work as a competitive

---

<sup>109</sup> See ORG. FOR ECON. CO-OPERATION & DEV., OECD TAX POLICY STUDIES NO. 4, CORPORATE TAX INCENTIVES FOR FOREIGN DIRECT INVESTMENT 10 (2001); Barker, *supra* note 16, at 198.

<sup>110</sup> See John Douglas Wilson, *Theories of Tax Competition*, 52 NAT'L TAX J. 269, 272 (1999).

<sup>111</sup> See, e.g., BUSINESS AND INDUSTRY ADVISORY COMMITTEE TO THE OECD, A BUSINESS VIEW ON TAX COMPETITION (1999), available at <http://www.biac.org/statements/tax/htc.pdf>; Daniel J. Mitchel, *OECD Tax Competition Proposal: Higher Taxes and Less Privacy*, 89 TAX NOTES 801, 801-02 (2000).

<sup>112</sup> See BUSINESS AND INDUSTRY ADVISORY COMMITTEE TO THE OECD, *supra* note 111, at 3.

<sup>113</sup> See OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS 55-59 (2000), available at <http://www.treas.gov/offices/tax-policy/library/subpartf.pdf> (discussing the effect of U.S. taxation on the competitiveness of U.S. multinationals). Though it is certain that the present U.S. tax system is overly complex and that it is expensive for taxpayers to comply with, Marsha Blumenthal & Joel Slemrod, *The Compliance Cost of Taxing Foreign Source Income: Its Magnitude, Determinants, and Policy Implications*, 2 INT'L TAX & PUB. FIN. 37, 37 (1995) (study showed that 40% of the compliance costs of U.S. multinationals were attributed to taxation of foreign source income even though only 20% of these multinationals' economic activities were in foreign operations), see also Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle with Subpart F?*, 79 TEX. L. REV. 1609 (2001), the same can be said about other countries, see OFFICE OF TAX POLICY, U.S. DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS 58-61 (2003) (discussing the similar complexity of foreign systems).

<sup>114</sup> Fleming, Peroni & Shay, *supra* note 90, at 1086. See also J. Clifton Fleming Jr., Robert J. Peroni & Stephen E. Shay, *Worse than Exemption*, 59 EMORY L.J. 79, 107 n.93, n.95 (2009) [hereinafter Fleming, Peroni, & Shay, *Worse than Exemption*].

<sup>115</sup> 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, 446, 453 (1995).



advantage for U.S. multinationals.<sup>116</sup> The system permits taxpayers to average the credit on high-taxed business income with low-taxed business income thus reducing the effective overall tax. Second, the appropriate U.S. tax on foreign interest, royalties, and rents is reduced if these flows are converted into deferred income. The evidence strongly indicates that multinationals engage in significant income shifting between high and low tax jurisdictions to take advantage of these systemic failures.<sup>117</sup>

Indeed, an underlying reason for the move of many nations to a territorial exemption system for active business income is to ensure the current taxation of income from rents, royalties, and interest.<sup>118</sup> Exemption systems must place high priority on segregating these sources from business income that is exempt. By exempting business income, foreign taxes on active business income cannot be credited against these more passive forms of capital income.<sup>119</sup> The result is that, if successful, nations raise more taxes by exempting active business income than by taxing it under present principles. In the United States, the Joint Committee on Taxation projected that a territorial exemption system would increase revenues by 54.8 billion dollars over a ten year period when measured against revenues under the existing law.<sup>120</sup>

Studies show that the incidence of tax under our present system is not a significant burden. A recent study showed that the tax on repatriated earnings of U.S. multinationals is only approximately 3.3%.<sup>121</sup> Since this tax is only assessed when earnings are repatriated, the effective tax on these earnings, in terms of the present value of the tax when the income was earned, may have been insignificant.<sup>122</sup>

Since that study, Congress passed the American Jobs Creation Act of 2004.<sup>123</sup> In that Act, Congress adopted a number of changes to the U.S. international tax rules that reduced the U.S. taxation of foreign business income.<sup>124</sup> These changes continued a trend toward rules that may be applied to achieve a very low effective rate of taxation of foreign business

---

<sup>116</sup> See Shay, Fleming & Peroni, *supra* note 74, at 149.

<sup>117</sup> See Harry Grubert, *Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location*, 56 NAT'L TAX J. 221, 221–24 (2003).

<sup>118</sup> See HM TREASURY, PROPOSALS FOR CONTROLLED FOREIGN CORPORATIONS REFORM: DISCUSSION DOCUMENT 21, 23 (2010) (U.K.) (noting that in light of a more territorial approach to taxing subsidiaries, rules should control the artificial diversion of profits from the U.K. since there is a continuing need to protect the U.K. tax base from erosion).

<sup>119</sup> See Graetz & Oosterhuis, *supra* note 83, at 775.

<sup>120</sup> STAFF OF THE JOINT COMM. ON TAXATION, 108TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 427 (Comm. Print 2005).

<sup>121</sup> Altshuler & Grubert, *supra* note 33, at 798.

<sup>122</sup> See *supra* note 73.

<sup>123</sup> American Jobs Creation Act of 2004, *supra* note 8.

<sup>124</sup> ABA Task Force Report, *supra* note 7, at 654.

income.<sup>125</sup>

Thus, the evidence is fairly strong that there is little that present law does that harms the competitiveness of our multinationals other than impose significant compliance costs. Indeed, the evidence appears to point to just the opposite conclusion—that is, that our present system may instead provide a significant tax subsidy to our multinationals, giving them a competitive edge over those multinationals based in other developed countries.<sup>126</sup> This is probably true only for those companies that enjoy sophisticated tax planning, however.<sup>127</sup> For those corporations in an excess credit position,<sup>128</sup> there is an incentive to create additional foreign income that will go untaxed. For those corporations in an excess limit position, there is an incentive to create additional deferred income.

## V. THE MAJOR PROBLEMS WITH INTERNATIONAL TAXATION OF BUSINESS INCOME

The prior analysis has underscored the major economic and equitable problems with the present system. The present system of worldwide taxation with deferral for active business income is an example of a system that evidences a structure compatible with CEN principles of neutrality but does not fully grasp all the problems with carefully identifying income from capital. It acknowledges fairness, but only one-sided American government or American taxpayer fairness. It shares a trait in common with other developed countries in that it perceives its system as a victim of tax competition, and that the principle culprits are developing countries and tax havens.<sup>129</sup>

The truth of the matter is that the developed countries, which control much of the world's wealth and most of its international commerce, have created the system that has failed. The reasons are basic to the system and, hence, have eluded resolution. This is true not only for systems, like the US, which nominally adopt the principle of worldwide taxation of business income, but also for those systems that aim solely at the source taxation of business income.

One reason is that all systems depend on the critical role played by the

---

<sup>125</sup> *Id.* at 692–717.

<sup>126</sup> Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 114, at 85, 149 (explaining how the various features of the present system make the present system at least as generous as a properly designed territorial exemption system).

<sup>127</sup> *ABA Task Force Report*, *supra* note 7, at 717.

<sup>128</sup> A corporation is in an excess credit position where its allowable credits are limited by section 904. I.R.C. § 904 (2006). A corporation is in an excess limit position where its foreign taxes are fully creditable.

<sup>129</sup> See G-20 Leaders, Leaders Statement: The Pittsburgh Summit, para. 15 (Sept. 24-25, 2009), available at [http://www.g20.org/Documents/pittsburgh\\_summit\\_leaders\\_statement\\_250909.pdf](http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf); Barker, *supra* note 16, at 169–71.

sourcing rules and source taxation. The difficulty of international tax principles begins with the concept of source itself. The source rules are the product of a time when practically all nations taxed territorially, most nations had significant legislation restricting the export of capital, national economies were relatively closed, and most income tax systems were quite unsophisticated.<sup>130</sup> Freer trade and freer factor mobility have made the traditional territorial notion of taxation obsolete,<sup>131</sup> and have placed considerable pressure on the ability of nations to apply transaction-based tax to a vast range of common transactions.<sup>132</sup>

Current approaches to sourcing income based on the location of things and events cannot hope to capture those factors that demonstrate that income belongs to a particular country.<sup>133</sup> There are many factors that contribute to the earning of a particular receipt, including capital in all its forms, labor, and benefits provided by governments. It is commonplace for these factors to be identified with several different nations' source rules, by fixing on one aspect of an income-producing event, necessarily ignoring the contribution provided by the other factors. Consequently, source rules have little to do with the economic connection of income to a country. This has resulted in many sourcing approaches to the same items.<sup>134</sup>

Countries chose their source rules to achieve many different objectives. Some countries adopt different source rules for inbound and for outbound transactions or residents and non-residents.<sup>135</sup> Often countries that have traditionally taxed only on a source basis have adopted broad domestic sourcing rules in order to approximate resident, worldwide taxation.<sup>136</sup> The consequence of the multiplicity of national rules is that

---

<sup>130</sup> See generally Graetz & O'Hear, *supra* note 16, at 1021 (providing an account of the history and context of the adoption of the current system of international tax norms). See also Barker, *supra* note 16, at 182-5.

<sup>131</sup> Barker, *supra* note 12, at 349.

<sup>132</sup> ABA Task Force Report, *supra* note 7, at 658.

<sup>133</sup> Barker, *supra* note 16, at 182-85 (account of the different approaches to source rules).

<sup>134</sup> *Id.*

<sup>135</sup> *Id.* at 203 (description of three principle approaches to sourcing income).

<sup>136</sup> *Id.* at 202 (stating that source rules are often inconsistent); see also INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION 42 (Am. L. Inst., Tentative Draft No. 10, 1983) (noting that in the United States, the single set of source rules is not entirely symmetrical for U.S.-source income and foreign-source income), citing Comm'r for Inland Revenue v. Lever Bros., 1946 AD 441 (A) (S. Afr.); First Nat'l Bank of Southern Africa v. Comm'r for Inland Revenue 2002(3) SA 375 (SCA) (S. Afr.); Millin v. Comm'r for Inland Revenue, 1928 AD 207 (A) (S. Afr.). The over reliance on source can easily create an over extension of the source rules. In Apartheid South Africa, for example, the principle of sourcing adopted by the courts included where the contract was made, where funds were made available to the debtor, the residence of the debtor, and the relevant factual matrix which focused on relevant business activities rather than the specific transactions. These rules provide many different approaches to a finding of South African source. See generally, Katz Fifth Interim Report of the Commission of Inquiry into Certain Aspects of the Tax

there is little consistency between national rules. This results in some cases in the unwarranted extension of the territorial reach of income tax laws because the primary right to tax cannot exist in several countries at the same time. In other cases these rules often result in inappropriate avoidance of territorial taxation. Whenever there is a disconnect between formal rules of sourcing and economic substance, there is latitude for tax planning and avoidance.

Resident taxation also depends on source rules for application of deferral regimes and for proper application of double taxation relief either through credit or exemption. Multinationals can also game resident rules through international source manipulation.<sup>137</sup>

One way to cure the defects would be to attempt to reform the source rules.<sup>138</sup> To accomplish anything, however, would take the reversal of almost a one hundred year tradition that arbitrarily assigns income based on isolated aspects of a transaction. What would be needed is a radical change in the way nations source income in order to find a sufficient economic tie between income and a location. Taxation of income, irrespective of who the taxpayer is, requires a strong economic justification for it to be effective and truly legitimate. These are proposals for source rules based on economic nexus.<sup>139</sup> Though a nation which adopted an economic nexus for source might have considerable success improving its system, unless other countries followed suit, the different treatment among nations will continue to be an incentive to manipulate.

Source taxation is not solely about identifying the connection between income and a territory. It is also about whether a nation should exercise its tax power solely on the basis of source. Though territorial taxation of business income must start with the proper placement of business income within that country, most nations conclude that mere source is not sufficient. Most countries require that business income be taxed only if it is the result of a substantial level of activity within the country, such as the income is derived by a permanent establishment within the country.<sup>140</sup> Where a foreign enterprise does not meet the minimum standard, there is no

---

Structure of South Africa, *Basing the South African Income Tax System on the Source or Residence Principle – Options and Recommendations* para. 1.3.3, 6.3.1.1 (March 7, 1997), available at [www.treasury.gov.za/publications/other/katz/5.pdf](http://www.treasury.gov.za/publications/other/katz/5.pdf) (discussing source taxation as a general rule but residence taxation for passive income generated abroad, including royalties).

<sup>137</sup> Shay, Fleming & Peroni, *supra* note 74, at 145.

<sup>138</sup> Fleming, Peroni & Shay, *supra* note 90, at 1079.

<sup>139</sup> An economic analysis of source was initially proposed to the League of Nations for its adoption. See *Report on Double Taxation Submitted to the Financial Committee by Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp*, League of Nations Doc. E.F.S.73.F.19 (1923). For a more modern suggestion, see Barker, *supra* note 16, at 202–12 (outlining how income could be sourced based on significant economic affinity).

<sup>140</sup> Articles of the OECD Model Tax Convention on Income and on Capital, art. 5 (2003).

source taxation. This source gap leaves substantial latitude for business between developed countries to be carried out through a foreign corporation located in a low-tax jurisdiction.

Lack of economically sound sourcing rules, high thresholds for the source taxation of business income, and inaccuracies and inconsistencies in income and expense classification also lead to problems with foreign tax credits. Not only can U.S. multinationals average the tax through business activities in high and low tax countries, they have been able, through manipulation of the forms of capital and business income, to offset highly-taxed business income with low taxed capital income.<sup>141</sup>

These problems are exacerbated by the shifting of income and deductions through pricing. Aggressive transfer pricing within the firm can dramatically change the allocation of income worldwide.<sup>142</sup> This leads to the distortion of locational decisions for economic activities.

In order for countries like the United States to try to maintain the appearance of worldwide taxation of all income, the legislatures are required to enact complex anti-avoidance measures.<sup>143</sup> Though these measures have been successful, their success depends on the imposition of significant, compliance costs for both taxpayers and government.<sup>144</sup>

## VI. FUNDAMENTAL REFORM: THE CURRENT DEBATE

Congress has many choices available to deal with the serious defects in the present system. This section will address the current debate as to the wisdom and efficacy of these choices based on the previous analysis that the root of America's problems is not the vagaries of politics but a disregard of certain critical principles of economic efficiency and fairness. This section will evaluate these proposals in terms of their fit with the principles of good taxation, their ability to deal effectively with the defects of the present system, and their ability to promote critical goals of international tax reform, namely, increasing revenue, protecting the domestic tax base, and promoting increased U.S. economic development and jobs.

This section starts by considering present proposals on incremental

---

<sup>141</sup> See Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 114, at 132.

<sup>142</sup> *Id.* at 119–31; Barker, *supra* note 16, at 174–77. Though most nations have adopted anti-abuse measures to curb transfer pricing abuse, see AULT & ARNOLD, *supra* note 87, at 420–24, compliance is a major problem. See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-934, INTERNATIONAL TAXATION: STUDY COUNTRIES THAT EXEMPT FOREIGN-SOURCED INCOME FACE COMPLIANCE RISKS AND BURDENS SIMILAR TO THOSE IN THE UNITED STATES 19–22 (2009).

<sup>143</sup> See I.R.C. § 951 (2006) (U.S. corporations are taxed on certain income of their controlled foreign corporations in order to prevent the erosion of the U.S. tax base).

<sup>144</sup> See AULT & ARNOLD, *supra* note 87, at 378 (describes controlled foreign corporation schemes in other countries).

reforms.<sup>145</sup> It will then turn to consideration of three recently suggested systematic reforms including worldwide taxation without deferral,<sup>146</sup> worldwide taxation with exemption for foreign active business income,<sup>147</sup> and worldwide income with exemption for foreign territorial business cash flow.<sup>148</sup>

#### A. Incremental Reform

The outline of President Obama's legislative agenda announced in 2009<sup>149</sup> has drawn both praise and criticism. It has been praised as a step in the right direction<sup>150</sup> for it addresses the goals of increased revenue and protecting the tax base. It has been criticized because it is out of step with the systems of the rest of the world and it will lead to a less competitive U.S. foreign presence.<sup>151</sup> One truth in these assertions is that incremental reform requires tradeoffs.

The Obama plan for business income has three principle components. The first addresses the problem of allowing deductions against U.S. domestic tax liability for expenditures incurred by domestic taxpayers that are attributable to deferred income earned by foreign subsidiaries of U.S. multinationals.<sup>152</sup> The second proposes to tighten the rules to prevent the cross-crediting of foreign tax credits between high and low taxed regimes.<sup>153</sup> The third addresses the problem of disregarded entities created under the check-the-box rules that prevent the intended operation of anti-deferral legislation,<sup>154</sup> namely Subpart F which deals with controlled

---

<sup>145</sup> See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 67, at 28–40 for President Obama's suggested international legislative agenda.

<sup>146</sup> Stephen Shay, Clifton Fleming and Robert Peroni have been the leading proponents of this view. See, e.g., Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999).

<sup>147</sup> The majority of the world's nations have already adopted a variation of these systems. See PRESIDENT'S ADVISORY PANEL, *supra* note 11.

<sup>148</sup> The author has set out the parameters of such a system. See, e.g., Barker, *supra* note 16.

<sup>149</sup> See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 67, at 28–40.

<sup>150</sup> See Reuven Avi-Yonah, *Tax Reform in the (Multi)National Interest*, 124 TAX NOTES 389 (2009). But see William B. Barker, *Tax Reform in the (Inter)National Interest: Why Wait*, 124 TAX NOTES 828 (2009).

<sup>151</sup> Kristen A. Parillo, *Panelists Find Fault with Obama's International Tax Proposals*, 123 TAX NOTES 1387 (2009).

<sup>152</sup> See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 67, at 29.

<sup>153</sup> *Id.* at 30–31.

<sup>154</sup> *Id.* at 28.

foreign corporations.<sup>155</sup>

Of the three proposals affecting business income, it is hard to fault the first proposal on cross crediting. It is aimed at closing a loophole that could be used to zero out low taxed income.<sup>156</sup> The other two proposals, however, show how difficult it may be to achieve important objectives in the international setting.

The second proposal is designed to limit the application of the check-the-box rules.<sup>157</sup> The 1997 application of these rules in the international setting opened a large loophole in the anti-deferral rules of Subpart F. The Joint Committee on Taxation (JCT) estimates indicate that the proposed reform would raise \$31 billion in revenue over ten years.<sup>158</sup> The check-the-box rules, however, opened up a much larger loophole that has nothing directly to do with U.S. taxes. It allowed U.S. multinationals to reduce profits from high-tax countries, thus reducing these countries' effective tax rates.<sup>159</sup> The effect of this reform may well be to increase the revenue gained by high-tax countries.<sup>160</sup> This would add to multinationals' foreign tax credits, which could reduce the amount that would otherwise be collected by the U.S. Treasury. This consequence may be reflected in the revised revenue estimates of the JCT which decreased the revenue estimates of Treasury by \$55 billion.<sup>161</sup>

The third proposal deals with the proper matching of deductions to foreign source income. In general, when a U.S. taxpayer incurs any expense related to the production of income, it would be a deduction. If that expenditure were not allocated to foreign income that it produced, it would distort the net foreign income. Either it would increase foreign source income currently taxable in a way that could decrease overall U.S. tax liability due to the allowance of extra foreign tax credits,<sup>162</sup> or it would increase the deferred income of controlled foreign corporations at the same time as decreasing U.S. income subject to tax.<sup>163</sup>

The difficulty is not with direct expenditures which present a rather

---

<sup>155</sup> I.R.C. § 951 (2006).

<sup>156</sup> Martin A. Sullivan, *A Simple Overview of the Obama International Tax Proposals*, 123 TAX NOTES 1301, 1302 (2009).

<sup>157</sup> Treas. Reg. § 301.7701-2(b) (as amended in 2009).

<sup>158</sup> STAFF OF THE JOINT COMM. ON TAXATION, 110TH CONG., ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL AS DESCRIBED BY THE DEPARTMENT OF THE TREASURY, MAY 2009 JCX-28-09 (2009), available at <http://www.jct.gov/publications.html?func=startdown&id=3558> [hereinafter JCT REPORT].

<sup>159</sup> See Sullivan, *supra* note 156, at 1301.

<sup>160</sup> *Id.*

<sup>161</sup> JCT REPORT, *supra* note 158.

<sup>162</sup> For a general discussion of this problem, see Fleming, Peroni & Shay, *Worse than Exemption*, *supra* note 114, at 110–15.

<sup>163</sup> *Id.* at 116–18.

straightforward problem of allocation. The difficulty instead is with indirect expenditures like research and development (R&D), general and administrative (G&A), and interest. The Obama Proposals focus solely on G&A and interest. The most likely reason that they ignore R&D is that R&D is already the subject of a very complex system of cost allocation between U.S. and foreign source income.<sup>164</sup> The G&A proposal differs from the R&D regulations in that it does not simply allocate expenditures to foreign source income for current U.S. tax purposes, but it allocates certain expenditures to the income earned by controlled foreign corporations with the consequence that these expenditures will be denied current deductibility and deferred until repatriation of the profits.<sup>165</sup> There have been reports, however, that G&A may be eliminated as the bill progresses.<sup>166</sup>

This proposal illustrates the dilemma of reform where there are so many variables of policy. R&D makes a good illustration of the complex tradeoffs for policy. For example, it contributes significantly to corporate wealth by creating intangible capital. These expenditures are currently deductible even though under general principles of income taxation, these costs should be capitalized and deducted ratably over the useful life of the value created.

Allowing a deduction for what otherwise would be a capital expenditure is an example of a tax expenditure. A nation rebates its tax in order to incentivize a particular activity. In the case of R&D, the case for tax relief is very strong. Technology development is an important element in the development of the wealth of a country, especially the United States. Research and Development has many positive externalities. It has a spillover effect that benefits others who did not incur the expenditure nor develop the technology.<sup>167</sup>

Allowing a deduction for a capital expenditure, however, which is a cash flow or expenditure tax concept, is the equivalent of not taxing the normal return from those investments.<sup>168</sup> Where the technologies produced by deducted expenditures are used domestically, the government taxes the future income flows produced by those technologies. To the extent that the expenditure generates a risk-free rate of return (which is the cost to the government of borrowing), the government breaks even on its tax expenditure (neither a gain nor a loss in revenue). To see how this works,

---

<sup>164</sup> See the 1995 Final Regulations, Allocations and Apportionment of Research and Experimental Expenditures, 60 Fed. Reg. 66,502 (Dec. 22, 1995), Treas. Reg. § 1.861-17.

<sup>165</sup> See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 67.

<sup>166</sup> See Martin A. Sullivan, *Obama Chooses a Clumsy Way to Limit Deferral*, 123 TAX NOTES 1163, 1164 (2009).

<sup>167</sup> Don Fullerton & Andrew B. Lyon, *Tax Neutrality and Intangible Capital*, in 2 TAX POLICY AND THE ECONOMY 63 (Lawrence H. Summers ed., 1988).

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



assume that a taxpayer invests \$100. Assume also a 35% corporate income tax rate and a government rate for borrowing of 5%. Deducting the \$100 expenditure results in a \$35 tax savings to the taxpayer or \$35 forgone government revenue. Were the taxpayer to dispose of the technology one year later for \$105 (recouping its investment plus a 5% return), the taxpayer would have \$105 in income and a tax liability of \$36.75. The government breaks even because the present value of \$36.75 at 5% paid one year later is \$35 today. Where those technologies are used to produce income which is deferred, exempt, or included in foreign income thus increasing the foreign tax credit limitation, the failure to allocate these deductions to that income causes the government to lose twice—both its tax and its investment. To illustrate, modify the first example by excluding the \$105 received one year later from income. The government relinquishes its claim to \$35 in tax revenue in year one and receives no taxes in year two. To see the government's double hit, assume alternatively that the expenditure would not have been originally deducted and the income would have been included. In year one the government would have collected \$35 in tax ( $\$100 \times .35$ ). In year two the government would have collected \$1.75 in tax ( $105 - 100 \text{ (basis)} = 5 \text{ income} \times 35\%$ ). The chart below compares the three results in government revenue.

	Income Taxed Expenditures Not Deductible	Income Taxed Expenditures Deductible	Income Not Taxed Expenditures Deductible
Year 1	\$35	<\$35>	<35>
Year 2	\$1.75	36.75	—

Research and Development expenditures are not the only costs that can contribute to the formation of intangible capital. General and Administrative (G&A) expenditures which are , generally deductible costs lead to the development of human capital including management, production and sales efficiencies. Where G&A expenditure produces intangible capital, the failure to allocate these expenditures to foreign income creates the same problem as R&D. Even where the expenditure only produces current income, however, the failure to allocate to a tax favored source results in an understatement of U.S. taxable income.

The Obama proposal contains a direct solution to this problem. In order to protect the domestic tax base and to increase revenue, which are two of the three critical goals that international tax reform should advance, appropriate portions of these expenditures would be allocated to foreign income. Efficient rules of allocation are not easily obtainable due to the complexity of determining how G&A should be allocated to foreign

operations, since the evidence for appropriate attribution is uncertain.<sup>169</sup> It is suggested that the present rules for R&D are the result of a highly contentious compromise between the government and taxpayers.<sup>170</sup> This compromise suggests that even if there were an optimum solution for G&A, it might not be the best tax policy as any effort in this area conflicts with the third goal of tax policy—promoting domestic growth and jobs.

A recent study by General Electric Corp. reached the following conclusion: “No major country in the world denies deductions for domestic expenses allocated to deferred or exempt foreign income.”<sup>171</sup> The national considerations this statement indicates are important. Nations understand the value that R&D and headquarters activity has to a nation by providing jobs and investments and countless other positive externalities.<sup>172</sup> In an increasingly globalized economy, these activities are becoming more mobile. At the same time, other countries look at them covetously because they create significant local wealth and are thought not to compete significantly with local business. Consequently, many nations use their tax preferences and other incentives to entice these activities to their countries.<sup>173</sup>

The stakes are high. The tax implications are subtle and contradictory. The United States starts with substantial incentives for the expenditures. To the extent it reduces these incentives for foreign income, it makes foreign development more attractive. To the extent the United States taxes all intangible transfer, it also makes foreign development more attractive. Finally, because the United States allows full deductibility for imported goods and services, it also makes foreign production and development more attractive.

Consequently, the unrestricted deductibility of G&A acts as a powerful tax incentive for locating headquarters activity in the U.S. G&A reform may be counterproductive. This is a reflection of the fact many

---

<sup>169</sup> See U.S. DEP’T OF TREASURY, *THE RELATIONSHIP BETWEEN U.S. RESEARCH AND DEVELOPMENT AND FOREIGN TAXATION* (1995), *reprinted in* 95 TAX NOTES INT’L 101 (1995) (referring to the uncertainty of the evidence for accurate R&D allocation).

<sup>170</sup> See *ABA Task Force Report*, *supra* note 7, at 771.

<sup>171</sup> Parillo, *supra* note 151, at 1389. In the case of R&D, the United States allocates a portion of the expenditures to foreign income of U.S. taxpayers. This results in a decrease in the foreign tax credit limitation under I.R.C. § 904. Where a corporation is in an excess credit position, this results in the practical equivalent of a denial of the deduction.

<sup>172</sup> TANZI, *supra* note 66, at 35; Assaf Razin & Chi-Wa Yuen, *Understanding the “Problem of Economic Development”: The Role of Factor Mobility and International Taxation* (Nat’l Bureau of Econ. Research, Working Paper No. 7115, 1999), available at <http://www.nber.org/papers/w7115.pdf>.

<sup>173</sup> See EASSON, *supra* note 49, at 80-81. See also *Communication from the Commission to the Council, Toward Tax Coordination in the European Union, A Package to Tackle Harmful Tax Competition*, COM (97) 495 final (Oct. 1, 1997), available at [http://aei.pitt.edu/3504/01/000656\\_1.pdf](http://aei.pitt.edu/3504/01/000656_1.pdf).

theoretically reasonable and just reforms cannot hope to satisfy the policy goals of taxation in a world of extreme tax competition for the mobile factors of production.

#### B. Changing Course: Ending Deferral: Comprehensive Income Taxation

A change in course is needed. Most countries are no longer following the lead of the United States in international tax matters. Today, most nations are adopting exclusion for foreign business income. Three prominent scholars have suggested instead, however, that the solution is to adopt a fully rigorous scheme for the worldwide taxation of corporate income.

As Fleming, Peroni, and Shay have so aptly said, "... worldwide taxation should be regarded as the benchmark of neutrality and that territorial taxation should be viewed as the distortive approach."<sup>174</sup> This view is founded on a perception of the consequences of the CEN approach to neutrality or economic efficiency.<sup>175</sup> Part IV(A) of this work demonstrates that CEN is the critical economic concept to issues of international taxation. But CEN is limited. Though CEN is the optimal theory of neutrality in a world of tax competition,<sup>176</sup> it is a theory of the efficient taxation of capital income, not business income. Once one concedes that business income is the product of factors other than capital (or the normal return from capital), theories of efficient capital allocation are no longer completely authoritative. Instead, economic efficiency requires a different principle of tax neutrality to provide for the non-distortive allocation of business activity worldwide.

In addition, the case for the worldwide taxation model takes the perspective of the American government and its taxpayers; the objective is that worldwide taxation should create equality among resident taxpayers.<sup>177</sup> This approach is negated by the need to provide double taxation relief in fairness to taxpayers. It is counterbalanced by the opposing equity of nations within which business activity occurs. Source countries can reasonably conclude that business income, attributed to value added to the world by reason of the special benefits conferred by that country, should be exclusively taxed by the source country.<sup>178</sup> Since economic rents are related to the benefits received from the source country, worldwide taxation of such rents is one nation poaching on the natural tax base of the other and

---

<sup>174</sup> Fleming, Peroni & Shay, *supra*, note 90, at 1088.

<sup>175</sup> *Id.* at 1088 n.110.

<sup>176</sup> See, e.g., Razin & Sudka, *supra* note 59, at 75; Barker, *supra* note 18, at 192.

<sup>177</sup> See Fleming, Peroni & Shay, *supra* note 90, at 1091-94.

<sup>178</sup> For example, emerging economies often require tax sparing or exemption before they enter into treaties with developed countries. See OECD, TAX SPARING, *supra* note 104, at 19-20.

restricts the exercise of that country's tax sovereignty.<sup>179</sup>

A solution needs to address the different requirements of fairness. The fundamental attitude implied by worldwide taxation is that a resident country is fully entitled to a full tax modified *only* by considerations of fairness to the taxpayer. Considerations of equity toward the source country should at least give the U.S. pause as to the justice of this claim. It should encourage the U.S. to consider that it may be appropriate for its claim to give way to the principle that the country that is the source of the value that produces the income should have the exclusive right to tax it.<sup>180</sup>

Different international approaches based on different views on efficiency and justice lead to conflict among nations. This necessarily limits the choices of nations proceeding unilaterally. Comprehensive taxation without deferral, which is based on many of the same fundamental principles and perceptions as the present system, cannot address the problems of the present system. There are several reasons for this.

One reason is that comprehensive taxation without deferral still depends on the niceties of source rules. Income taxation cannot provide an adequate solution without some kind of consensus among nations based on a recognition of a more economically-based connection between the income and the territory. Since territorial allocation of income and deduction is still critical for application of foreign tax credits, transfer pricing planning will remain an important aspect leading to the distortion of source. Because foreign tax credits will become the principal offset to current taxation, cross crediting and the incentive to locate real or apparent activity or capital by multinationals will remain strong.

Worldwide taxation must, however, pass a different kind of reality check, that is, its realistic chance of promoting good policies. Fleming, Peroni, and Shay argue that the evidence does not support the conclusion that U.S. multinationals are currently at a competitive disadvantage vis-à-vis those of other countries.<sup>181</sup> Though the conclusion may be correct at present, the conclusion does not follow that these corporations would not be at a disadvantage if the ineffectual current system were replaced with a system that raised substantial revenue from foreign sources. Comprehensive taxation would discourage the formation of new business in America, other than those activities that need close proximity to American markets. Compared with the present system, it would discourage R&D and

---

<sup>179</sup> Barker, *supra* note 12, at 388.

<sup>180</sup> This is Value Export Neutrality and Value Import Neutrality, which reconciles the claims of resident and source countries by adherence to the principal of CEN, the exchange theory of source taxation, and equitable reconciliation of conflicting claims of fairness. See Barker, *supra* note 16, at 202.

<sup>181</sup> Fleming, Peroni & Shay, *supra* note 90, at 1101–02. (citing the lack of evidence on noncompetitiveness in addition to the fact that evidence indicates the overall success of U.S. multinationals abroad.)

G&A activities in America. There would be considerable pressure on existing businesses to change their residence eliminating taxation of their foreign operations and their domestic operations to the extent these depended on highly mobile factors of production. In a world where most countries adopt a type of foreign territorial exemption system,<sup>182</sup> increased U.S. taxation would have to have a huge impact on locational decisions. If existing companies actually could not avoid the costs, there could very well be a decline in U.S. competitiveness even at home. Ultimately, little revenue might be raised over the long run.

### C. Changing Course: Comprehensive Income Taxation with Exemption of Foreign Active Business Income

With the recent addition of the United Kingdom and Japan to the ranks of those countries that adopt some form of exclusion for foreign business earnings,<sup>183</sup> the United States now finds itself as the principal proponent of worldwide taxation.<sup>184</sup> In general, under an exemption system, the active business income of a resident-owned foreign corporation, and in cases of countries like Australia, Canada, France and Germany, resident-owned foreign branches,<sup>185</sup> is not taxed in the resident country either when it is earned or when it is repatriated as a dividend. Exemption is granted for active business income only; exemption is not granted for passive income—that is, rents, royalties, and interest.<sup>186</sup>

Exemption systems are thought to promote the competitiveness of resident companies internationally, to promote the simplification of tax administration by eliminating foreign tax credits for exempt income, and to promote a domestic tax base that is protected from erosion.<sup>187</sup> Yet the evidence strongly suggests that income exemption systems are largely subject to the same level of difficulty in accomplishing its taxation goals as is the case of worldwide taxation with deferral.<sup>188</sup> This is because exemption presents similar compliance risks as deferral systems because both systems must segregate appropriately exempt or deferred income. In both cases active business income is preferred income.

Exemption countries use different criteria to qualify foreign-source

---

<sup>182</sup> See U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO THE COMMITTEE ON FINANCE, U.S. SENATE, GAO-09-934 INTERNATIONAL TAXATION: STUDY COUNTRIES THAT EXEMPT FOREIGN-SOURCED INCOME FACE COMPLIANCE RISKS AND BURDENS SIMILAR TO THOSE IN THE UNITED STATES (2009) [hereinafter GAO REPORT].

<sup>183</sup> *Id.*

<sup>184</sup> *Id.*

<sup>185</sup> *Id.*

<sup>186</sup> Graetz & Oosterhuis, *supra* note 83, at 774–75.

<sup>187</sup> See, e.g., U.S. Treas. Dep't, International Tax Reform: An Interim Report, 1993 TAX NOTES 15 (1993); Graetz & Oosterhuis, *supra* note 83, at 772–73.

<sup>188</sup> GAO REPORT, *supra* note 182, at 18.

dividends for exemption.<sup>189</sup> Ownership percentages are used to distinguish between dividends and returns that are considered to be essentially business profits and those that are investments. Type of income requirements for exemption reflect the need to examine the underlying foreign income to determine whether the dividend paid out of that income should be afforded active (exempt) or passive (taxed) status. Finally, exemption may be designed to be fully operative only in the case where there are tax treaties between the two countries or the source country imposes a significant rate of tax.<sup>190</sup> The consequence is that the old system of taxation with foreign tax credits would still apply to some of taxpayers' operations in tandem with territorial exclusion.

To address the problem of tax-motivated locational decisions and the unwarranted shifting of net income from nonexempt to exempt income, many countries adopting exemption still have significant anti-avoidance rules.<sup>191</sup> These include Controlled Foreign Corporation ("CFC") legislation that is similar to or at least share the same objective as Subpart F of the U.S. tax law.<sup>192</sup> In both the deferral and exemption systems, CFC legislation generally taxes resident shareholders on some of the income that is not deemed to be appropriate for deferral or exemption, including passive sources and business income that may be located in particular countries for tax-motivated purposes.

Though in theory foreign tax credits present less of a problem in an exemption system because they are unnecessary for exempt business income,<sup>193</sup> distinctions between active non-creditable income and passive creditable income continue to create opportunities for the same types of planning found in deferral systems, such as the transformation of interest royalties and other forms of income into exempt (or deferred) income, or the transformation of high taxed active income into passive income for crediting purposes.<sup>194</sup>

Domestic expense deductions related to foreign income also present a problem for exemption systems. It is generally recognized that it is extremely difficult and potentially ineffective to attempt to allocate indirect expenses like R&D and G&A to foreign income.<sup>195</sup> Allocating G&A has

---

<sup>189</sup> *Id.* at 11.

<sup>190</sup> *Id.* See also H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT'L L. 1525, 1544 (2001) (suggesting that exemption should be limited to foreign corporations operating in countries that impose significant taxation).

<sup>191</sup> GAO REPORT, *supra* note 182, at 23–24.

<sup>192</sup> *Id.* at 14. See also I.R.C. § 954.

<sup>193</sup> GAO REPORT, *supra* note 182, at 25.

<sup>194</sup> *Id.* at 23, 25, 27.

<sup>195</sup> *Id.* at 28.

not been tried, even in the United States.<sup>196</sup> Consequently, countries such as Germany and France attempt only rough justice by requiring that 5% of exempt dividends be added into the domestic tax base when repatriated.<sup>197</sup> A 5% inclusion can have little relation to the amount of the current deduction of G&A and R&D associated with this income and the effect of postponement of the tax until dividends are repatriated.

The experience of France, Germany, Canada, Australia, and the Netherlands, supports the conclusion that exemption countries faced the same degree of compliance risk and taxpayer compliance burden as found under the American deferral system.<sup>198</sup> In particular, governments adopting territorial exemption stated that “transfer pricing was the most significant risk they faced in the area of international taxation.”<sup>199</sup> Complying with transfer pricing rules is also one of the most burdensome parts of international tax compliance.<sup>200</sup> Exemption systems still face significant risk in regard to segregating income between exempt and taxable subject to foreign tax credits and to the allocation of deductions to foreign exempt income, all problems associated with deferral.<sup>201</sup> They also depend on protective anti-abuse measures.

Considering administrative feasibility and compliance issues, an exemption system may be an improvement over the present system of deferral. However, defects closely approximating those found in a deferral system remain. Consequently, the theoretical prediction that an exemption system for the United States would increase revenue might be exaggerated because exemption is subject to the same kinds of manipulation as the present system.

In addition, there is a more fundamental economic reason why exemption systems are not much more effective than deferral systems. Exemption systems are predicated on the principle of capital import neutrality. The only tax is the source country tax. Deferral systems can have the same practical result where income earned by a controlled foreign

---

<sup>196</sup> See U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 67 (setting forth the current proposal that would require the allocation of G&A to foreign income).

<sup>197</sup> *Id.*

<sup>198</sup> *Id.* at 3.

<sup>199</sup> *Id.* at 19.

<sup>200</sup> For a thorough study of the significance of compliance costs in regard to international activities, see Marsha Blumenthal & Joel B. Slemrod, *The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications*, 2 INT'L TAX AND PUB. FIN. 37 (1995) (study showing that 40% of the compliance costs of U.S. multinationals were attributed to taxation of foreign source income even though only 20% of these multinationals' economic activities were in foreign operations). See also Robert J. Peroni, *Deferral of U.S. Tax on International Income: End It, Don't Mend It—Why Should We Be Stuck in the Middle with Subpart F*, 79 TEX. L. REV. 1609 (2001).

<sup>201</sup> GAO REPORT, *supra* note 182, at 23, 25, 26, 27, 28.

corporation is deferred for a substantial period of time.

To be accurate, exemption and deferral are CIN applications only to a certain extent. That is, to the extent that foreign business income represents the normal return on equity capital, its exemption or deferral produces the efficiencies of CIN which require the exclusive taxation of income from capital by the source country.

Underlying these rules is a critical dichotomy. Capital return that is classified as debt is passive and is subject to tax. Capital return that is equity is active and is tax-preferred. Debt follows CEN principles of neutrality. Equity follows CIN principles of neutrality. Where taxpayers have flexibility and choice as to form, the regime is elective. Where the regime is elective, the results reflect taxpayer savings and not efficient principles of capital allocation among capital exporting and capital importing nations.

The present system reflects this inconsistency. Multinationals choose debt financing to the extent possible in high tax countries because interest is deductible, and equity capital in low tax countries in order to accumulate income and defer the tax on that income. Even where debt is used, the return on debt financing is not necessarily taxed by the United States because debt is often held by offshore financial subsidiaries in a way that prevents effective tax.

The failure to tax domestic and exported capital in all of its forms alike in a world of fierce tax competition is a ticket for disaster. Capital and business will tend to flow from countries like the United States to any place where the after-tax return is greater. Many countries subsidize multinationals by providing tax preferences and low rates of tax. Thus, both deferral and income exemption guarantee that which countries most fear—that the absence of effective source tax will exert a strong influence on locational decisions.<sup>202</sup>

This is not the way these systems are supposed to work. International taxation principle assumes general taxation of capital and business income by source countries.<sup>203</sup> Actual international practice does not follow theory. One reason is the developed world pushes source countries to exempt or greatly reduce the rate on most forms of direct capital income including interest, royalties, and dividends.<sup>204</sup> Developed countries adopt this principle by unilaterally exempting the income from debt held by nonresidents.

A second reason is competition among nations for foreign business requires emerging economies to provide tax incentives to multinationals.

---

<sup>202</sup> See OECD, *TAX SPARING*, *supra* note 104.

<sup>203</sup> Barker, *supra* note 12, at 377.

<sup>204</sup> See Articles of the OECD Model Tax Convention on Income and on Capital, Art. 11 (2003) (proposing international norm of little or no source tax on capital income).



Lower foreign taxes produce a powerful incentive to locate business activities outside the resident countries, with a consequent loss of jobs and value to the home state.<sup>205</sup>

D. Changing Course: Comprehensive Income Taxation with an Exemption for Real Profits from Foreign Business Activity (Real Profits equal net (positive) cash flow from business activity)

The first step toward sensible international tax principles is the acknowledgment of the realities of source taxation. The emphasis should be on a fair and efficient strategy for the source taxation of business income in accordance with practical constraints.

There is an optimal system for the source taxation of business activities. Since source countries may truly lack the power and the economic justification for taxing the normal return from capital, they should not tax it. The tax base for the source taxation of active business income that is economically justified is economic rents. A tax on economic rents, which can be implemented by a source country through an expenditure or broad-based cash flow tax,<sup>206</sup> exempts the normal return from capital. Principles of fairness to taxpayers require that resident states provide double taxation relief. Principles of fairness between nations would dictate that double taxation relief provided by the home state would only need be afforded to economic rents. The income from equity capital would be included in the resident's tax base without any need for double taxation relief.

The fact is that economic rents is the natural, economically neutral tax base for source taxation which strongly reflects the exchange principle of fair taxation. Economic rents is a perfect base for exclusion as a method of double taxation relief because the source country has a much stronger economic justification for exclusive taxation than it did for active business income. Exemption, contrasted with comprehensive tax of economic rents with credit system, would be a rational response to the considerations of fairness to source countries.

Though an expenditure tax is the model for source taxation of economic rents, it would be difficult to blend a general income tax with an exclusion based on an expenditure tax model. Thus, exemption for economic rents could be implemented by the resident country more easily by starting with the previous model for the exemption of active business income. Modifications would be required for the current taxation of the normal return from capital. This could be implemented by imputing an

---

<sup>205</sup> See Barker, *supra* note 16, at 195–97 (describing the consequence of capital flight).

<sup>206</sup> See Charles E. McLure, Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm*, 45 NAT'L TAX J. 145, 145 (1992). See also Barker, *supra* note 16, at 212–14; Barker, *supra* note 12, at 382.

interest payment from the foreign enterprise to its domestic parent as a charge for the use of all equity capital used by the enterprise.<sup>207</sup>

Comprehensive taxation with the exemption of foreign economic rents deals directly with many of the defects of the present system. It cures the undesirable consequence of little or no taxation of equity income. It provides a backup to the current taxation of rents, royalties, and interest by taxing equity capital. It would virtually eliminate the advantage of mischaracterizing or mis-sourcing income or expenses. The tax incentive will be much less for transforming interest and royalties into equity return; it will take some pressure off the foreign tax credit system, especially the problem of cross-crediting. Compared with comprehensive taxation without deferral, it substantially reduces the need for foreign tax credits that depend on transfer pricing rules, sourcing rules, debt-equity distinctions, intangible asset/business income distinctions, and financial service income characterized as cross-crediting.

Implementation of exemption for economic rents faces certain challenges. First, all equity capital must be valued in order to impute an appropriate return. Transfer pricing would be an important concern. Second, exclusion for economic rents puts pressure on the somewhat arbitrary selection of the imputed return rate included in the domestic base for the normal return on equity capital.

The exemption for foreign economic rents deserves strong consideration as a vastly improved solution to the present system. The system is based on sound economic principles, it accomplishes fundamental fairness to the United States, its taxpayers, and to foreign governments, and it should simplify administration and compliance. In all, it should aid U.S. multinational competitiveness.

Exemption for foreign economic rents is the best solution considered so far, but it still has its disadvantages making it susceptible to manipulation.

## VII. A RADICAL PARADIGM SHIFT: REPLACING THE CORPORATE INCOME TAX WITH A TERRITORIAL EXPENDITURE TAX

The present focus of tax reform is on the foreign element of a resident taxpayer's affairs. International tax law is also about defining and protecting the domestic tax base from erosion due to residents' and non-residents' foreign activities. A simple fact of international taxation is that a resident of one country is a non-resident of others. Consequently, one person's activities reflect a complex relation between different nations' tax

---

<sup>207</sup> The rate for the normal return from capital to be used for the interest rate must be a judgment call. In a different context, The American Law Institute chose a rate that was 2% above the U.S. Treasury debt risk-free rate of return. See AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT: SUBCHAPTER C, REPORTER'S STUDY DRAFT 88-97 (1989) (proposal to allow corporations an interest-like deduction on new equity).

bases. Reform requires identifying and resolving the conflicting claims to these tax bases. International tax reform would advance if it focused on the relation of a U.S. corporation's foreign income and enterprises with its domestic activities, and on the relation of a foreign corporation's foreign activities to its U.S. activities. The common denominator is territorial taxation.

Territorial taxation of any corporation is justified on the basis of benefit received from the taxing jurisdiction.<sup>208</sup> Since the concept of corporate resident lacks sufficient social, political, or economic support, international tax law should put to the side corporate taxation in accordance with ability to pay and residence and should start instead with a supportable rationale for corporate taxation—benefit received. International tax reform would be founded on a universal assumption: all corporations are appropriately taxed in accordance with territorial principles.

Territorial taxation of nonresidents has not worked well under an income tax system plagued by the same types of problems outlined above for resident taxation of foreign income.<sup>209</sup> Source plays a critical role in the taxation of nonresidents, and the present source rules fail to reflect an economic justification for taxation.<sup>210</sup> Since many of the factors of production of enterprises are mobile and can be used in various locations, the physical location of business on account of tax incentives is inefficient. Consequently, some countries granting incentives may not even receive in taxes the value of public goods and services provided to corporations.<sup>211</sup> There are, however, other factors of production found in a nation that are sufficient to attract and *retain* economic activities. It is these national endowments that benefit economic activity that form the justification for territorial tax.<sup>212</sup>

Once the taxpayer-supplied factors of production are accounted for through deduction of these costs from the tax base, it is reasonable to conclude that these “benefits” of a national system make it possible to realize this true net profit. Economic rents are the one clear basis for territorial taxation over which all countries, including developing countries,

---

<sup>208</sup> See *supra* text accompanying notes 91–93.

<sup>209</sup> See Part II.A. *supra* (outlining principle problems with the present system).

<sup>210</sup> Sophisticated planning today exploits weaknesses in the U.S. system by taking advantage of “(1) the evolution of economic activity in the developed world toward value-added services and intangible assets, (2) increased flexibility in locating tangible economic functions and intangible assets, (3) technological and communications advances that challenge the ability of countries to impose tax at source, (4) substantial innovations in the structuring of financial assets, (5) the continued availability of low-tax countries that sometimes erect enforcement obstacles in the form of confidentiality restrictions.” Shay, Fleming & Peroni, *supra* note 74, at 84–85 (citations omitted).

<sup>211</sup> In general, governments should recover from firms the costs of providing public goods and services to them. See Wilson & Wildasin, *supra* note 68.

<sup>212</sup> See *id.*; Barker, *supra* note 16, at 212–16.

have real taxing power. Thus, the United States should start with the most justifiable base for the taxation of all corporations, a territorial tax on rents.

An income tax on economic rents can be implemented by a business expenditure, cash flow, or consumption tax.<sup>213</sup> One way of looking at the essential difference between an income tax and an expenditure tax is that an income tax taxes the entire return including the return on capital. An expenditure tax does not tax the normal return on capital. Income tax permits a deduction for interest on debt capital only, whereas an expenditure tax removes the normal return on all capital from the tax base. Thus, an income tax that would allow a deduction for all capital costs, both debt and equity, would be equivalent to a tax on economic rents.

Expenditure taxes follow two designs. The basic model (R-type) starts with a comprehensive income tax base and allows immediate deduction for the cost of materials, labor, and fixed assets.<sup>214</sup> It differs from an income tax in that income taxes require the capitalization of expenditures that produce future value and thereafter allow a deduction for that cost over time through depreciation. Under an R-type, dividends and interest are not taxed, and interest payments are not deductible.

The second expenditure tax design is an R&F-type. Under an income tax, interest receipts are included in income and interest payments are deductible. Under an R&F-type expenditure tax, the treatment of financial instruments is changed. Interest, dividends, and the principle amount of loans are included in the tax base; interest, dividends and principle payments are deducted from the tax base.<sup>215</sup> The R&F is the superior solution for assessing financial businesses and transactions because there is no need to separate capital income and expenditures from noncapital.<sup>216</sup>

Expenditure or consumption taxes are territorially based. One reason is that the philosophical underpinnings of consumption tax theory have been based on linking the tax base to a country, which is an *in rem* or territorial concept. To Thomas Hobbes, one of the earliest theorists of consumption taxation, the only fair and equitable tax was a consumption tax.<sup>217</sup> Hobbes focus was on people; an individual is taxed on what she takes out of a system, rather than what she adds. Consumption is linked to benefit. Thus, where benefits-received is the justification, territorial tax is the norm. Expenditure tax design aims at a national tax base that belongs to

---

<sup>213</sup> See HENRY C. SIMONS, *PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY* 50 (1938) (stating that consumption equals income less savings or plus dissavings).

<sup>214</sup> See THE INSTITUTE FOR FISCAL STUDIES, *THE STRUCTURE AND REFORM OF DIRECT TAXATION* 230–31 (1978). The allowance of a deduction for labor is what distinguishes an expenditure tax from another kind of consumption tax, the Value Added Tax.

<sup>215</sup> *Id.* at 233.

<sup>216</sup> *Id.* at 213–14.

<sup>217</sup> THOMAS HOBBS, *THE LEVIATHAN* 158 (George Routledge and Sons 1887).

that nation and no other.

Businesses do not technically consume, but their tax obligations can be measured in terms of a consumption or cash flow base. For a corporation, the tax base is what is available for consumption—that is, the cash flow that remains when all expenditures are accounted for. If applied universally, cash flow would be measured by all receipts and disbursements worldwide. When applied territorially, receipts and disbursements must be segregated and assigned to a territory.

There are two general schemes for defining the territorial attributes of an expenditure tax base. These are the origin principle and the destination principle.<sup>218</sup> Though there is much overlap in practical results, the two principles approach the tax base design from different perspectives.

#### A. The Origin Principle

The origin principle is about indentifying the value created within a territory after the normal cost of capital has been removed. It begins with inflows that include the total income from the sales of all goods and services in the United States. It also includes export sales of goods and services plus all other exported value. Outflows, or deductions, include all expenditures for goods and services and productive assets, whether produced domestically or imported.<sup>219</sup>

An origin-based expenditure tax is analogous to our current income tax system differing only in its treatment of tax of the normal return from capital. Both tax bases reflect the net value produced by a taxpayer. They differ in that a comprehensive income tax would tax the value produced worldwide by a resident taxpayer, whereas origin-based expenditure tax only taxes the value produced by the taxpayer within the territory of the United States. Where a taxpayer uses a foreign corporation for foreign production, comprehensive income taxation with deferral adopts an origin principle reaching only U.S. production currently.

The origin principle theoretically accomplishes much of what an optimal tax in the international setting should do. It should raise revenue in a simpler, less complicated fashion that eliminates the distinction between debt and equity. When it is applied solely to corporations, it leaves taxation of capital income to “human” persons who can be taxed as residents on a progressive basis.<sup>220</sup> It identifies an economically justifiable base for

---

<sup>218</sup> Modern proposals, like the Flat Tax, are origin based expenditure taxes. See ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (1995). An example of a consumption tax that is not a cash flow tax but that follows the destination principle is a European-style value added tax. See CHARLES E. MCCLURE, JR., *THE VALUE-ADDED TAX: KEY TO DEFICIT REDUCTION?* (1987).

<sup>219</sup> See David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599, 618–19 (2000).

<sup>220</sup> The replacement of the income tax on corporations with an expenditure tax on

source taxation—the value that a nation has added to the world, which consists of the economic rents made possible by that system.<sup>221</sup> It exempts economic rents that are attributable to value derived from other nations.

One major advantage of a territorial expenditure tax is that it completely eliminates the need for foreign tax credits. The territorial tax base belongs to that nation. All income from foreign production is excluded from the tax base. From the point of view of the country of origin, its right to tax is primary and any other nation's taxation of the same base would be secondary. An advantage of all expenditure taxes is that they eliminate the distinction between capital income and other forms of income since it eliminates the tax on capital income through expensing capital expenditures and it treats all receipts the same.<sup>222</sup>

However, the similarity of the origin principle to comprehensive income taxation causes it to share many of income tax's defects in the international setting. The origin principle as applied to corporations would be open internationally.<sup>223</sup> Deductions and inclusions taken by one U.S. taxpayer would not, in respect of imports and exports, be reflected by other U.S. taxpayers as, respectively, inclusions and deductions. Open systems foster tax avoidance. Most imports to the United States come through related party transactions either involving controlled foreign corporations of U.S. multinationals or involving U.S. affiliates of foreign multinationals.<sup>224</sup> The cost of these imports in an origin base expenditure tax is deducted against U.S. tax liability. In addition, imports of services and tangible and intangible capital is fully deducted under an origin-based expenditure tax. The true net profit derived from imports is not taxed by the importing state. Transfer pricing abuse resulting from inflated pricing would be a significant risk for importing countries implementing an origin-based expenditure tax.

Exports represent an analogous problem. The vast majority of exports from the United States involve related party transactions.<sup>225</sup> The origin-based expenditure tax requires the taxation of all exports, including exports of goods, services, tangible and intangible capital. The tax base includes the value of exports on the basis of actual sales or notional sales for value if exports are transferred at no cost to a related entity. The true net profit from exports is taxed by the exporting state. Transfer pricing abuse, resulting from deflated pricing, would be a significant risk for exporting countries implementing an origin-based expenditure tax.

The origin-based expenditure tax has many advantages. It puts taxation of corporations on a fair, economically-sound basis. It

---

corporations would eliminate the double taxation of capital income.

<sup>221</sup> See *supra* Part IV.D.

<sup>222</sup> See HALL & RABUSHKA, *supra* note 218, at 60–64, 72.

<sup>223</sup> See Weisbach, *supra* note 219, at 601.

<sup>224</sup> Zeile, *supra* note 4, at 208.

<sup>225</sup> *Id.* at 209.

substantially reduces the complexity of compliance and administration. The system has an important advantage to corporations: the exemption for the normal income return from capital, which could help make it politically feasible. On balance, it cures many of the critical defects of the present system. However, its revenue raising potential could be undermined by transfer pricing abuse. Since transfer pricing would be the focal point for effective taxation, the government would likely focus its efforts in the transfer pricing area.

An important negative result of the origin-based expenditure tax is that it does not achieve all of the policy goals that an international tax system should achieve. Though it chooses an economically neutral and internationally equitable domestic tax base, it could promote outcomes that are dramatically opposed to the goals of creating American jobs and spurring domestic development. First, since imports are deductible, foreign production even by U.S. multinationals is favored because there is no tax on foreign production, even foreign production resulting in U.S. sales. It might also give a substantial advantage in the United States to foreign multinationals that follow the typical pattern of foreign production leaving distribution activities as the primary activity performed in the United States.<sup>226</sup>

Export taxation has an equally undesirable effect. It would disincentivize domestic production for non-U.S. markets. It would certainly discourage foreign multinationals from production in the United States and this could be a serious threat to the continuation of the significant contribution to exports of the U.S. affiliates of foreign multinationals.<sup>227</sup> It would create a strong incentive for U.S. multinationals to relocate their production overseas where tangible and intangible asset values could be shifted through non-arm's length transfer pricing. R&D and G&A activity in the United States would also experience extra costs because all value exported must be taxed (because all value created domestically would be deducted). Of course, R&D and G&A performed outside the U.S. would not be deductible, but foreign income would not be taxable. Since imports would be deductible, the income resulting from foreign R&D and G&A expenditures would never be included in the U.S. tax base. Significant tax planning would still be important for multinationals.

### B. The Destination Principle

The destination principle changes the fundamental object of an expenditure tax. While the origin principle taxes the value which a national territory has added to the world, the destination principle taxes the value

---

<sup>226</sup> *Id.* at 208.

<sup>227</sup> U.S. affiliates of foreign multinationals account for 20% of total U.S. exports of goods. *Id.*

which a nation has taken out of the world. The destination principle adheres directly to its consumption-based roots.

The destination principle begins with all dispositions of goods and services that are made for U.S. consumption. It permits deduction for all expenditures for goods and services produced in the United States.<sup>228</sup> All dispositions are included except for exports; all expenditures are deducted except for imports.

Under the origin principle, taxing exports and deducting imports results in a tax on all production occurring within the United States, a tax on value added by the U.S. system to the world. Under the destination principle, exempting exports and ignoring imports results in a tax on production consumed in the United States no matter where that production originated.

A cash flow destination expenditure tax includes all dispositions in the tax base except for exports from the United States. Exports include all exported goods, services and capital. The costs associated with exported U.S. production are deductible, however. This would include domestically incurred R&D and G&A costs.<sup>229</sup> Imports of whatever kind are tax-irrelevant, since the costs associated with imported value are not deducted. Since the value of imports is not excluded from the tax base by deduction, it is effectively taxed.<sup>230</sup>

Cash flow taxes share many features. Like the origin principle, the destination principle raises taxes in a simpler fashion that eliminates the distinction between debt and equity. When applied solely to corporations, it leaves the taxation of capital income to “human” persons who can be taxed as residents on a progressive basis. Like the origin principle, the destination principle identifies an economically justifiable base for source taxation. Unlike the origin principle, the destination principle’s tax base is the value that nation has taken from the world, which consists of the economic rents consumed by that nation. The destination principle exempts the economic rents that are consumed elsewhere.

As a cash flow tax, the destination principle also eliminates the need for foreign tax credits. The tax base of domestic consumption belongs primarily to the consuming nation. All foreign consumption is excluded from the tax base. Since the primary right to tax domestic consumption belongs to the source country, there can be no acceptable double taxation of income that would require relief from the point of view of the country of destination.

---

<sup>228</sup> See Weisbach, *supra* note 219, at 620.

<sup>229</sup> Interest is deductible only under a cash flow, R&F, system. R models ignore both interest receipts and interest payments.

<sup>230</sup> Since the sale of those imports to U.S. consumers is included in the tax base, and no deduction is allowed for the cost of those imports, the full value of imports is taxed. This includes the costs as well as the profits from those imports.



There is an important difference in effect, however, between an origin and a destination-style consumption tax. In its focus on U.S. production, the origin principle establishes a system that is quite similar in operation to our present income tax system. In its focus on U.S. consumption, however, the destination principle establishes a system that in some critical respects is different in operation to our present system and an origin expenditure tax. While the origin principle thus shares some of the defects of the present system, principally the problem of cross-border adjustments, which leads to the critical risk of transfer pricing abuse, the destination principle does not.

A major advantage of the destination principle is that it is closed internationally.<sup>231</sup> All deductible expenditures end up as taxable receipts to a U.S. taxpayer. Non-corporate taxpayers include these receipts for income tax purposes; corporate taxpayers include them for expenditure tax purposes. Expenditures for imports are not deductible, nor are they included as receipts in the income of any U.S. taxpayer. Consequently, the pricing of imports and transfer pricing issues are irrelevant under the destination principle.

There is the same kind of advantage with respect to exports under a destination principle. Exports are not included in the base, nor are purchasers permitted to deduct these amounts from the U.S. tax base. Exports are not taxed because they represent potential consumption by another system. Imports are taxed (in essence, because they are not deductible) because they represent consumption by the U.S. system. Thus, the major advantage of the destination principle is that it has eliminated the tax significance of cross border transfer pricing. Neither overcharging for imports nor undercharging for exports has any tax utility.

The destination principle also cures the problem of transforming interest and royalties into exempt or deferred income. An expenditure tax does this by allowing deductions for all outputs and taxing all inputs (assuming the R&F model). This accomplishes the abolition of the distinctions among all types of income. Because capital expenditures are immediately deducted, the value that capital creates shows up as inflows (such as sales, rents, royalties, etc.). To the extent that the inflows are U.S. sales, this value is included. To the extent the value is from exports, it is excluded.

Unlike any other system considered, the destination principle has no need to allocate domestic expenditures to foreign income. That is because domestic expenditures are created-value, not consumed-value. Consequently, they are appropriately deducted in their entirety from a tax base that targets consumed value.

The key to effective taxation is the creation of an unavoidable tax. This is especially true where income producing events have an international

---

<sup>231</sup> See Weisbach, *supra* note 219, at 620.

dimension. The destination principle eliminates the reason for cross-border pricing strategies because neither exports nor imports are included in the tax base. Eliminating transfer pricing issues makes the destination expenditure tax a highly unavoidable tax.

Financial services are handled in a different way. An R-model, which is a yield-exempt model, is an awkward model for capturing the service component or true net profit of financial services. An R&F model, on the other hand, is an accurate way of doing so because it records all cash flows including financial ones. It automatically excludes the normal return on capital leaving the rents to be taxed. It is the preferred model for all corporations because it would eliminate any distinctions between business and capital income.<sup>232</sup>

Every system previously considered has defects that have a profound effect on locational decisions. These systems do not achieve tax neutrality. The elimination of virtually all of these problems by the destination expenditure model has moved taxation to a neutral factor in locational decisions. Legislators can be confident that the destination principle creates a corporate tax base that accomplishes the twin goals of establishing and preserving the U.S. domestic tax base for both U.S. and foreign multinationals.

This base does more, however. The destination principle taxes in a manner that enhances growth and business activity domestically. By permitting taxpayers to deduct expenditures for all production in the United States, no matter whether it results in domestic sales (taxable income) or exports (nontaxable income), it promotes the production of goods and services, the location of research and development, and the location of headquarters and administration in the United States. If anything could reverse the flow of jobs and business activity outside the United States, a destination expenditure tax would.

No tax is immune from fraud, however. Though it cures the problems associated with tax planning and avoidance, it provides predictable avenues for evasion. Because exports are not taxable, there will be the temptation to recharacterize sales to Americans as exports. Since imports are not deductible, there will be the temptation to recharacterize foreign production as domestic. In the case of direct imports to consumers, a destination principle requires sophisticated border supervision. The problems of evasion do not appear, however, to be greater than under the alternatives considered, whereas the problems of avoidance under a destination expenditure tax are substantially eliminated.<sup>233</sup>

Different factors affect production activity. Obviously, a considerable

---

<sup>232</sup> See *id.* at 624.

<sup>233</sup> Raymond J. Mataloni, Jr., *A Note on Patterns of Production and Employment by U.S. Multinational Companies*, DEP'T OF COMMERCE, SURVEY OF CURRENT BUSINESS, Mar. 2004, at 52.

amount of the production is still located in the United States based on export figures. A considerable amount of production is also undertaken by foreign affiliates of U.S. multinationals that is destined for countries other than where produced. Some of this production ends up as U.S. imports. It is logical that this production is accounted for, at least in large part, by capital and technologies developed in the United States. A destination expenditure tax captures this repatriated value by denying a deduction for imports.

A destination type expenditure tax reverses traditional notions of planning for taxes both for U.S. and foreign multinationals. There is no tax advantage to production abroad. Indeed, production for domestic markets is fully taxed only where the production occurred outside the United States. Production for foreign markets is not taxed at all. Consequently, all costs of U.S. production wherever destined would be fully deducted. Income tax systems of other countries would not match the incentivizing effect on business. This system would encourage all multinationals to produce in America for domestic consumption. Moreover, America would offer multinationals a favorable tax environment for the production of exports.

Consequently, a destination expenditure tax is both tax neutral and growth enhancing. It places all foreign production on a level playing field with respect to domestic consumption. It places all domestic production on a level playing field with two different dimensions. The first dimension is domestic production for domestic consumption. Because only domestic production is deductible, a destination tax promotes U.S. production. The second dimension is domestic production for exports. Since all domestic expenditures are deductible, domestic production for export results in a negative tax on exports which reduces U.S. tax liability.

## CONCLUSION

The present international tax system is riddled with problems because it does not satisfy principles of economics, justice, or common sense. The literature contains many solutions to the present system, from incremental reform to radical reform. This paper has examined several of these proposals, including comprehensive income taxation with exemption for foreign active business income, comprehensive income taxation without deferral, and comprehensive income taxation with exemption for foreign economic rents. The analysis has shown that a territorial income exemption system does little to address the defects in the present system and errs in relying on outmoded theories of economic efficiency. The analysis shows that comprehensive income taxation, though it is based on a better understanding of economic principles, shares many of the defects of the present system. The analysis shows that the third model, territorial exemption of economic rents for corporations, best exemplifies sound economic principles of neutrality, and addresses many more of the defects of the present system. Though exemption for foreign economic rents

presents the best economic model for reform, adoption would still present some opportunities for tax avoidance. None of these systems, however, advance the goal of promoting U.S. job and economic development in the United States.

This paper then considers a paradigm change: the replacement of the corporate income tax with an expenditure tax. What is different about this proposal from other consumption tax proposals is that it is designed solely as a replacement for the corporate income tax. This proposal is advanced because it promotes fair and efficient U.S. international tax rules for corporations. An expenditure tax model changes the focus from the difficult task of taxing foreign income to the more practical task of taxing the domestic income of all corporations well. Of the two expenditure tax models, the origin principle, by focusing on U.S. production, still shares some of the defects of most international income tax systems and shares the inability of income tax systems to promote domestic growth and welfare. The destination principle expenditure tax, however, is so different in its fundamental conception that it does not share the defects of the present system. It taxes in a way that should promote long-term revenue gains, protect the domestic tax base, and, at the same time, stimulate economic growth in U.S. jobs and business in a tax neutral fashion. The destination principle creates an efficient, fair, largely unavoidable tax that would enhance U.S. welfare, a clearly superior solution.

