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Taxing International Portfolio Income

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I. Introduction

Most analyses of the taxation of international income earned by U.S. corporations or individuals have addressed income from direct investments abroad. With the exception of routine bows to the "international tax compromise" and sporadic discussions of the practical difficulties residence countries face in collecting taxes on international portfolio income, the taxation of international portfolio income generally has been ignored in the tax literature.[1]

Analysis and reassessment of U.S. tax policy regarding international portfolio income is long overdue. The amount of international portfolio investment and its role in the world economy has grown exponentially in recent years. In most years since 1990, the total market value of U.S. persons' foreign portfolio investments has exceeded the value of U.S. corporations' foreign direct investments, and the total amount of U.S. taxpayers' foreign portfolio income has exceeded their income from foreign direct investments.[2] Cross-border portfolio investments are no longer a tiny tail on a large direct-investment dog. International portfolio investments now play a major role in the world economy, a role quite different from that played by foreign direct investments. We can no longer afford simply to assume, as we have in the past, that the way the United States taxes the latter is obviously appropriate to the former. Instead we must ask explicitly what tax policy for income from portfolio investments best serves our nation's interest. That is the task we undertake here.

Corporations raise money to do business in three ways: They retain what they have earned, they borrow, and they issue equity to shareholders. At the corporation's inception, borrowing and raising equity capital are the only options. When U.S. equity capital is invested abroad, sometimes a U.S. corporation will open a foreign branch, but typically it invests equity capital in the shares of a foreign corporation.

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[1] Some exceptions include Doron Herman, Taxing Portfolio Income in Global Financial Markets (2002); Reuven S. Avi-Yonah, The Structure of International Taxation: A Proposal for Simplification, 74 Tex. L. Rev. 1301 (1996) [hereinafter Structure]; Yaron Z. Reich, Taxing Foreign Investors' Portfolio Investments: Developments & Discontinuities, 98 Tax Notes International 119-16 (1998) (focusing on inbound foreign portfolio investment).

[2] Elena L. Nguyen, The International Investment Position of the United States at Yearend 2002, Surv. Current Bus., July 2003, at 12, 20-21 tbl.2 (comparing lines 17 and 19); Douglas B. Weinberg & Patricia E. Abaroa, U.S. International Transactions, First Quarter 2003, Surv. Current Bus., July 2003, at 58-59 tbl.1 (comparing lines 14 and 15); see also Avi-Yonah, note 1, at 1315.

Often the voting stock of the foreign corporation is wholly or majority-owned by a U.S. corporation or corporations or by U.S. persons. Even without control, important shareholders—whether individuals or other corporations—may exercise substantial influence over the company's business decisions. To have control or even significant influence over corporate decisionmaking, one must own a substantial percentage of shares in the company. In the commonly used vernacular, one must be a "direct investor." Those who do not own sufficient shares to influence business decisions are labeled passive, or portfolio, investors. If portfolio shareholders are unhappy with the company's business decisions, they may sell their shares.

In the United States, investment is classified as direct whenever a U.S. individual or company owns, directly or indirectly, at least 10% of the voting stock of a foreign corporation or, contrariwise, when a foreign individual or company owns, directly or indirectly, at least 10% of the voting stock of a U.S. corporation.[3] Investment is classified as portfolio whenever the individual or corporation owns less than 10% of the foreign entity.[4]

Perhaps the lack of discussion in the tax policy literature regarding the taxation of international portfolio income is due to the congruent structure of U.S. taxation of income from foreign direct investments of U.S. multinational corporations and income from foreign portfolio investments of U.S. individual citizens or residents. The United States allows foreign income taxes imposed by the nation where the income is earned to be credited against the income taxes that the United States otherwise would impose.[5] This system of crediting foreign income taxes first entered the U.S. income tax law in 1918.[6] In 1921 the foreign tax credit (FTC) was limited to the amount of U.S. tax that

[3] IRC § 902.

[4] Id. Obviously, one can quarrel with the 10% ownership threshold as establishing the division between direct and portfolio investment, but that number is commonly used throughout the OECD. See, e.g., Robert H. Gordon & James R. Hines Jr., International Taxation 42 (NBER Working Paper No. 8854, 2002) (defining foreign direct investment as 10% or more of total ownership), available at http://papers.nber.org/papers/w8854.pdf. Herman, note 1, at 72. Some countries, however, use a lower threshold—5% or even 1%—in classifying investment as direct. Richard J. Vann, General Report, Trends in Company/Shareholder Taxation: Single or Double Taxation?, 88a Cahiers de Droit Fisc. Int'l 21, 33 n.12 (2003). The precise dividing line between direct and portfolio investment may be controversial, but that is not important to us here, only that some dividing line exists.

[5] IRC § 901(a).

[6] Revenue Act of 1918, ch. 18, §§ 222(a)(1), 238(a), 240(c), 40 Stat. 1057, 1073, 1080-82 (1919) (§ 222(a)(1) provided a foreign tax credit for individuals, § 238(a) provided a similar credit for domestic corporations, and § 240(c) allocated taxes paid by a foreign corporation in which a U.S. corporation had a direct investment).

would have been imposed on the foreign source income.[7] The FTC has served as the cornerstone of U.S. international tax policy ever since.[8]

When the U.S. regime for taxing international income first came into place, policymakers focused on direct investment abroad by U.S. corporations: "The United States says, in effect, to its citizens—go abroad and trade."[9] U.S. international tax policy was essentially mercantilist, driven largely by concerns that double taxation of international income by both the United States and the country where the income was earned would inhibit U.S. direct investments abroad and also would be unfair.[10] The U.S. decision unilaterally to grant a tax credit for foreign income taxes also was grounded in the policymakers' conviction that the source country—the country where the income was earned—had a right to tax such income and inevitably would exercise that right.[11]

Soon after the United States enacted its foreign tax credit, the League of Nations, spurred in part by the United States, examined the problem of international taxation, and in 1928 the League produced a model bilateral income tax treaty.[12] The decades since have seen some changes, to be sure, but the basic structure of the League's 1928 model treaty undergirds today's model treaties of the United States, the OECD, and the United Nations, which, in turn, form the basis for the more than 2000 bilateral income tax treaties now in effect throughout the world.[13] Like the instigators of the U.S. foreign tax credit, the drafters of the League's 1928 model treaty were over-

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[7] Revenue Act of 1921, ch. 136, §§ 222(a)(5), 238(e), 42 Stat. 227, 249, 259 (§ 222(a)(5) provided limitation on credit for individuals and § 238(e) provided limitation on credit for corporations).

[8] Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke L.J. 1021, 1044-59 (1997).

[9] Mitchell B. Carroll, The Double Taxation Conference 28-29 (Sept. 3, 1927), unpublished manuscript, available in T.S. Adams Papers, Yale University, box 16, Sept. 1927 folder, (Carroll was an associate of T.S. Adams, then Tax Advisor to the Treasury Department), quoted in Graetz & O'Hear, note 8, at 1050. U.S. tax policy was relatively forward-looking; economic policy in the 1920's was generally protectionist.

[10] For more on T.S. Adams' role in founding the modern U.S. international tax system, see Graetz & O'Hear, note 8.

[11] Id. at 1036-41.

[12] Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion, League of Nations, Doc. C.562.M.178. 1928 II (Oct. 31, 1928) [hereinafter League Report], reprinted in 4 Staff of Joint Comm. on Tax'n, Legislative History of United States Tax Conventions 4161-75 (1962).

[13] OECD, Model Tax Convention on Income and on Capital, Jan. 28, 2003, art. 24(1), available at http://www.oecd.org/dataoecd/52/34/1914467.pdf [hereinafter OECD Model Treaty] (proposing a model convention that includes a provision for eliminating double taxation); UN, Model Double Taxation Convention Between Developed and Developing Countries, Jan. 1, 1980, 1 Tax Treaties (CCH) ¶ 206 [hereinafter U.N. Model Treaty]; U.S. Model Income Tax Convention, Sept. 20, 1996, 1 Tax Treaties (CCH) ¶ 214 [hereinafter

whelmingly concerned with international business income.[14] A few moguls may have owned widespread international portfolio investments, but portfolio investments simply were not of much importance to the world economy at that time.

The tax literature frequently labels the League of Nations' basic allocation of income taxes in its model treaty between countries of source and countries of residence as the "international tax compromise." That compromise typically is described as allocating active business income to the jurisdiction where it is earned (the source jurisdiction) and passive or portfolio income to the jurisdiction from which the capital is supplied (the residence jurisdiction).[15] But this description buries the fact that source countries frequently impose income taxes on income from passive portfolio investments in the form of so-called withholding taxes: final taxes imposed at a flat rate on gross dividend and interest income paid to foreigners.[16]

In 1984—both to encourage foreigners to purchase U.S. debt to help finance federal deficits and to help U.S. companies borrow in world markets—Congress repealed the U.S. withholding tax on portfolio interest income.[17] Since then zero taxation by source countries of portfolio interest income has become commonplace.[18] But source countries typically continue to impose withholding taxes on dividend income earned by foreigners. The Code imposes such a tax at a 30% rate, but the United States commonly reduces that rate to 15% by treaty.[19] In an income tax treaty negotiated in 2001, the United States and the United Kingdom both agreed to eliminate their withholding taxes on certain direct dividends, thus—in that instance at least—bringing the longstanding description of the "international tax compromise" closer to reality.[20] The U.S.-U.K. treaty may signal a fundamental change in U.S. tax policy. A similar policy was included in new

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U.S. Model Treaty]; U.N. Conference on Trade and Development, U.N., World Investment Report 2002: Transnational Corporations and Export Competitiveness xv–xvi (2002).

[14] League Report, note 12.

[15] See, e.g., Avi-Yonah, Structure, note 1, at 1305-06.

[16] See, e.g., IRC §§ 871(a) (nonresident alien individuals), 882(a) (foreign corporations).

[17] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127, 98 Stat. 494, 648-52; IRC §§ 871(h), 881.

[18] See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital, Aug. 31, 1994, Fr.–U.S., art. 11(1), 2 Tax Treaties (CCH) ¶ 3001, at 27,005-8; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital Gains, July 24, 2001, U.K.–U.S., art. 11(1), 4 Tax Treaties (CCH) ¶ 10,900, at 44,505-11 [hereinafter U.S.-U.K. treaty].

[19] U.S. Model Treaty, note 13, art. 10, 1 Tax Treaties (CCH) ¶ 214.10.

[20] The 2001 U.S.-U.K. treaty allows a withholding rate of up to 15% on portfolio dividends. U.S.-U.K. treaty, note 18, art. 10, ¶ 2, 4 Tax Treaties (CCH), at 44,505-9. U.S. portfolio investors in the United Kingdom will not face any withholding tax only because the United Kingdom does not impose withholding tax on dividends, but instead negotiates

protocols signed with Australia and Mexico.[21] A zero withholding tax on similar dividends will likely be considered in Treasury's forthcoming treaty negotiations with the Netherlands.[22] Income from international portfolio dividends has grown more rapidly than income from international direct dividends in recent years, but the taxation of these portfolio dividends has yet to receive serious review from Treasury.

II. The Growth of Outbound U.S. Foreign Portfolio Investment

Numerous commentators have remarked on the shortcomings of the data available about the magnitude of foreign portfolio investments (FPI) by U.S. persons and of portfolio investments by foreigners into the United States.[23] We fill that gap somewhat here by

withholding tax-equivalents through its tax treaties. There is no such equivalent in the new U.S.-U.K. treaty. Id.

21 Second Additional Protocol to the 1992 Mex.-U.S. Convention for the Avoidance of Double Taxation, Nov. 26, 2002, art. II(2), 3 Tax Treaties (CCH) ¶ 5903A; Protocol to the 1982 Austl.–U.S. Convention for the Avoidance of Double Taxation, Sept. 27, 2001, art. 6(2), 1 Tax Treaties (CCH) ¶ 505. Like the new U.S.-U.K. treaty, the new protocols signed with Australia and Mexico preserve withholding taxes on foreign portfolio dividends.

22 U.S., Netherlands to Revise Income Tax Treaty, Treasury Announces, 94 Tax Notes 1111 (Mar. 4, 2002).

23 See, e.g., Roy Culpeper, Resurgence of Private Flows to Latin America: The Role of North American Investors, in Coping With Capital Surges: The Return of Finance to Latin America 1, 32-33 (Ricardo Ffrench-Davis & Stephany Griffith-Jones eds., 1995) [hereinafter Capital Surges] (noting that "[m]ore complete, consistent, and prompt reporting of secondary market and derivative transactions would be beneficial to all participants (source and recipient countries, savers, investors, and borrowers alike)"); UN TDBOR, Commission on Investment, Technology and Related Financial Issues, Expert Meeting on Portfolio Investment Flows and Foreign Direct Investment, Provisional Agenda Item 3, Foreign Portfolio Investment (FPI) and Foreign Direct Investment (FDI): Characteristics, Similarities, Complementarities and Differences, Policy Implications and Development Impact, U.N. Doc. TD/B/com.2/EM.6/2 and Corr.1 (1999), available at http://www.unctad.org/en/docs/c2em6d2&cl.en.pdf [hereinafter UNCTAD Report]; International Monetary Fund, Results of the 1997 Coordinated Portfolio Investment Survey 8, 12 tbl.1.1 (1999). Certain institutional characteristics of international financial markets make it difficult to accurately track flows of portfolio investment. For example, bearer bonds that allow buyers to remain anonymous are the most commonly traded bond instruments in the Eurobond markets. Anonymity of buyers means that a U.S. mutual fund purchasing Latin American debt in the London markets will not register as a transaction in which a U.S. taxpayer has purchased Latin debt. Rather, traditional government tracking mechanisms will treat the purchase as a flow of portfolio investment from Europe to Latin America. Stephany Griffith-Jones, European Private Flows to Latin America: The Facts and the Issues, in Capital Surges, supra, at 41. Recent efforts such as the IMF's 1997 coordinated portfolio investment survey and related efforts by Treasury to track FPI help to provide snapshots of the sources and destinations of international portfolio investment, but do not solve the problem of tracking flows of portfolio investment on an ongoing basis. See William L. Griever, Gary A. Lee & Francis E. Warnock, The U.S. System for Measuring Cross-Border Investment in Securities: A Primer With a Discussion of Recent Developments, 87 Fed. Res.

describing the growth over time of U.S. outbound and inbound FPI, and by reporting recent data on flows of U.S. outbound FPI.

In 1960, outbound FPI by U.S. nationals totaled only $10 billion.[24] Portfolio investment in long-term securities by foreigners in the United States totaled $13.8 billion.[25] By 1986 U.S. outbound foreign portfolio investment was $158 billion.[26] In 1997 outbound FPI from the United States was more than $1.7 trillion,[27] while portfolio investments by foreigners in long-term securities in the United States had expanded to $2.806 trillion.[28] The $1.7 trillion in U.S. outbound FPI in 1997 accounted for 29% of FPI holdings reported worldwide.[29] By the end of 2001, the stock of U.S. outbound FPI had grown to $2.262 trillion dollars.[30] Total FPI assets owned by U.S. persons grew 21.1%

Bull., 633, 646 (2001) (discussing recommended changes to the U.S. data collection system for tracking flows of portfolio investments).

24 Russell Scholl, The International Investment Position of the United States: Developments in 1971, Surv. Current Bus., Oct. 1972, at 18, 21 tbl.3 (foreign securities).

25 Office of the Asst. Sec'y for Econ. Pol'y, Treasury Dep't, Summary of Report on Foreign Portfolio Investment in the United States as of December 31, 1997 tbl.2, available at http://www.treas.gov/tic/shl94sum.html [hereinafter Treasury FPI Summary].

26 Christopher L. Bach, U.S. International Transactions, Revised Estimates for 1974-96, Surv. Current Bus., July 1997, at 43, 46 tbl.2, available at http://www.bea.doc.gov/bea/articles/internat/bpa/1997/0797bp.pdf; Office of the Ass't Sec'y, Int'l Affairs, Treasury Dep't & Division of Int'l Finance, Board of Governors, Federal Reserve System, Report on U.S. Holdings of Foreign Long-Term Securities as of December 31, 1997, and December 31, 1999 (Apr. 2000), available at http://www.treas.gov/tic/flts.pdf [hereinafter Treasury FLTS Report].

27 Treasury FLTS Report, note 26, at 22 tbl.15.

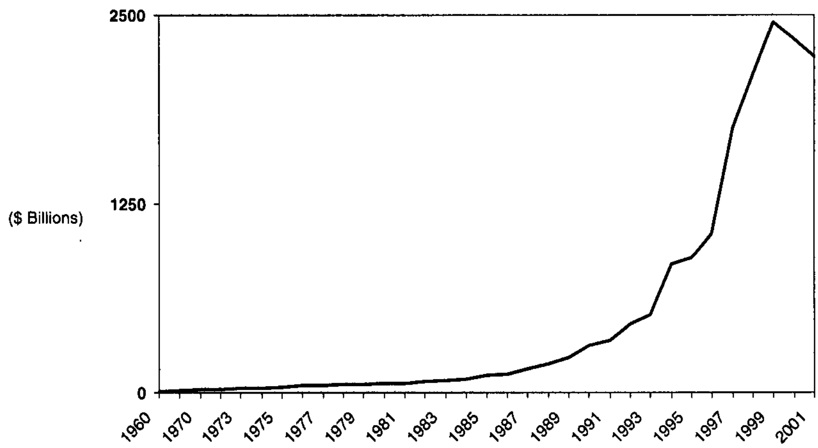
28 Treasury FPI Summary, note 25, at tbls.1-3. Inbound FPI to the United States has grown rapidly as well, albeit at a slightly lower rate. Between 1984 and 1997, inbound FPI to the United States grew at a compound growth rate of 20%. That translated to a 10-fold increase in the stock of inbound FPI in the United States—from $268 billion in 1984 to $2.8 trillion in 1997. Even more impressive, between 1994 and 1997, inbound U.S. FPI in long-term securities more than doubled, from $1.2 trillion to $2.8 trillion. Treasury FPI Summary, note 25, at tbls.1-3. Over the 1994-1997 period, foreign holdings of U.S. equities increased 133%, while foreign holdings of debt securities increased 122%. Id. By March 31, 2000, the time of the last benchmark survey of foreign holdings of U.S. long term securities, and a date near the peak of the U.S. stock market bubble, inbound foreign investors held almost $3.6 trillion in U.S. long-term securities. Griever et al., note 23, at 638 tbl.1 (2001).

29 Portfolio investment channeled through offshore financial centers was not included in the IMF's 1997 coordinated portfolio investment survey. Thus, this figure may under- or over-represent portfolio investment holdings by U.S. taxpayers. International Monetary Fund, note 23, at 132, 141-42 tbl.III.2.

30 Office of the Under Sec'y, Int'l Aff., Treasury Dep't, Securities Reports Division, Federal Reserve Bank of New York & Division of Int'l Finance, Board of Governors, Federal Reserve System, Report on U.S. Holdings of Foreign Securities as of Dec. 31, 2001, at 3 tbl.1 (May 2003), available at http://www.treas.gov/tic/shc2oo1r.pdf [hereinafter Treasury Report on Holdings].

per year between 1986 and 2001.[31] Between December 31, 1997 and December 31, 1999, the stock of U.S. outbound portfolio investment jumped from $1.755 to $2.456 trillion dollars.[32] Between December 31, 1999 and December 31, 2001, the stock of U.S. outbound portfolio investment fell to $2.262 trillion dollars,[33] principally due to the decrease in equity prices from the bursting of the stock market bubble of the late 1990's.

FIGURE 1
TAKING INTERNATIONAL INCOME
FOREIGN PORTFOLIO INVESTMENT BY U.S. TAXPAYERS ABROAD



Sources: Scholl, note 24; Bach, note 26; FLTS Report, note 26; Treasury Report on Holdings, note 30.
Note: 1997, 1999, and 2001 data comes from U.S. Treasury benchmark surveys on U.S. holdings of foreign securities. Earlier data is only available through the standard Survey of Current Business publication and revisions, and is likely underestimated.

In an average month in 1999, U.S. taxpayers sent $215 billion in portfolio investment abroad.[34] The average monthly outbound flow of U.S. FPI today is significantly larger than the total stock of U.S. FPI

[31] Compound annual growth rate calculated based on $158 billion of outbound FPI in 1986 and $2.262 trillion for the stock of U.S. outbound FPI in 2001. See Bach, note 26, at 46 tbl.2 (1986); Treasury Report on Holdings, note 30, at 3 tbl.1.

[32] Treasury FLTS Report, note 26, at 22 tbl.15.

[33] Treasury Report on Holdings, note 30, at 5 tbl.2.

[34] Id. Note that this figure is based on reported annual cash purchases for outbound FPI divided by 12. The figure likely underestimates the size of gross U.S. FPI due to the growing frequency of international mergers and acquisitions implemented through stock swaps. These stock swaps provide U.S. shareholders with in kind compensation of foreign stock holdings without any cash flow that would require reporting. Griever et al., note 23, at 641-42; Treasury Dep't, TIC Capital Movements: United States Transactions with Foreigners in Long-Term Securities charts CM-C, CM-D, available at http://www.treas.gov/tic/exhibitsc&d.pdf.

assets in 1986.[35] In 2002 alone, U.S. foreign portfolio investors bought nearly $1.26 trillion in foreign equities.[36] The level of investment flows is particularly relevant here since income tax consequences are triggered by flows of investment—sales and purchases of assets as well as payments of investment income—not the level of the stock of investment assets.

Notwithstanding the overall growth in U.S. outbound FPI, the bulk of U.S. portfolio investment abroad is still concentrated in relatively few countries. In 1999, 68% of U.S. FPI went to 10 countries.[37] These 10 leading recipients of U.S. FPI account for less than 30% of worldwide GDP.[38] U.S. FPI is therefore significantly more concentrated than is worldwide economic output. The United Kingdom leads the countries where U.S. taxpayers invest FPI dollars, accounting for 16% of all U.S. outbound FPI.[39] Figure 2 depicts shares of outbound U.S. FPI invested in specific countries in 1999.

While U.S. FPI tend to be concentrated in those countries that are most important in terms of worldwide economic activity—all of the G-7 countries, for example, are among the top 10 locations for U.S. FPI—there is surprisingly little correlation on a country-by-country basis of U.S. FPI per capita compared to GDP per capita.[40] U.S. portfolio investment simply does not mirror the global distribution of economic activity. The concentration of U.S. FPI in 10 or 15 countries may instead be explainable by the relative accessibility of various markets over time, the path dependence of investment patterns, and other factors, perhaps including net shareholder tax rates for investments in specific countries.[41]

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[35] Compare text accompanying note 34 with text accompanying note 26. The churn rate suggested by these figures is extremely high and may be the result of problems with the TIC data collection system. For a discussion of the limitations of the current TIC system, see Griever et al., note 23.

[36] Treas. Bull., Sept. 2003, at 88 tbl.CM-V-5, col.14 (Sept. 2003), available at http://fms.treas.gov/bulletin/b33cm5.doc.

[37] Treasury FLTS Report, note 26, at 23 tbl.16. Authors' calculations based on raw data provided in the Treasury report.

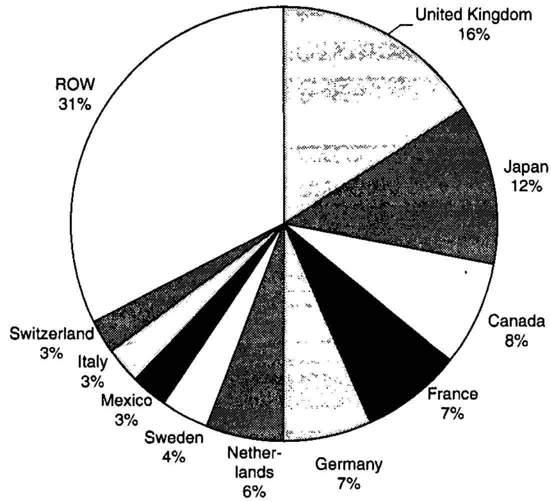
[38] GDP numbers used in this analysis are for 1997 in 1995 Dollars estimated via the Atlas Method. World Bank, World Development Indicators CD-ROM (2002), available at http://www.worldbank.org/data/onlinedatabases/onlinedatabases.html.

[39] Treasury FLTS Report, note 26, at 23 tbl.16.

[40] See Figure 3. When viewed through the lens of concentration of investment, Switzerland, the Netherlands, Canada, and Sweden become worthy of attention as nations into which the United States disproportionately directs portfolio investment. Meanwhile, Japan appears relatively under-represented in the portfolios of U.S taxpayers. That country's prolonged recession may explain the relative paucity of U.S. FPI into Japan. Reliable data are not available for country-by-country U.S. outbound FPI in the late 1980's, before the Japanese downturn.

[41] See generally Brian Aitken, Have Institutional Investors Destabilized Emerging Markets?, 16 Contemp. Econ. Pol'y 173 (1998) (examining impact of "positive feedback trad-

FIGURE 2
DISTRIBUTION OF FOREIGN PORTFOLIO INVESTMENT BY U.S. TAXPAYERS IN 1999



Source: **Treasury FLTS Report, note 26, at 23 tbl. 16.**

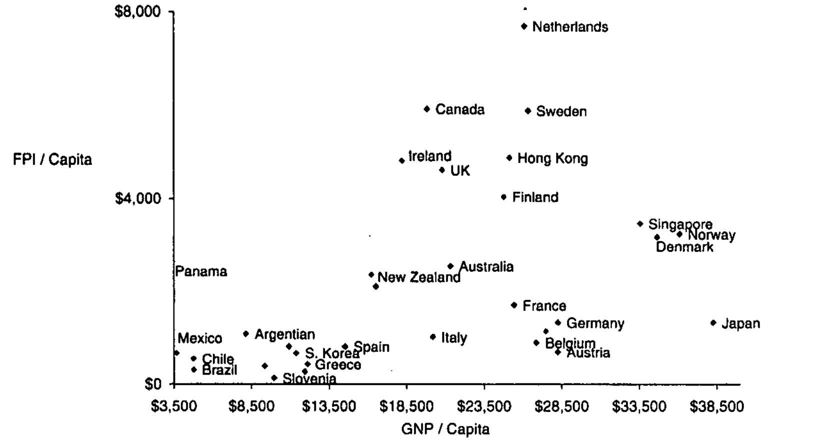
III. HOW ARE DIRECT AND PORTFOLIO INVESTMENTS DIFFERENT?

As we have indicated, U.S. policy for taxing income from FPI followed—without any serious independent analysis—the policies developed for U.S. foreign direct investments (FDI). But there are important economic differences between direct and portfolio investments that may imply quite different tax treatment of their income. Indeed, these economic differences suggest that the principal normative concepts used to evaluate international tax policy generally—capital export neutrality and capital import neutrality—have far less relevance to the taxation of international portfolio income than they might for evaluating the taxation of income from direct investments. This Section describes how these two types of investments diverge ec-

ing" by institutional investors on emerging stock markets); Culpeper, note 23. For example, the net shareholder tax rate on dividends for portfolio investments by U.S. taxpayers through "collective investment institutions," such as a U.S. mutual fund, was historically 33.25% in the United Kingdom, compared to 46.6% for an investment in the United States. OECD, Taxation of Cross-Border Portfolio Investment: Mutual Funds and Possible Tax Distortions 114 tbl.AI.1.F (1999). This disparity may help explain the UK's position as the top recipient of U.S. outbound FPI. British tax laws changed beginning in the year 2000. Thus, the net shareholder tax rate for investment by U.S. taxpayers in the United Kingdom in 2003 is higher than 33.25%. See Rev. Proc. 2000-13, 2000-1 C.B. 515; see also note 67 and accompanying text.

FIGURE 3

FOREIGN PORTFOLIO INVESTMENT BY U.S. NATIONALS ABROAD



Sources: Treasury FLTS Report, note 26.; World Bank Development Indicators (1997). Population numbers are for 1997. GDP/Capita Numbers are for 1997 in 1995 Dollars estimated via the Atlas Method.

Note: Three countries with GNP/Capita are off the scale of this chart. Switzerland has $9,000 FPI/Capita and GNP/Capita $43,100. Luxembourg has FPI/Capita $19,600 and GNP/Capita $46,700. Finally, Bermuda has FPI/Capita of $422,300 and GNP/Capita of $35,600. (Note that Bermuda has a population of only around 60,000 persons).

onomically and outlines the key distinctions in the current taxation of income from direct and portfolio investments.

A. *The Key Tax Distinction Between Foreign Direct Investment and Portfolio Investment*

Foreign portfolio income often is earned today by both individuals and corporations, while FDI virtually always is made by corporations. As we noted, whether an investment in a foreign entity by a U.S. corporation is classified as direct or portfolio technically turns on the degree of ownership of the foreign company; to qualify as a direct investment, some minimum threshold of ownership—generally 10% of voting stock—must be crossed.[42] It may be simpler analytically, however, to regard income from FDI as representing the profits from conducting business activities abroad—the profits of the firm—and income from FPI as representing passive investment income—the profits realized by investors in the firm.[43] Although we follow the technical definitions here, it may similarly be helpful to think of an investment as direct when a U.S. taxpayer has sufficient control over the business decisions of the foreign entity; when the U.S. taxpayer has little or no control over the foreign entity's business decisions, the investments are typically FPI.

[42] See, e.g., IRC § 902.

[43] See, e.g., Avi-Yonah, Structure, note 1, at 1308-10.

Although a number of U.S. tax consequences turn on the distinction between FDI and FPI, which generally corresponds to the tax law's distinction between active and passive income,[44] here we emphasize one. Whenever a U.S. company has sufficient control over a foreign corporation, it is permitted to credit against its U.S. tax liability corporate income taxes imposed by the foreign country on the foreign corporation's earnings, either when those earnings occur or when the U.S. corporation receives dividends paid out of those earnings. In other words, a direct corporate investor is entitled to the "deemed-paid" or "indirect" foreign tax credit.[45] In contrast, portfolio investors generally are not allowed any U.S. tax credit for corporate income taxes imposed abroad but instead are allowed to credit only foreign withholding taxes paid on dividend or interest income.[46] In some instances, however, most notably for portfolio investments in France, integration of corporate and shareholder taxes has overridden this dichotomy, and U.S. portfolio shareholders effectively receive a credit for some or all of corporate taxes paid abroad.[47]

In the OECD countries where U.S. corporations have substantial FDI, corporate income taxes in 2002 ranged from a low of 16% (in Ireland) to a high of 40.2% (in Belgium).[48] Most corporate tax rates in OECD countries today are in the range from 25% to 35%. By imposing these corporate income taxes, source countries exercise their right to tax international business income. On the other hand, source countries today rarely exercise any right to tax interest income earned by foreign portfolio lenders and, where bilateral treaties are in force, tend to tax portfolio dividend income at a zero to 15% withholding

[44] For instance, passive income is income that would be considered foreign personal holding company income as defined in § 954(c). IRC § 904(d)(2)(A)(i). Passive income is put in a separate "basket" from other income under the FTC limitation system, thereby preventing cross-crediting of passive income foreign tax credits against credits on active income. IRC § 904(d)(1)(A). Dividends, interest, royalties, rents, and annuities are all treated as passive income. IRC § 954(c)(1)(A). The Code treats effectively connected income (active income), IRC §§ 871(b), 882, differently from fixed or determinable annual or periodical income, IRC §§ 871(a), 881 (passive income).

[45] Section 902 provides that "a domestic corporation which owns 10 percent or more of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid" a ratable proportion of such foreign corporation's foreign income taxes. IRC § 902(a).

[46] IRC § 901.

[47] See OECD, Taxation of Cross-Border Portfolio Investment: Mutual Funds and Possible Tax Distortions 39, 42 tbl.2.7 (1999); see also notes 136-142 and accompanying text.

[48] Centre for Tax Policy and Administration, OECD, OECD Tax Database tbl. 5 (July 23, 2002), available at http://www.oecd.org/EN/document10,,EN-document-99-3-no-1-32519-99,00.html; see David Carey & Economics Dep't, OECD, Tax Reform in Belgium, ECO/WKP (2003)8, at 33 & box 2 (May 15, 2003), available at http://www.oecd.org/eco (noting the Belgian government announced in 2002 it would reduce the corporate tax rate from 40.17% to 33.99% in order to restore the country's competitive position).

rate. This is why commentators frequently describe the "international tax compromise" as generally allocating the taxation of portfolio income to the country where the investor resides, although that is an oversimplification.[49]

B. *The Key Economic Distinctions Between Foreign Direct and Portfolio Investment*

Foreign direct investment is often undertaken by corporations to earn economic rents.[50] Foreign direct investment decisions therefore frequently are driven by opportunities to exploit economies of scale, economies of scope, or proprietary business advantages. Furthermore, considerable evidence suggests that FDI by U.S. multinationals is complementary to domestic investments, rather than a substitute for them.[51] Empirical economic evidence, however, also suggests that FDI decisions are sensitive to differences in tax burdens.[52]

In contrast, portfolio investment dollars are volatile and move rapidly throughout the world seeking the highest return possible for a given level of risk.[53] In portfolios managed by investment professionals, investments in one foreign country are frequently interchangeable with investments in countries with similar risk/return profiles.[54] One consequence is that portfolio investment dollars abroad may substitute for investments at home.

Surprisingly, economic analysis to date offers no clear consensus about the extent to which U.S. portfolio investors are tax-sensitive. While economic theory suggests that portfolio investors should be tax-sensitive, seeking the greatest after-tax returns, the empirical data is mixed. For example, empirical research by Joel Dickson and John Shoven suggests that as recently as 1993 investors did not pay much attention to the effect of income taxes on the rates of return of their portfolio investments.[55] Shoven and Dickson examined 147 of the 150

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[49] See, e.g., Avi-Yonah, Structure, note 1, at 1306.

[50] See, e.g., Michael P. Devereux, Issues in the Taxation of Income From Foreign Portfolio and Direct Investment [hereinafter Investment Income Taxation], in Taxing Capital Income in the European Union 110, 131 (Sijbren Cnossen ed., 2000).

[51] John H. Dunning, Multinational Enterprises and the Global Economy 568-70 (1993).

[52] Gordon & Hines, note 4, at 43-49, 56-57.

[53] Barry Eichengreen & Albert Fishlow, Contending With Capital Flows: What Is Different About the 1990s?, in Capital Flows and Financial Crises 23, 59 (Miles Kahler ed., 1998).

[54] See generally UN Conference on Trade and Development, Comprehensive Study of the Interrelationship Between Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) 24-25 (1999).

[55] Joel M. Dickson & John B. Shoven, Ranking Mutual Funds on an After-Tax Basis (NBER Working Paper No. 4393, 1993), available at http://papers.nber.org/papers/w4393.pdf.

largest U.S. mutual funds in existence on October 31, 1992.[56] They convincingly showed that for these funds the relative ranking based on rates of return was substantially different pretax and post-tax.[57] In 1993, however, only one among the very large number of information sources dedicated to providing investors with mutual fund information published after-tax returns.[58] Nor had prior academic papers evaluating mutual fund performance adjusted returns for shareholder–level taxation.[59] The lack of easily available data regarding after-tax performance, combined with the disparity between pretax and post-tax rankings for mutual funds, suggests that (as recently as 1993 at least) most mutual fund investors did not make their mutual fund portfolio investment decisions on a post-tax basis. And most mutual funds apparently were little concerned with the tax consequences of their investments for their fund's shareholders.

Since 1993, however, after-tax information and after-tax results have become increasingly available and possibly important to mutual fund investors. In January 2001, the SEC approved a rule requiring mutual funds to disclose after-tax returns.[60] New mutual funds have emerged in the decade subsequent to the Shoven–Dickson study advertising themselves as "tax-efficient" or "tax-sensitive." Major nonproprietary sources of information about mutual funds, such as Morningstar, now rank mutual funds based on after-tax performance.[61] These changes suggest that both mutual fund investment managers and individual mutual fund shareholders are becoming more sensitive to tax effects on portfolio investment returns.

Nevertheless, tax-efficient funds accounted for only 12% of all inflows into equity funds in the first 10 months of 2001.[62] This figure represents significant growth compared to the 2% of equity fund inflows into tax-efficient funds in 2000,[63] but still represents only a relatively small portion of mutual fund investments. In the 12-month period ending March 2003, tax-managed funds performed only half a percentage point better than other funds, and tougher times are now

[56] Id. at 4-5. Two of the 150 largest funds were excluded for technical reasons related to unavailability of appropriate data, and one was excluded because it merged into another fund.

[57] Id. at 12-16 and data referred to therein.

[58] Id. at 1.

[59] Id. at 2 (citing only one exception).

[60] Disclosure of Mutual Fund After-Tax Returns, Securities Act of 1933 and Investment Company Act of 1940 Release Nos. 33-7941, 34-43857, 66 Fed. Reg. 9002 (Jan. 18, 2001).

[61] Morningstar.com offers preliquidation, post-tax rates of return for all the mutual funds it rates on its highly popular "quicktake" reports. See http://morningstar.com.

[62] Elizabeth Reed Smith, Fund Strategies to Soothe Tax Pain, N.Y. Times, Nov. 25, 2001, at C8.

[63] Id.

predicted for tax-managed funds since most investors now have capital losses to offset gains from funds that are not tax–sensitive.[64] The extent to which U.S. portfolio investors' investment decisions are now tax-sensitive therefore remains unclear.[65]

C. *Portfolio Investors Favor Their Home Country*

Economic theory, which emphasizes the role of risk diversification in the investment choices of portfolio investors, predicts, without taxes, a full worldwide diversification of portfolio investments.[66] The problem for the theory, however, is that portfolio investment exhibits a substantial "home bias," that is, a large percentage of the debt and equity issued in any country is directly in the hands of that country's residents.[67]

Economists, to date, have been unable to explain the home-bias phenomenon. Indeed, given the difficulties of enforcing residence–country income taxes on FPI (discussed in Section VI), we might expect to see a bias in favor of foreign rather than domestic investments.

A large economic literature is devoted to efforts to explain the home bias,[68] but no explanation is yet regarded as convincing. Hedging explanations are to little avail, and neither transaction costs nor tax differentials have much explanatory power. In several countries, corporate-shareholder tax integration regimes favor domestic over foreign investment.[69] But these tax effects are far too small to explain the home–country bias seen in the data.[70] Intuitively, the most con-

[64] J. Alex Tarquinio, Tougher Path for Tax-Managed Funds, N.Y. Times, Apr. 13, 2003, at C6.

[65] Mutual funds play an increasingly important role in meeting the financial goals of U.S. portfolio investors, and are useful to study in attempting to understand the decision-making that drives the destination of portfolio investment more generally. Total assets of equity mutual funds increased from $83.1 billion at year-end 1984 to $3,962.3 billion at year-end 2000, representing a compound annual growth rate of 25.2% over the period. Investment Company Institute, 2001 Mutual Fund Fact Book 64 (May 2001), available at http://www.ici.org/ici_frameset.html (last visited July 6, 2003). In general, this reflects a relative shift away from direct household investment in equities to indirect ownership of equities through investment vehicles. The trend with respect to FPI reflects the same relative shift. At the end of 1999, U.S. investors held over $700 billion in FPI through U.S.-based mutual funds, thereby accounting for almost 30% of total U.S. outbound FPI. Lipper Analytical Services, World Equity Database (2000). Data assembled by Derek Lewis at authors' request and on file with authors. Mutual funds are now the single most commonly utilized vehicle for FPI for U.S. taxpayers.

[66] Gordon & Hines, note 4, at 37.

[67] Id.; Kenneth R. French & James M. Poterba, Investor Diversification and International Equity Markets, 81 Am. Econ. Rev. 222 (1991).

[68] Gordon & Hines, note 4, at 39-40 & n.59 (citing studies).

[69] Vann, note 4, at 24.

[70] Gordon & Hines, note 4, at 39.

vincing explanation is grounded in information asymmetries; investors have better information about domestic than foreign securities.[71] But, whatever the reason, "aggregate demand for domestic equity is much less elastic than would be implied by standard models of portfolio choice."[72] This means that the economic impact of taxes on domestic portfolio investment income is less than might be expected.

D. *Portfolio Capital Flees When the Milk Goes Sour*

Unlike direct investments, portfolio investments are highly volatile. Portfolio investments move through the international capital markets quickly in response to changes in economic circumstances.[73] In the 1990's, for example, the UK's unplanned exit from the European Rate Mechanism in 1992, the Mexican Peso crisis, the Asian financial crisis, and the financial fallout associated with the demise of the Long Term Capital Management hedge funds all demonstrated the volatility of portfolio investments. The most dramatic instances of the volatility of portfolio capital during that decade involved the flight of capital from developing countries. The serious political and economic consequences that resulted often were not caused by specific policy decisions within the country, but rather resulted from flows of portfolio capital triggered by changes in market expectations and herd behavior.[74]

Institutional investors, especially from the United States, dominated the flow of portfolio equity to the developing world in the 1990's.[75] "Modern risk management techniques of portfolio managers, such as computerized portfolio insurance/programme trading strategies, value-at-risk and mark-to-market models, may exacerbate the movements of asset prices and increase the risk of [portfolio] contagion."[76] The five developing economies that received the largest flows per capita of portfolio capital from the United States as of 1997 were Mexico, Brazil, Chile, Hungary, and Malaysia.[77] Each experienced serious ec-

[71] Roger H. Gordon & A. Lans Bovenberg, Why Is Capital So Immobile Internationally? Possible Explanations and Implications for Capital Income Taxation, 86 Am. Econ. Rev. 1057, 1073 (1996) (concluding that asymmetric information is a "promising explanation for the empirical evidence on the international mobility of capital").

[72] Gordon & Hines, note 4, at 40.

[73] See, e.g., Eichengreen & Fishlow, note 53, at 59.

[74] See generally Capital Flows and Financial Crises, note 53.

[75] Rachel McCulloch & Peter A. Petri, Equity Financing of East Asian Development, in Capital Flows and Financial Crises, note 53, at 158, 166.

[76] UNCTAD Report, note 23, at 15.

[77] Treasury FLTS Report, note 26; World Bank, World Development Indicators CD-ROM, note 38. Developing countries for purpose of this analysis were defined as countries with GDP/capita of less than $6,000, as measured by the World Bank. Brazil and Mexico top the list of countries influenced by U.S. investment. U.S. taxpayers held $64

onomic shocks due to the flight of portfolio investor capital during the 1990's.[78] A study of 20 emerging markets in the aftermath of the 1994 Mexican peso crisis found a connection between a country's financial and currency vulnerability and the composition of its capital inflows.[79] In particular, larger short-term foreign portfolio flows were correlated with greater disarray in the local financial markets.[80]

The pain of these shocks, however, was not limited to developing countries. Particularly in response to the Asian financial crisis and the demise of Long Term Capital Management, financial turmoil reached markets in Europe and the United States when portfolio equity churned as investments turned sour.[81] In response, debates emerged over the appropriate international economic policies in light of the risks posed by foreign portfolio flows. Nobel Prize-winning economists, world-renowned financiers, and central bankers have all debated whether and how global portfolio capital flows should be constrained.[82] Numerous popular books[83] as well as major works of economic scholarship have addressed the subject. Jeffrey Sachs, for example, claims that, at a minimum, the international financial system needs the functional equivalent of the U.S. bankruptcy code and much

billion and $52 billion respectively in investments in Brazil and Mexico in 1999. These two nations received 48% of U.S. outbound FPI to developing countries. Mexico was first in terms of dollars of U.S. outbound FPI received and second in U.S. FPI dollars received per capita. Brazil was second in U.S. FPI received and eleventh in FPI received per capita. Chile, Hungary, and Malaysia were the other reasonably large developing countries that received over $400/capita in FPI from the United States in the 1990's.

[78] See Andrés Velasco & Pablo Cabezas, Alternative Responses to Capital Inflows: A Tale of Two Countries, in Capital Flows and Financial Crises, note 53, at 128; Dorothy Meadow Sobol, Central and Eastern Europe: Financial Markets and Private Capital Flows, in Capital Flows and Financial Crises, note 53, at 186 (suggesting, inter alia, that Hungary was spared from the effects of the 1994 peso crisis because of the fact that portfolio investment had not yet entered the country).

[79] Jeffrey Sachs, Aaron Tornell & Andrés Velasco, Financial Crises in Emerging Markets: The Lessons From 1995, 147, 152 (Brookings Papers on Economic Activity, 1996).

[80] Id.; see also Jeffrey Sachs, Aaron Tornell & Andrés Velasco, The Collapse of the Mexican Peso: What Have We Learned?, 22 Econ. Pol'y 13, 21, 25 (1996) (noting the Mexican banking system converted massive capital inflows, a significant part of which was short-term portfolio investment, into short-term peso debt, which was responsible in large part for the banking system's fragility).

[81] See generally Roger Lowenstein, When Genius Failed: The Rise and Fall of Long-Term Capital Management (2000).

[82] "Distinguished mainstream economists are questioning the wisdom of capital account liberalisation, the efficiency of international capital markets or the role of the IMF. Among them are Martin Feldstein, head of the National Bureau of Economic Research, Paul Krugman of the Massachusetts Institute of Technology, Jeffrey Sachs, director of the Harvard Institute for International Development and, with the official institutions, Joseph Stiglitz, chief economist of the World Bank." Martin Wolf, Ins and Outs of Capital Flows, Fin. Times (London), June 16, 1998, at 25. (some of the affiliations of the people listed have changed since 1998.)

[83] See, e.g., George Soros, George Soros On Globalization (2002); Joseph Stiglitz, Globalization and its Discontents (2002).

more extensive banking regulation.[84] In the international tax context, portfolio capital movements renewed interest in the "Tobin Tax," named after James Tobin, the Nobel Prize–winning economist who first proposed the tax in 1971.[85] The Tobin Tax is an excise tax on capital transactions specifically designed to impose an additional burden on fast-moving capital, including much of the world's current FPI. Its burden would be far lower or nonexistent for slow-moving capital, which includes nearly all FDI.[86] The debate over policies appropriate to deal with global capital flows in international economic policymaking circles, however, has had almost no impact on the international income tax literature, which, as we have indicated, generally has ignored the question of whether FPI should be taxed differently from FDI.[87]

E. *The Taxation of Portfolio Investment Does Not Affect the Location of Plant and Equipment*

The empirical economic evidence demonstrates that corporate decisions about where to locate plant and equipment and headquarters activities, such as research and development, are quite sensitive to differences in the corporate–level taxes applicable to the income generated by these investments. But taxes on portfolio investment income generally do not affect the location of corporate investments in plant and equipment.[88]

Economic theory holds that effective marginal tax rates on FPI might influence the locational decisions of companies if a change in tax policy changes world interest rates. If, however, as most policy-

[84] Jeffrey D. Sachs, Alternative Approaches to Financial Crises in Emerging Markets, in Capital Flows and Financial Crises, note 53, at 247, 259, 260-61; see also Stephany Griffith-Jones, Global Capital Flows: Should They be Regulated? (1998).

[85] See, e.g., Policy Forum: Sand in the Wheels of International Finance, 105 Econ. J. 160 (1995) (noting support of influential commentators for a tax on speculative transactions); R. Glenn Hubbard, Securities Transactions Taxes: Tax Design, Revenue, and Policy Considerations, 61 Tax Notes 985, 986 & n.1 (Nov. 22, 1993) (offering brief introduction to the debate over securities transactions taxes); Lawrence H. Summers & Victoria P. Summers, The Case for a Securities Transactions Excise Tax, 48 Tax Notes 879, 881 (Aug. 13, 1990) (discussing Tobin's concern over the diversion of human and capital resources into securities trading).

[86] Barry Eichengreen, James Tobin & Charles Wyplosz, Two Cases for Sand in the Wheels of International Finance, 105 Econ. J. 160, 163-65 (1995).

[87] The tax literature, however, has considered whether differences in enforcement issues suggest differences in taxation of FPI and FDI. See, e.g., Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573, 1583-85 (2000) [hereinafter Globalization]; Hubbard, note 85; Summers & Summers, note 85.

[88] See Company Taxation in the Internal Market 142-43 box 5, 150-52 box 6 (European Comm'n, Working Paper No. 582, 2001) [hereinafter EC Working Paper].

makers believe, capital markets are sufficiently integrated that the world interest rate is unaffected by the domestic amount of saving in any one country, personal taxes generally will not affect the investment behavior of companies.[89] Along these lines, the European Commission's Working Paper on Taxation in the Internal Market (the "EC Working Paper") recently examined a set of simulated tax reforms in which either the domestic elements of various European corporation tax regimes, the international elements of those regimes, or the relationship between the corporation tax regime and the personal tax regime were harmonized across EC countries.[90] The Commission Staff concluded that "personal taxes have little effect on the impact of hypothetical policy scenarios to corporation tax."[91]

Changes in the marginal income tax rates for portfolio investors, to some extent, might affect the allocation of portfolio investments throughout the world. But in a classical corporate income tax system, taxes on portfolio investors generally will not influence the decisions of companies about where to locate their plant or equipment. Decisions about where to locate productive plant and equipment are made at the corporate level. So long as business decisionmakers cannot know the identity and tax position of their marginal shareholders, they will take only corporate-level taxes into account in making their business decisions.[92] As a practical matter, this seems to describe corporate behavior accurately, at least for publicly traded companies. In a classical corporate income tax system, while corporate-level taxes may vary depending on where investments are made, the residence country's taxation of a portfolio investor's dividends and capital gains typically does not vary based on the location of the corporation's investments.[93]

Our conclusion that taxes on the income from FPI do not influence the locational decisions of companies is true only if internationally mobile portfolio capital is available to a company.[94] This holds generally for large publicly traded multinational companies, which account for the bulk of FDI, but internationally mobile portfolio capital may not be available for small and medium-sized companies.[95] As a result,

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[89] Id. at 142-43 box 5.

[90] Id. at 215-38.

[91] Id. at 223 box 10.

[92] See id. at 142-43 box 5.

[93] For example, a U.S. investor holding stock in a U.S. corporation faces identical tax consequences from dividends paid on her investment regardless of whether the dividends are paid out of income earned by the corporation in the United States or in Europe. Similarly, the U.S. investor pays the same capital gains tax on his sale of shares of a U.S. corporation regardless of where that corporation earns its income. See notes 136-44.

[94] See EC Working Paper, note 88, at 142-43 box 5, 150-52 box 6.

[95] Id. at 142-43 box 5.

tax policy changes for FPI might affect these companies in a way that such changes would not affect larger multinationals. Small and medium-sized companies, however, are also less likely to base their foreign locational decisions on tax rates, and, in any event, are relatively unimportant in terms of the international allocation of productive plant and equipment.

Thus, the taxation of FPI—in sharp contrast to the taxation of FDI—has, at most, a small impact on where productive plant and equipment will be located.[96] It might affect the national origin of the owners of the company that owns the plant and equipment, and the nations from which the capital to finance the plant and equipment has been raised, but not the location of the plant and equipment itself.

IV. Evaluating the Taxation of Foreign Portfolio Investment Income

Most analyses of international income tax policy assume that the fundamental goal of such policy should be to advance worldwide economic efficiency.[97] This norm in turn has been translated into "capital export neutrality" (CEN), which requires that a nation strive for a tax policy that is neutral about a resident's choice between domestic and foreign investments providing the same pretax rates of return.[98] CEN requires that a resident of any nation pay the same marginal rate of

[96] Another important distinction between portfolio and direct investment is that locational decisions associated with FDI are likely to be affected by effective average tax rates. In contrast, locational decisions for portfolio investment, at most, are affected by the effective marginal tax rate. The difference is due to the fact that portfolio investment does not come with controlling influence. For this reason, portfolio investors expect to obtain only the required rate of return and not a share of the economic rent. If a project was expected to earn an economic rent, its price to new investors (the market price of the portfolio) would be higher. Therefore, a tax with a zero effective marginal rate but a positive effective average tax rate will affect the locational decisions for multinationals as contrasted to their pretax decision, but should not affect locational decisions for portfolio investments.

[97] See, e.g., Office of Tax Pol'y, Treasury Dep't, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study 23-54 (2000), available at http://www.ustreas.gov/offices/tax-policy/library/subpartf.pdf. For discussion of CEN see, e.g., David F. Bradford & Treasury Dep't, Blueprints for Basic Tax Reform 89-90 (2d ed., rev. 1984); Joint Comm. on Tax'n, 102d Cong., Factors Affecting the International Competitiveness of the United States 5, 236 (Comm. Print 1991) [hereinafter JCT Competitiveness Report]; Joint Comm. on Tax'n, 106th Cong., Overview of Present-Law Rules and Economic Issues in International Taxation (Comm. Print 1999) [hereinafter JCT Economic Issues Report]; Michael J. Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, 26 Brook. J. Int'l Law 1357, 1363-71 (2001) [hereinafter Inadequate Principles].

[98] See, e.g., Hugh J. Ault, Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices, 47 Tax L. Rev. 565, 571-73 (1992); Daniel J. Frisch, The Economics of International Tax Policy: Some Old and New Approaches, 47 Tax Notes 581, 582 (Apr. 30, 1990).

income taxation regardless of where she invests.[99] CEN also is indifferent about which country obtains the income tax revenue from the investment.[100] CEN often is advanced as the basis for the residence country's allowing a credit for income taxes imposed by the foreign country where the income is earned.

Businesses often advance policies based on a second kind of neutrality, capital import neutrality (CIN), which requires that all investments in a given country pay the same rate of income tax regardless of the residence of the investor.[101] CIN thus would subject income earned within a country to the same overall level of taxation, whether the income is earned by a resident or a foreigner. CIN often is advanced as a basis for taxation only by the country of source, with the residence country exempting foreign source income from tax.[102] The U.S. business community typically has opposed CEN and advanced CIN in connection with arguments to improve the "competitiveness" of U.S. multinationals doing business abroad.[103] It is now well known that it is impossible to achieve CEN and CIN simultaneously whenever countries' tax bases and tax rates differ.[104] As a result, U.S. international income tax policy (and that of other OECD nations) often is described as a "compromise" between CEN and CIN.[105] One problem with basing policy on this notion of compromise is that almost any policy can be described as meeting the compromise criterion.

Rather than endorsing CEN or CIN—or some compromise between them—as the basis for U.S. international income tax policy, we instead endorse the view—which one of us previously has advanced in detail elsewhere[106]—that U.S. international tax policy should be fashioned to advance the interests of the American people. By this we mean long-term U.S. well-being, not short-term advantage. Designing such policies requires U.S. policymakers to take into account the

[99] Richard E. Caves, Multinational Enterprise and Economic Analysis 190 (2d ed. 1996); Thomas Horst, A Note on the Optimal Taxation of International Investment Income, 94 Q.J. Econ. 793, 793-94 n.3 (1980).

[100] See Avi-Yonah, Globalization, note 87, at 1604.

[101] See, e.g., Caves, note 99, at 190; Frisch, note 98, at 582, 584-85.

[102] See, e.g., Hugh J. Ault & David F. Bradford, Taxing International Income: An Analysis of the U.S. System and Its Economic Premises, in Taxation in the Global Economy 11, 39 (Assaf Razin & Joel Slemrod eds., 1990); Frisch, note 98, at 584.

[103] Terrence R. Chorvat, Ending the Taxation of Foreign Business Income, 42 Ariz. L. Rev. 835 (2000); National Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21st Century, 1999 TNT 58-17, Mar. 26, 1999, available at LEXIS, TNT File; see also Robert A. Green, The Future of Source-Based Taxation of the Income of Multinational Enterprises, 79 Cornell L. Rev. 18, 63-70 (1993) (discussing alternative approaches for enhancing the stability of international income taxation).

[104] JCT Competitiveness Report, note 97, at 5, 240-41.

[105] See, e.g., NFTC Foreign Income Project, note 103, ¶ 7.

[106] Graetz, note 97, at 1371-77.

potential responses of other nations and to be mindful of the substantial advantages to this nation from U.S. participation and leadership in furthering cooperation in international tax policy among nations.

Not everyone is convinced, however, that the approach to policy that we advance here is the best normative approach to international tax policy; both CEN and CIN still have their adherents. Thus, before turning to the question of what tax policy for FPI would be most equitable and economically advantageous for Americans, we discuss in some detail why CEN and CIN have little to offer as a basis for establishing U.S. policy for taxing income from FPI, even for those who urge CEN or CIN as the basis for U.S. income tax policy for FDI.[107]

A. *Capital Import Neutrality Is Not Relevant to the Taxation of Foreign Portfolio Income*

Multinational corporations sometimes have advanced CIN as the basis for U.S. international tax policy, urging that the fundamental purpose of such policy should be to promote the "competitiveness" of U.S. multinationals doing business abroad.[108] The claim most often made is that the United States should impose no residual U.S. corporate-level tax when the tax in the country where the income is earned is below that which would have applied if the income had been earned domestically.[109] U.S. multinationals arguing for such a policy contend that the United States should enhance (or at least not inhibit) their ability to compete in foreign markets with multinational companies from other OECD countries. Whatever one thinks about advancing U.S. multinationals' competitiveness in foreign markets as a basis for the taxation of income from FDI, it has little or no relevance to the appropriate income taxation of FPI. Taxation of FPI, indeed taxation

[107] A new standard, capital ownership neutrality (CON), recently has been advanced as an alternative basis for developing international tax policy. Mihir A. Desai & James R. Hines Jr., Economic Foundations of International Tax Rules (July 10, 2003) (paper prepared for the American Tax Policy Institute, on file with the Tax Law Review). A tax system satisfies CON if it does not distort ownership patterns. Id. at 23. CON maximizes the efficient allocation of capital if the productivity of capital depends on the identities of its owners. Id. Like CEN and CIN, CON does not provide a firm analytical foundation from which to establish international tax policy for FPI, as opposed to FDI. As Desai and Hines point out, the analytical force of CON depends upon ownership at a level that influences businesses' operational and investment decisions. Id. at 14-17, 34. This is not the case for FPI. By definition, portfolio investment lacks this sort of influence on operational and investment decisions, see notes 40-42 and accompanying text; although, as both we and Desai and Hines point out, the 10% threshold that divides direct from portfolio investment for purposes of U.S. tax law may be somewhat arbitrary. Desai & Hines, supra, at 34; see also note 4.

[108] See note 103.

[109] Chorvat, note 103, at 845-59 (distinguishing between active foreign source income and other forms of income).

of investment income generally, may affect the ability of corporations to raise capital,[110] whether from foreigners or U.S. nationals, but has no effect on the ability of U.S. multinationals to compete against foreign corporations in doing business in a foreign country.

B. *How Relevant Is Capital Export Neutrality to the Taxation of Foreign Portfolio Investment Income?*

Tax policy grounded on CEN should produce a tax system where domestic and foreign investments that earn the same pretax return also yield identical after-tax returns. CEN is intended to prevent companies or individuals from forgoing investments with a higher pretax yield in favor of investments with a lower pretax yield but a higher post-tax return.[111] From a worldwide economic efficiency perspective, investment decisions made with reference to post-tax rather than pretax outcomes reduce productive efficiency and create deadweight economic losses.[112] Capital export neutrality therefore is principally concerned with preventing tax distortions of the decisions of U.S. and other firms about where to locate their real investment assets, their plant, and equipment.[113] Even in the context of direct investments, however, it is difficult to know how important such distortions in the location of investments are to the efficient functioning of the world economy. As the economist Michael Keen has remarked: "[W]e currently know almost nothing about the quantitative welfare implications of alternative tax treatments of cross-national direct investment."[114]

The most important recent attempt to assess the magnitude of such distortions in the current international tax system is the EC Working Paper.[115] That analysis demonstrates that the current international tax system does not come close to achieving CEN for direct investments. For example, the EC Working Paper shows that U.S. companies engaging in direct European investment through European subsidiaries face widely variant effective average tax rates in different European countries.[116]

The EC Working Paper analyzes investment by a U.S. parent company in various European countries (assuming wholly-owned subsidiaries) and computes the effective average tax rate (EATR) for these

[110] See the discussion at notes 178-88 and accompanying text.
[111] See note 98.
[112] Avi-Yonah, Globalization, note 87, at 1604.
[113] See note 98.
[114] Michael Keen, The Welfare Economics of Tax Coordination in the European Community, in The Economics of Tax Policy 206 (Michael P. Devereux ed., 1996).
[115] EC Working Paper, note 88.
[116] Id. at 195-97, tbls.20-22.

direct investments.[117] The EC Working Paper studied three categories of direct investment by U.S. firms in wholly-owned European subsidiaries: (1) investment financed with retained earnings, (2) investment financed with new equity, and (3) investment financed with debt.[118] The paper shows that for such FDI the EATR varies from 25% for an investment in a subsidiary in Ireland, when the investment is financed by retained earnings, to 43.6% for an investment in a subsidiary in Portugal, when the investment is financed by issuing new equity.[119] Even within each of the three categories of financing, variation in the EATR is substantial. For investment financed by retained earnings, the highest EATR was 43.5% in Germany; the lowest EATR was 25% in Ireland.[120] For investment financed by new equity, the highest EATR was 43.6% in Portugal; the lowest EATR was 31.5% in Sweden.[121] For investment financed by debt, the highest EATR was 39.7% in Portugal; the lowest EATR was 31.5% in Sweden.[122]

Nor does the current international tax regime achieve CEN for portfolio investors. Our own analysis shows disparate tax rates for FPI into different countries by U.S. investors. We calculated the total rate of taxation borne by a top-bracket U.S. individual portfolio investor investing in France, Germany, the United Kingdom, and the United States in 2000. These computations included both the corporate-level tax on earnings and all U.S. and foreign taxes on the shareholder. A U.S. investor, subject to the highest U.S. individual tax rate, investing in a U.S. company bore a total marginal tax burden of 58% on dividend payments, while the same U.S. investor paid a 40% tax on dividends paid by a French company, 58% on dividends paid by a German company, 45% on dividends paid by an Irish company, and 47% on dividends paid by a U.K. company.[123] The total tax on divi-

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[117] Id. The EC Working Paper never calculates the EATR for a U.S. company engaging in domestic direct investment. As a result that data is not included here.

[118] Id. at 194-99.

[119] EC Working Paper, note 88, at 195 tbl.20, 196 tbl.21. The EATR was calculated by expressing the net present value of tax revenue from a given investment as a percentage of the net present value of the income stream produced by the investment. The pretax rate of return used to determine the EATR on these inframarginal investments was fixed at 20%. Id. at 194. In making these calculations, the EC Staff considered only the effect of corporate taxes because it assumed that companies engaged in cross-border investment would have access to the international financial market. Id. at 187.

[120] EC Working Paper, note 88, at 195 tbl.20.

[121] Id. at 196 tbl.21.

[122] Id. at 197 tbl.22. Analysis of the unweighted average of all the various EATRs for each of the EC countries across each of the forms of financing shows that the standard deviation of the EATR on U.S. FDI in the EC is 3.4%. Id. at 204 tbl.24. The standard deviation of the EATR on U.S. FDI in the EC rises to 3.9% when the most tax-efficient mechanism for financing direct investment into a subsidiary in each individual EC company is used. Id. at 208 tbl.26.

[123] Using highest marginal tax rates, original calculations on file with authors.

dends earned by U.S. portfolio investors in these European countries and in the United States varied by as much as 18 percentage points.

Both the EC Working Paper and our own calculations demonstrate that CEN does not exist for either FDI or FPI under the current international tax regime. Investments that earn similar pretax rates of return do not earn comparable post-tax rates of return. Thus, U.S. individuals and U.S. multinational companies may eschew investments with higher pretax yields in favor of investments with lower pretax yields but higher post-tax returns.

The economist Michael Devereux has illustrated in detail the policies that would be necessary to move from the current income tax regime on foreign investment to CEN with respect to both FDI and FPI.[124] Devereux's work reveals that achieving CEN would require the U.S. government to make a series of difficult, politically infeasible, and undesirable tax policy changes.[125]

CEN will exist for portfolio investments only if post-tax rates of return on portfolio investments abroad are equal to those available domestically.[126] But, as Devereux demonstrates, these post-tax rates of return on portfolio investments depend in part on rates of corporate taxation at home and abroad. If both the foreign and domestic companies in which portfolio investments can be made are able to choose in which country to invest, the companies will, in principle, divide their investments (including the capital they raise via the portfolio investments they receive) between the foreign and domestic countries up to the point at which the post-corporate tax rate of return

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124 Devereux, note 50.

125 Devereux uses a model in which there are two portfolio investors, each of which can invest in either of two identical companies. One of those two companies is domestic and the other is foreign. Devereux then considers two scenarios. In the first scenario, both of the hypothetical companies reside in countries with classical tax systems. Id. at 119-23. In the second scenario, one or both of the hypothetical companies reside in a country with an integrated tax regime that provides some relief from corporate-level withholding to nonresident portfolio investors. Id. at 123-26. Devereux speaks in terms of "production efficiency" rather than CEN. His definition of production efficiency, however, is equivalent with CEN so long as he is examining what he calls the "cooperative" case. Id. at 121-26. Devereux also considers the requirements for economically efficient taxation under a set of assumptions where countries are "non-cooperative." Id. at 126-28; see also Peter A. Diamond & James A. Mirrlees, Optimal Taxation and Public Production I: Production Efficiency; II: Tax Rules, 61 Am. Econ. Rev. 8-27; 261-78 (1971); I: Production Efficiency (in Errata), 62 Am. Econ. Rev. 238 (1972). By non-cooperative, Devereux means that the countries are neither interested in maximizing worldwide economic efficiency regardless of the consequences for their country nor willing to reallocate post-tax revenues between countries to solve distributional inequities resulting from tax systems that are more economically efficient but inequitably distribute income between countries. Id. at 116-17, 126. Devereux argues that a non-cooperative country should implement a policy of national neutrality with respect to both FDI and FPI. Id. at 117. For a discussion of national neutrality, see notes 141-152 and accompanying text.

126 Devereux, note 50, at 120.

is equal on investments in the two countries.[127] Furthermore, if the post-corporate tax rate of return is higher in one country than in all others at all levels of investment, then all the corporate investments will flow to the country that provides the higher post-corporate tax rate of return.[128]

Thus, in an international capital market in which investors from both foreign and domestic countries invest in the corporations of both foreign and domestic countries, CEN for FPI will exist only if two conditions hold true simultaneously. First, corporate tax rates must be independent of the location in which the investment is made.[129] Second, any differences in the corporate tax rates faced by the domestic and foreign corporations must be offset by the personal taxes faced by all investors.[130]

Thus, to achieve CEN, U.S. companies must face the same corporate tax rate on investments made in the United States or abroad.[131] As the EC Working Paper shows, however, this condition does not hold.[132] Nor is it ever likely to hold absent a uniform worldwide tax base and a single worldwide tax rate. Moreover, if, for example, the corporate tax rate on companies resident in England were higher than that on companies in the United States, in order to achieve CEN for all U.S. portfolio investors investing into England, the United States would need to impose a lower personal tax rate for investments in British companies than for investments in similar U.S. companies.[133] Similarly, offsetting increases or reductions in U.S. taxes for U.S. portfolio investors would be necessary as a reaction to different corporate tax regimes in every other nation.[134] This is not an appealing or practical personal income tax regime.

Faced with the widespread failure to achieve locational neutrality for investments in plant and equipment, even within the countries of the European Union, the EC Working Paper—quite properly in our view—focuses its policy analysis and recommendations on the taxation of corporate income, principally the taxation of corporate direct investments.[135] As we have discussed, the taxation of FPI can be expected to have little or no impact on the location of productive plant and equipment, even if it does affect who owns the investment. Thus,

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[127] Id. at 121.
[128] See id. 120-21.
[129] Id. at 122.
[130] Id.
[131] See id. at 122-23.
[132] See notes 115-23 and accompanying text.
[133] See Devereux, note 50, at 122.
[134] See id.
[135] EC Working Paper, note 88, at 73-74, 131-35.

there would be little point in striving to achieve CEN in fashioning policy for the income taxation of residents' FPI—even if the practical barriers to doing so were not so great.

While this conclusion seems indisputable from the perspective of a country with a classical corporate income tax system, integration of the corporate and individual income taxes may change the analysis. Integrated corporate and individual tax systems add an additional level of complexity in considering CEN for FPI.[136] Several of the countries among the top 10 recipients of U.S. portfolio investments have integrated their corporate and shareholder income tax systems, at least to some extent.[137] While achieving such integration by excluding all or a portion of dividends from shareholder-level taxation has become more common in recent years, in most countries integration was accomplished through so-called "imputation credits," shareholder credits for all or a portion of the corporate income tax.[138] This puts three tax variables at play (tax rules and rates at the corporate level, imputation credits available to shareholders, and the tax rules and rates at the personal level) in any effort to achieve CEN for FPI.[139] When two countries' integration regimes interact or when an integration regime interacts with a classical regime, the simplest way to achieve CEN for FPI would be to provide greater imputation credits to investors in companies resident in the higher-corporate-tax-rate country in order to offset the higher corporate tax.[140] Devereux's analysis implies that in each country in the world in which U.S. portfolio investors invest, a separate credit should be calculated to offset differences in the rate of corporate tax that exists relative to U.S. corporate taxes.

This means that to achieve CEN for FPI, in the absence of CEN for direct investment, the United States would have to tax some portfolio investments into certain foreign countries at a lower rate than the rate at which it taxes identical domestic portfolio investments. Moreover, the United States also would have to negotiate bilateral tax treaties

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136 Devereux, note 50, at 123-26.

137 See Ault, note 98, at 585.

138 Peter Andrew Harris, Corporate/Shareholder Income Taxation: And Allocating Taxing Rights Between Countries 69-72 (1996). Imputation relief is one of three major options available for providing dividend relief at the shareholder level. The other two are dividend exclusion and shareholder differentiation. Id. at 67-69. A dividend exclusion system excludes dividends from shareholder taxable income. Id. at 67-68. A shareholder differentiation system reduces the shareholder tax rate applicable to dividends received below shareholders' marginal income tax rates. Id. at 68-69. Additionally, relief of double taxation can be achieved in principle at the corporate level as well as at the shareholder level. Id. at 57.

139 Devereux, note 50, at 123-25.

140 Id. at 124-25.

perfectly calibrated to offset the effects of foreign corporate and withholding taxes, including those above the U.S. corporate tax rate. And the United States would have to modify the rules mandated by such treaties each time U.S. or foreign corporate tax rates changed.

If such bilateral tax treaties were not adopted, the United States would have two remaining options to achieve CEN. First, it might try to convince all foreign governments to exempt income from taxation at source. While some countries might exempt foreign investments in an effort to attract foreign capital, taxation by the source country is common and such an exemption would not be universally accepted. Alternatively, the United States might try to persuade all countries in the world to agree on a uniform corporate tax rate and also to treat foreign and domestic portfolio and direct investors identically with regard to integration credits.[141] Devereux points out that if corporate tax rates across all countries were equal, and all countries were willing to grant imputation relief at identical rates for both domestic and foreign investments of their resident investors, CEN would be achieved for FPI.[142] The world, of course, is not going to harmonize tax rates or integration systems to this extent in the foreseeable future; to date, the EU has failed even to harmonize its corporate income tax rates.

Furthermore, the kinds of bilateral adjustments necessary to achieve CEN for FPI in the presence of both classical and integrated tax regimes would conflict, at least in some cases, with the principle of nondiscrimination, that is, the requirement that foreigners and domestic residents be treated similarly.[143] To achieve CEN, European countries would have to adopt similar country-specific tax policies as described above for the United States.[144] Indeed, every country would have to tax its resident investors differently depending on the country where investments are made. But varying the level of domestic taxation depending on the country where a resident invests would violate the free movement of capital requirement of the EU Treaty.[145]

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141 Id. at 124-25.

142 Id. at 125. Finally, Devereux suggests that if integration credits were available only on portfolio investments in domestic economies, CEN still could be achieved if both the country of residence and country of source were to exempt all FDI from taxation. Id.

143 Harris, note 138, at 315; see also Hugh J. Ault, Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices, 47 Tax L. Rev. 565, 600 (1992).

144 As Devereux notes "the government in country A would need to set the personal tax rate on outward bound FPI lower than the personal tax rate on domestic portfolio investment, in order to offset the effect of the higher corporate tax in country B. This offsetting effect is clearly unlikely in practice." Devereux, note 50, at 122.

145 Case C-35/98, Staatssecretaris van Financiën v. B.G.M. Verkooijen, 2000 E.C.R. I-4071, ¶ 62; Consolidated Version of the Treaty Establishing the European Community, art. 293, 2002 O.J. (C 325) 33.

And this seems neither a desirable nor practical international tax policy.

Finally, we briefly assess CEN's role for taxing FPI in a dividend exclusion system, such as that proposed by President Bush in January 2003. The proposal would have exempted from individual income tax dividends paid to shareholders whenever dividends were paid out of fully taxed corporate earnings.[146] In determining whether dividends are eligible to be excluded from the recipients' income, the proposal would have treated foreign income taxes paid by the corporation—up to the foreign tax credit limit—as equivalent to U.S. income taxes.[147] Thus, assuming that the corporation cares whether it pays excludable or taxable dividends to its shareholders, the dividend exclusion proposal would have prevented dividend exclusion integration from changing the impact of current corporate-level taxes on companies' decisions about where to locate their productive investments. To the contrary, allowing excluded dividends to be paid only from corporate income subject to U.S. taxes, as a 1992 Treasury study of a dividend exclusion method of corporate-individual tax integration had recommended,[148] would have shifted incentives for corporate investment toward domestic investment, again assuming that companies would prefer paying tax-free rather than taxable dividends. Many integration systems abroad have preferred domestic over foreign investments, causing them in some instances to run afoul of the EU prohibition of domestic legislation inhibiting the free movement of capital.[149]

Consistent with our earlier discussion, the Bush proposal conformed to the view that the important decisions about the location of productive investments are made at the corporate level. This view is also consistent with the analysis of the EC Working Paper,[150] which treats all corporate-level taxes as important to locational decisions, even if paid only to enable the company to pay dividends that are

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[146] H.R. 2, 108th Cong. §§ 116, 281 (2003). Under the proposal, to compute the dividends that could have been paid to shareholders without tax, a corporation would calculate an excludable dividend amount (EDA), which is essentially equivalent to taxable income less federal corporate income taxes paid and foreign tax credits used to offset U.S. tax liability. If a corporation's EDA exceeded the dividend it paid in a given year, each shareholder's basis in its stock would increase by the amount retained per share. Foreign corporations with income that was effectively connected with a U.S. trade or business or that receive excludable dividends could pay excludable dividends under the administration's proposal. Dividends paid out of EDA would be excludable from the income of both corporate and individual recipients.

[147] H.R. 2, 108th Cong. § 284 (2003).

[148] Treasury Dep't, Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once at ix (1992).

[149] B.G.M. Verkooijen, 2000 E.C.R. I-4071, ¶ 62.

[150] See notes 115-23 and accompanying text.

either excluded from shareholders' income or for which shareholders receive tax credits for corporate taxes paid.

On the other hand, the Bush proposal was unconcerned with achieving neutrality in the investment choices of portfolio investors. It provided no exclusion for dividends paid directly to U.S. portfolio shareholders by foreign companies out of income earned outside the United States. In this regard, the Bush plan would have introduced into the U.S. tax law a new preference for U.S. portfolio investors in favor of investments in domestic rather than foreign corporations.[151] We next turn to the question whether a preference for domestic portfolio investment is desirable as a policy matter.

But, before leaving CEN altogether, we emphasize that the foregoing analysis illustrates the changes in U.S. tax policy that would be necessary to achieve CEN for U.S. investors in the face of differences in the taxation of both direct and portfolio investments that exist in other countries throughout the OECD. And other countries would have to make similar adjustments to achieve CEN on their outbound portfolio investments. In other words, worldwide economic efficiency cannot be achieved for investments by U.S. persons in the absence of either uniform worldwide taxation or the kinds of offsetting adjustments described above.

A different view of CEN, however, might require only that U.S. income taxation itself not contribute to the distortion of the allocation of capital throughout the world, in effect, regarding any distortions that would remain as the responsibility of other nations. The idea is that at least U.S. tax law itself would not distort worldwide economic efficiency. For example, the limitation on the foreign tax credit could be justified on this view—contrary to the standard view of CEN—if the higher tax burden on foreign capital is simply regarded as a distortion introduced by the tax policies of other nations. This perspective would require far less of U.S. tax policy, only that the U.S. tax system itself be neutral as between domestic and any foreign investments with similar pretax rates of return.

We see little reason to take this view. The normative justification for CEN is to achieve worldwide economic efficiency. That one country—even one as big and important as the United States—can disavow responsibility for the distortions that prevail is unimportant. If achieving CEN is the desired goal, either the nation should strive to

[151] The Bush dividend exclusion proposal as described herein was not enacted. The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 302, 117 Stat. 752, 758-64, reduced the tax rate applicable to dividend income, but did not create any preference for dividends paid by U.S. corporations or out of U.S.-source income so as to favor domestic over foreign portfolio investment. See IRC § 1(h)(11). Nor did it tie the exclusion of dividends to the existence of foreign or domestic taxes paid at the corporate level.

achieve genuine neutrality in its residents' investment decisions or it should strive to achieve multinational arrangements and agreements to enhance such neutrality. Short of that, it should abandon CEN as the normative basis for its policy and focus its efforts on something it can better control: enhancing the well-being of its own citizens and residents.

C. *Resurrecting the Discredited Criterion of "National Neutrality": Enhancing National Well-Being*

Four decades ago, in her classic analysis of international tax policy, the economist Peggy Musgrave demonstrated that when one views international tax policy from a national, rather than a worldwide, perspective—as we do here—that the country of the investor's residence will obtain the maximum benefit by equating pretax returns on domestic investments and after-tax returns on foreign investments.[152] In essence, this policy treats returns earned both in the United States and abroad on investments by U.S. persons as increasing the welfare of the U.S. people, along with taxes paid to the U.S. government. From the U.S. national perspective, taxes paid to a foreign government are simply a cost of earning income.[153] This policy, which unfortunately came to be known as "national neutrality," allows only a deduction, not a credit, for foreign income taxes.[154] In essence, it ensures that the return to the U.S. fisc from investments abroad is as great as the return on domestic investments.

This idea of national neutrality never attracted many adherents. It implies investments abroad will be made only when the returns after imposition of foreign taxes are as great or greater than returns available before tax in the United States. Obviously, this would result in less investment abroad than that which would occur when a credit is allowed for foreign taxes. Today "national neutrality" seems completely out of favor,[155] principally, we think, because it rarely has been examined separately in the context of FPI.

For direct investment, a policy of national neutrality is inappropriate. Given the levels of corporate income taxes prevalent in the world since World War I, allowing only a deduction for foreign income taxes would surely have inhibited U.S. investment abroad, resulting in little

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[152] Peggy B. Musgrave, United States Taxation of Foreign Investment Income 134 (1969).

[153] Id. at 99, 134.

[154] Joint Comm. on Tax'n, 108th Cong., The U.S. International Tax Rules: Background and Selected Issues Relating to the Competitiveness of U.S. Businesses Abroad 20-21 (Comm. Print 2003); Frisch, note 98, at 583.

[155] See, e.g., Frisch, note 98, at 583-84.

or no U.S. direct investment in the OECD countries where most U.S. direct investment is located today.[156] For investments in Europe, Japan, and Canada, allowing only a deduction for foreign income taxes often would have produced a combined tax rate on foreign investments of U.S. companies approaching 100% (taking into account both corporate and shareholder-level income taxes). It is simply not plausible that the standard of living of U.S. citizens and residents would be higher today had such investments abroad not been made.[157] It is not surprising, therefore, that no one today endorses a policy of "national neutrality" for international direct investments. The unilateral enactment by the United States of a foreign tax credit for income from direct investments and subsequent treaty negotiations to eliminate double taxation of such income through credits for foreign income taxes or exemption of foreign source income has clearly served U.S. national interests.[158] Indeed, no OECD country allows only a deduction for foreign income taxes on outbound direct investments. About one-half the OECD countries allow a foreign tax credit as in the United States; the other half exempt foreign earnings from domestic income taxation.[159]

Such uniformity of approach does not hold, however, for FPI. Belgium, for example, allows only a deduction for foreign income taxes paid by domestic residents on their portfolio investments abroad.[160] Indeed, in the context of a classical corporate income tax or the reduced tax rate system for both foreign and domestic dividends enacted in 2003, a deduction rather than a credit for foreign taxes on portfolio investments by U.S. residents and citizens merits serious consideration.

D. *The Case for a Deduction Rather Than a Credit for Foreign Taxes on Portfolio Investments*

An FTC regime (like an exemption of foreign source income) recognizes as primary the claim to taxes on international income of the country where the income is earned, the source country. By allowing a credit for foreign income taxes, the residence country asserts only a residual claim to tax revenues from the income and generally collects

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[156] Graetz, note 97, at 1382.

[157] See id. at 1391.

[158] See generally Graetz, note 97, at 1390-91.

[159] Michael J. Graetz & Paul W. Oosterhuis, Structuring an Exemption System for Foreign Income of U.S. Corporations, 54 Nat'l Tax J. 771, 771 (2001); see also OECD, Taxation of Cross-Border Portfolio Investment: Mutual Funds and Possible Tax Distortions 30 tbl.2.1 (1999) [hereinafter OECD 1999 Report].

[160] OECD 1999 Report, note 159, at 38.

taxes only when the source country's tax rate is lower than that of the residence country.

Principles of international equity and interpersonal fairness, however, imply that FPI should be taxed by the country where the individual resides. Most analysts contend that in the division of revenues among countries, the source country's claim to tax international income stems, in large part, from the benefits it provides that allow that income to be earned.[161] These benefits include such things as legal and physical infrastructure, for example. The country of source also often provides benefits such as education to the company's workers, who are responsible for generating much of the business's revenues. This is one reason why revenues from taxing wages generally are allocated first to the country where the wages are earned. Source-based taxation of active business income—of direct investment—therefore is justified, "[a]s a matter of both principle and administrative convenience."[162] Governments that provide the infrastructure and institutional capital that enable foreigners to earn income by conducting business activities there merit at least a substantial share of the tax revenues from FDI if they want to claim it.

In contrast, a source country's claim to the tax revenues from FPI is more attenuated. For portfolio income, taxation at source generally is justified essentially on enforcement grounds. The claim is that taxation at source is essential to collect income taxes.[163] Enforcement aside, the claims of the residence country, which has funded the government services that provide for the well-being of the portfolio investor, seem to deserve priority in the inter-nation allocation of tax revenues from FPI. The primary allocation of the taxation of portfolio income to the residence country by the "international tax compromise" reflects this priority. At most, source countries impose withholding taxes on such income—withholding taxes that routinely are reduced or eliminated bilaterally through tax treaties.

The fact that FDI almost always is made by corporations, while individuals account for the bulk of FPI, further supports the allocation of the income from the former to the source country and the income from the latter to the country where the investor resides. Corporate-level income taxes typically are imposed at flat rates, while individual

[161] See, e.g., Graetz, note 97, at 1396; Herwig J. Schlunk, I Come Not to Praise the Corporate Income Tax, But to Save It, 56 Tax L. Rev. 329, 335-36 (2003).

[162] International Chamber of Commerce, Resolutions Unanimously Adopted by the Committee on Double Taxation 3 (Nov. 24, 1923) (statement of T.S. Adams, tax adviser to the U.S. Treasury), available in T.S. Adams Papers, Yale University, box 12, 1923-24 folder; Graetz & O'Hear, note 8, at 1036.

[163] See, e.g., Avi-Yonah, note 1, at 1336; see also Graetz & O'Hear, note 8, at 1056-59. We evaluate this claim separately in Section VI.

income taxes frequently are imposed at progressive rates, rates that increase as the individual's income increases. When an individual invests abroad, only the residence country has the ability to measure the person's worldwide income. Since the primary justification for imposing personalized income taxes is the idea that taxes should vary based on a person's ability to pay, it is essential that the residence country take into account all income, no matter where earned, in measuring its citizens' and residents' ability to pay.[164] No one believes that source country-imposed, gross basis withholding taxes are a good way to measure ability to pay.[165] They ignore deductions necessary to measure net income and, even if the residence country allows tax credits for the foreign withholding taxes, the tax imposed may be inconsistent with the residence country's judgments about appropriate taxation. For example, the FTC may be to no avail if the shareholder is tax-exempt.[166]

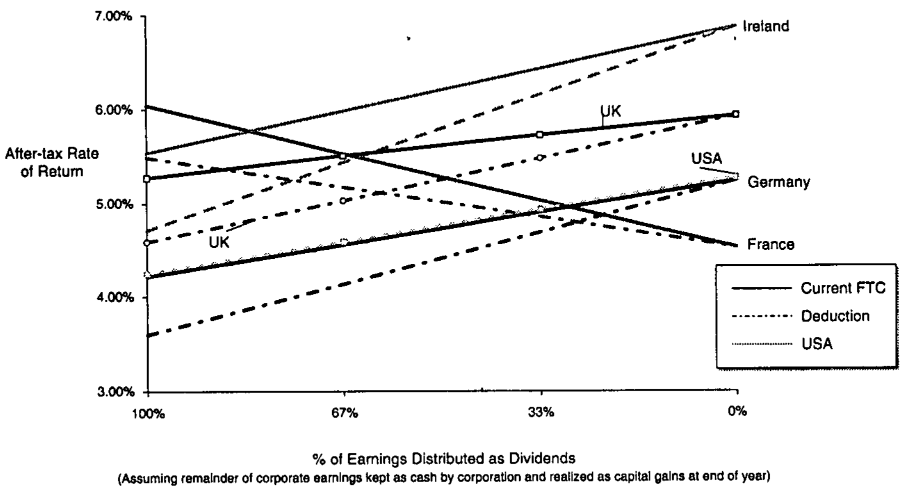
Source countries may levy withholding taxes on dividends to encourage corporations to reinvest the earnings there rather than repatriating them to the shareholders' residence. But such a policy has no relevance to portfolio investors, since they cannot control a company's decisions about paying dividends. Since it is common for source countries not to levy any tax on gains on the sale of shares by nonresidents, the nonresident portfolio investor is taxed only on distributed, not retained earnings. Moreover, unlike interest and royalties, the two other categories of income that might be subject to withholding taxes by source countries, dividends are not deductible in computing the corporate tax and thus already have been taxed once by the source country at the corporate rate. Other than historical practice, what claim does the source country have for taxing this income twice?[167] Substituting a deduction for the FTC properly recognizes as primary the residence country's claim to foreign portfolio income.

From the residence country's perspective, the important economic objections to substituting a deduction for the FTC with respect to income from FDI do not apply to FPI. Taxation by the country of residence of portfolio income—even when that country allows a deduction for foreign income taxes—will not distort decisions of corporations about where to locate their real investments in plant or equipment.[168] Nor does such a policy inhibit free trade—the free movement across borders of goods and services.

[164] See, e.g., Green, note 103, at 29.
[165] Id.
[166] Vann, note 4, at 34-35.
[167] Some countries provide relief for the double tax through imputation credits and a few sometimes extend such credits to nonresidents, see id. at 50, n.27.
[168] See notes 88-96 and accompanying text.

Given the relatively small level of source-based taxation of FPI, moving from a credit to a deduction for foreign income taxes on portfolio investments would have only a small impact on investors' rates of return. Figure 3 below charts after-tax rates of return to U.S. FPI into four European countries, compared to after-tax rates of return to domestic FPI, when returns are divided in different ratios between capital gains and dividend distributions, assuming in each case a 10% pretax rate of return on equity investments.[169] Figure 3 demonstrates that substituting a deduction for the FTC would not increase the degree of disparity among the after-tax returns produced by identical investments in the most tax-favorable and least tax-favorable jurisdictions. Substituting a deduction changes only the countries and the dividend–to–capital gain ratios that are most tax-efficient. Thus, substituting a deduction for the foreign tax credit, in practice, would not create any greater deviations from CEN in the U.S. international tax system than the tax credit regime.

FIGURE 4
RATES OF RETURN GIVEN NATIONAL EATRS U.S. OUTBOUND FPI TAXED AT THE TOP BRACKET UNDER BOTH A FOREIGN TAX CREDIT AND A DEDUCTION SYSTEM



Under year 2000 tax rates and law, the largest disparity in post-tax rates of return between two identical investments by an investor subject to the top income tax rates, each with 10% pretax rates of return, was between investments in France, with a 6.04% after-tax return, and Germany, with a 4.22% after-tax return. This disparity, which occurs

[169] Underlying calculations on file with authors. Calculations do not reflect changes in the U.S. taxation of dividends enacted in 2003.

when 100% of corporate earnings are distributed as dividends, represents a difference of 1.82 percentage points. With a deduction for foreign income taxes, the difference in after-tax returns on identical investments with 100% of corporate earnings distributed as dividends grows a bit. The post-tax rate of return when the United States allows only a deduction for foreign withholding taxes for an investment in France would equal 5.43%, while the rate of return in Germany would be 3.59%. This represents a disparity of 1.90 percentage points, slightly bigger, but extremely close to a credit regime.[170] Replacing the FTC with a deduction for foreign taxes would shuffle the attractiveness of investments in various countries, decreasing in the process the income tax disadvantage U.S. nationals now sometimes face for domestic portfolio investments compared to FPI.[171] And shifting to a deduction would increase U.S. tax revenues,[172] perhaps by hundreds of millions of dollars annually, revenues that might be used to decrease U.S. taxes on capital income generally.[173]

[170] The 2003 Act, note 151, § 302, modified U.S. law to tax dividends at the same rate as capital gains—currently a top rate of 15%—for taxable years beginning after 2002 and before 2009. Under this law, the largest disparity in post-tax rates of return, with the current foreign tax credit, between two identical investments, each with a 10% pretax rate of return and 100% of corporate earnings distributed as dividends, is 2.8 percentage points. This disparity arises between an investment in France, which produces an 8.5% after-tax return, and an investment in Germany, with a 5.7% after-tax return. A deduction for foreign income taxes instead of the foreign tax credit would slightly increase the difference in after-tax returns on these otherwise identical investments to 2.9 percentage points.

[171] See text accompanying note 123. While substituting a deduction for foreign taxes for the FTC would create some disincentives to portfolio investment abroad, it is far from clear whether such a shift would have any substantial impact. As we have indicated, economists have discovered—but have yet to explain—a stubborn tendency of portfolio investors to invest in companies from their home country, notwithstanding economic advantages for investments abroad. See notes 67-72 and accompanying text. The economic effects from a change in the taxation of FPI could likely be significantly smaller than standard portfolio theory would predict, at least if foreign portfolio investors' decisions fail to conform to economic theory in the same way as domestic portfolio investors' decisions. Id.

When dividends from FPI are taxed similarly to capital gains under the 2003 Act, note 151, substituting a deduction for foreign taxes paid for the foreign tax credit would require structuring the deduction so that it offsets only such "qualified dividend income."

[172] Since foreign withholding taxes on portfolio dividends are often imposed at a rate of 15% when received from countries with which the United States has entered into a bilateral income tax treaty, the current foreign tax credit, in those cases, will fully offset the 15% tax on dividend income when such dividends are taxed at the maximum 15% rate now applicable to capital gains. See 2003 Tax Act, note 151, § 302 (certain dividends paid by "qualified foreign corporations" taxed as capital gain for taxable years beginning after 2002 and before 2009). In these circumstances, replacing the FTC with a deduction for foreign taxes would allow the United States to collect some tax on income from U.S. investors' outbound FPI in those countries. We contend here, see note 163 and accompanying text, that residence countries should receive priority in taxing income derived from FPI.

[173] Our preliminary calculations suggest that, under 2000 law and rates, moving to a deduction for foreign taxes paid with respect to corporate and individual foreign portfolio investors would provide approximately $350 million of additional revenue annually for the

A deduction, rather than a credit, could serve the national interest of the United States by improving internation equity and interpersonal fairness and removing tax disincentives to domestic portfolio investment, while increasing revenues. Indeed, a goal of U.S. international tax policy should be to eliminate source-based taxes on portfolio income altogether and focus taxing authorities internationally on collecting taxes on portfolio income exclusively in the country of residence. "U.S. tax treaty policy for many years has been to eliminate (or when that is not possible, to substantially reduce) source-country withholding taxes on [portfolio] interest and royalties."[174] And source-based taxation of portfolio income is slowly disappearing. Since 1984, when the United States abolished its withholding tax on portfolio interest, most investments by U.S. taxpayers that generate portfolio interest income have become exempt from source-country taxation. Similarly, capital gains realized by U.S. shareholders on their sales of foreign shares now generally are taxed only by the United States. Only portfolio dividends continue to be subject to any significant income taxation at source, and even these source-based withholding taxes may be in decline.[175] A deduction, rather than a credit, coheres with an international tax policy that sees source-based taxation of portfolio income as being, at most, a necessary expedient

U.S. fisc. This estimate assumes no behavioral changes on the part of investors as a result of the change in the tax law. The estimate, however, is based on the value of individual FTC claimed on interest and dividend payments in 1996 (the most recent year for which data was available). Jeff Curry, Maureen Keenan Kahr & Sarah E. Nutter, Individual Foreign-Earned Income and Foreign Tax Credit, 1996, SOI Bull., Summer 1999, at 130, 147-48 tbl.3, also available at http://www.irs.gov/taxstats/article/0,,id=96621,00.html; Nick Ward, Corporate Foreign Tax Credit, 1996: An Industry and Geographic Focus, SOI Bull., Summer 2000, at 180, 209-11 tbl.2, also available at http://www.irs.gov/taxstats/article/0,,id=96337,00.html. The estimate also assumes that all individuals who claim the FTC are in the top individual tax bracket. Note that individuals outside the top tax bracket claimed at least 28% of the total individual FTC claimed in 1996. Furthermore, our calculation also ignores the exception for working capital investments discussed at note 176 and accompanying text. Finally, the estimate does not take into account changes in the taxation of dividends enacted, on a temporary basis, in 2003. For these reasons the estimated revenue gain from this preliminary calculation is probably high, but there seems to be some substantial revenue at stake. Gary Hufbauer, who assumes that a U.S. move to a deduction for foreign taxes paid with respect to outbound FPI and abolition of U.S. withholding taxes on inbound FPI would be accompanied by worldwide abandonment of withholding tax regimes, has calculated that moving to a deduction system would generate as much as $12 billion annually. Gary Clyde Hufbauer, U.S. Taxation of International Income: Blueprint for Reform 76 (1992). We are skeptical of Hufbauer's assumption that withholding tax rates would fall to zero in all countries that are important recipients of U.S. outbound FPI. See notes 178-88 and accompanying text.

[174] Barbara Angus, Treasury Testimony at Foreign Relations Hearing on Pending Tax Treaties, ¶ 28 (Mar. 5, 2003), 2003 TNT 45-19, Mar. 7, 2003, available at LEXIS, TNT File (testimony of Barbara Angus, Int'l Tax Counsel, Treasury Dep't, Before the Senate Comm. on Foreign Relations).

[175] See, e.g., U.K.-U.S. Treaty, note 20, art. 10, ¶ 3, 4 Tax Treaties (CCH) ¶ 10,900.

for preventing tax evasion on portfolio dividends. We consider alternative ways successfully to prevent tax evasion on residence based taxes in Section VI.

1. *Two Caveats to the Case for a Deduction Rather Than a Credit*

We would make one exception to our proposal that a deduction be substituted for the credit now allowed for foreign income taxes on FPI. Corporations often invest, usually on a short-term basis, a certain level of funds as working capital for their ongoing business operations. Such working capital is a necessary adjunct to corporate direct investments abroad. Foreign corporations often invest such working capital abroad, even when the corporation is owned by one or more U.S. corporations or other U.S. shareholders. Income from such investments of working capital generally are treated as FPI. Since such income actually represents active business income of the corporation, we would continue to allow an FTC on portfolio income earned from corporate investments of working capital.[176]

Furthermore, the computations of the impact of moving from a credit to a deduction on an investor's rate of return presented above are based on a U.S. classical corporate income tax system. President Bush's January 2003 proposal to integrate the corporate and shareholder taxes through an exclusion from income for dividends would have moved the U.S. tax system with regard to FPI generally in a direction similar to that which would occur by substituting a deduction for the FTC in the current classical system. Under the Bush plan, the United States would have exempted from tax dividends paid by domestic companies on earnings abroad, but not dividends paid to U.S. shareholders by foreign companies from similar investments. In this scenario, some countries would likely retain withholding taxes at source on dividends, and elimination of such taxes would likely occur only through bilateral treaty negotiations. As with many integration systems, U.S. tax law then would systematically favor investment in domestic over foreign companies. If dividends from U.S. companies were excluded from shareholders' income, but not dividends from foreign earnings of foreign companies, the case for retaining the FTC for foreign withholding taxes imposed on dividends paid from foreign companies might seem stronger on both equity and economic efficiency grounds. Under a dividend exclusion, the normative background against which to compare taxes on dividends paid from FPI

[176] For further discussion of the working capital issue, see Graetz & Oosterhuis, note 159, at 775 (recommending that the definition of working capital under Subpart F be based on a proportion of total gross income or total assets).

would be a zero rate of U.S. tax on most domestic dividends. It no longer would make sense to consider the FTC on taxes paid on dividends from FPI a loss to the U.S. Treasury, since dividends received on FPI invariably would face a higher rate of tax than comparable investments in the United States. The Bush proposal, however, was not enacted by Congress, which instead decided—at least on a temporary basis—simply to lower the tax rate on dividends, whether from domestic or most foreign investments.[177]

V. Should We Worry About the Response—or Perhaps Even Retaliation—by Foreign Governments?

With direct investments, attempting to pursue U.S. national interests through a policy of national neutrality—allowing a deduction rather than a credit for foreign taxes—would be folly. Not only would direct investments abroad by U.S. multinationals shrink toward nothing, but other countries might retaliate against the United States by allowing only a deduction rather than a credit or exemption for income from their companies' direct investments in the United States. This would deprive the United States of the advantages of both outbound and inbound direct investments, a consequence that surely could not be described as advancing the interests of U.S. residents and citizens.

But such dire consequences would not follow if the United States were to substitute a deduction for the FTC with respect to FPI. As we have shown, the most likely scenario would be some shifting of portfolio equity investments by U.S. residents and citizens to U.S. companies with little or no effect on the location of real investments in plant and equipment throughout the world. In the case of FPI in the form of debt, most U.S. lenders are not taxed by the source country and the choice between a deduction and a credit is generally irrelevant. The question remains, however, how other countries likely would respond to a shift from a credit to a deduction with regard to outbound portfolio equity investments from their countries. We cannot be certain.

The economist Gary Hufbauer has suggested that if the United States were to abolish its FTC for outbound FPI and eliminate all of its withholding taxes on inbound FPI, market forces would lead other countries to drop their withholding taxes as well.[178] Hufbauer contends that residence-based taxation alone would result, and that this would produce a more efficient worldwide allocation of capital.[179]

[177] IRC § 1(h)(11).
[178] Hufbauer, note 173, at 67–68.
[179] Id at 65-68.

Hufbauer's essential premise is that U.S. portfolio investment is sufficiently large that it lowers the cost of capital in economies where it is present. He claims that without a FTC, U.S. investors would "withdraw funds from countries that imposed withholding taxes on [portfolio] income."[180]

Hufbauer cites Germany's 1989 attempt to institute a withholding tax on interest to support his prediction.[181] In that instance, German banks confronted a massive withdrawal of foreign-owned capital to jurisdictions such as Luxembourg and Switzerland, which impose no withholding tax on interest income. Eventually, pressure by German banks forced the German government to repeal its withholding tax.[182] Hufbauer suggests a similar dynamic would occur if the United States were to eliminate its FTC.[183]

To be sure, allowing only a deduction for foreign taxes on FPI would disfavor FPI whenever the foreign before-tax rates of return were equal to domestic pretax rates of return if the foreign jurisdiction had any source-based tax on income from portfolio investments. Those foreign jurisdictions with zero or lower source-based taxes would be favored by U.S. portfolio investors over countries with higher source-based taxes. Hufbauer predicts that competition for U.S. capital would lead source countries interested in U.S. portfolio investments to abolish any remaining source-based taxation of such investments. Hufbauer therefore expects withholding rates on dividends to disappear if the United States were to substitute a deduction for the FTC.[184] Under current U.S. tax law, zero source-based taxation would make domestic portfolio investments equally favorable on an after-tax basis as FPI with comparable (risk-adjusted) pretax rates of return.

We are more skeptical than Hufbauer about the magnitude of the shifts in portfolio investment flows that would be likely to accompany a U.S. shift to a deduction for foreign income taxes on FPI. The current multinational allocation of FPI by U.S. investors persists despite substantial variance in after-tax rates by country. U.S. portfolio investors already experience significantly different effective tax rates in multiple geographies with imperceptible effects on portfolio allocations. For instance, the effective tax rate for U.S. investors on investments in France through U.S.-based mutual funds has been more than 20 percentage points lower than a similar investment in Germany.[185]

180 Id. at 68.
181 Id. at n.11 & 69 n.13.
182 Id. at 69 n.13.
183 Id. at 68.
184 Id.
185 OECD 1999 Report, note 159, at 42 tbl.2.7.

Nevertheless, Germany remains the fifth largest recipient of U.S. investment, with more U.S. FPI than France. Nor do we find the German case Hufbauer cites persuasive; the differences between the U.S. and German situations are quite substantial.[186] Thus, we would predict much smaller investment shifts than Hufbauer from replacing the FTC with a deduction for foreign withholding taxes. Indeed, some evidence suggests that portfolio managers' interest in diversification may be sufficiently high to make the percentage of their investments allocated to foreign jurisdictions quite inelastic. The UN Commission on Investment, Technology, and Related Financial Issues, for example, claims that between 1991 and 1999 investments in emerging markets in general decreased the return on global portfolios and increased their volatility.[187] UNCTAD's survey of fund managers revealed that despite this fact, fund managers reported that they "continue[d] to believe in the benefits of diversifying into emerging markets and d[id] not plan to discontinue investing in such markets."[188]

Thus, we do not expect major shifts in U.S. portfolio investments from this proposed change in tax policy, although some reshuffling among favored destinations for FPI might occur. It is impossible, however, given the available data, to be confident about the effects on portfolio investments from a policy shift from the FTC to a deduction for foreign taxes paid. In any event, the current trend is toward lower withholding taxes for portfolio dividends, the only form of FPI currently subject to any substantial source-based taxation. We expect that trend to continue and we agree with Hufbauer that it might well

[186] Another anecdotal example that often is mentioned in discussions regarding the effect of changes in U.S. tax policy on FPI patterns is the U.S. experience in the Eurobond market after the 1984 repeal of the 30% withholding tax on portfolio interest paid to foreign residents. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127(a), 98 Stat. 494, 648-50 (codified as amended at IRC § 871(h)). The widespread utilization of Netherlands Antilles finance subsidiaries by U.S. corporate borrowers to access the Eurobond market prior to repeal of the 30% portfolio interest withholding tax and the subsequent transition to direct borrowing in the Eurobond market following the repeal of the withholding tax illustrate that U.S. multinational corporations will go to great lengths to obtain cheaper financing by providing tax-favorable investment vehicles to creditors. See generally Leslie E. Papke, One-Way Treaty With the World: The U.S. Withholding Tax and the Netherlands Antilles, 7 Int'l Tax & Pub. Fin. 295 (2000). Lessons from the Eurobond case principally concern the effect of tax policy changes on the actions of U.S. multinationals, and are of limited relevance in considering the responsiveness of U.S. outbound foreign portfolio investors to changes in U.S. tax policy.

[187] UNCTAD Report, note 23, at 14. A strong interest in diversification, making overall levels of FPI inelastic, is consistent with speculative volatility. While small shifts in rates of return may encourage portfolio managers to shift their allocations between foreign portfolio investments, a desire for diversification will lead those managers to keep the capital in question in some form of foreign investment.

[188] Id.

be accelerated if the United States were to shift from the FTC to a deduction for foreign taxes on income from FPI.

VI. Collecting Residence-Based Taxes on FPI Is the Key Concern

The major issue facing the United States, as well as all other capital-exporting nations, with regard to FPI is enforcement of residence-based income taxation on income earned abroad.[189] We argue here in favor of a policy of taxation of FPI by residence countries and suggest elimination of taxation of such income at source. In this connection, we suggest that the United States should consider replacing its credit for such income with a deduction for foreign taxes. The major difficulty for any regime of taxing FPI, however, is the widespread underreporting and evasion of income taxes. While shifting from the FTC to a deduction might increase the tax savings from evasion in some cases, underreporting of income from FPI is also beneficial when a credit is allowed for foreign withholding taxes. Relying on source-based withholding taxes as the principal enforcement mechanism is simply to accept the impracticality of enforcing residence-based taxes, clearly a second–best outcome. There is no other compelling policy justification for the imposition of withholding taxes at source.

We do not agree that enforcing residence-based taxes is impractical. Ultimately, therefore, the question becomes how to enforce residence-based taxation of FPI. Multilateral cooperation and coordination is the linchpin for success, but unilateral innovations also may help.

A. *The Magnitude of Underreporting and Evasion of Taxes on Foreign Portfolio Investment*

The extent of underreporting and tax evasion of FPI is, of course, unknown. If we knew what income was underreported, we would know enough to collect the tax. The best data available, however, suggests that tax evasion by foreign portfolio investors is commonplace.[190] Foreign investment earnings are substantially easier than domestic earnings for investors to underreport or to fail to report to their residence country's tax authority.[191]

In March 1994, for the first time in 50 years, Treasury conducted a comprehensive survey of outbound portfolio investments from the

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[189] See, e.g., Vito Tanzi, Globalization, Technological Developments, and the Work of Fiscal Termites, 26 Brook. J. Int'l L. 1261, 1262, 1274-75 (2001).

[190] Graetz, note 97, at 1414-15.

[191] Tanzi, note 189, at 1274-75.

United States.[192] As a result of this survey, the Department of Commerce revised its 1993 estimates of portfolio interest income on foreign bonds earned by U.S. persons upward by $6.1 billion, from $17.2 billion to $23.3 billion,[193] and its estimate of portfolio dividends on stocks upward by $4.1 billion, from $6.8 billion to $10.9 billion.[194] The 1993 estimate of U.S. holdings of foreign stocks increased from $302.8 billion to $543.9 billion.[195] In 1997, a similar Treasury survey produced a reduction of more than $10 billion in the reported U.S. balance of payments deficit due to increased estimates of interest and dividends received by U.S. residents from foreign securities.[196] In combination, the magnitude of these adjustments suggests massive gaps in the tax reporting of interest, dividends, and capital gains from FPI.[197] As foreign investments have increased over time, the limited ability to tax foreign earnings has become an increasingly serious problem for tax administrators.

Bilateral action by the United States and its treaty partners through tax treaty renegotiations may help combat the underreporting problem. The OECD has suggested that countries intensify the exchange-of-information provisions in their tax treaties.[198] Tax treaties also could incorporate additional provisions encouraging coordinated tax enforcement and assistance in enforcing each country's tax laws by other signatories.

B. *Current Multilateral Efforts to Improve Information Reporting*

Jurisdictional limitations, tax competition, and administrative obstacles have limited the effectiveness of unilateral or bilateral approaches to address underreporting of income from FPI.[199] Thus, multilateral coordination has become necessary to achieve the effective international information exchanges required for residence-based taxation of FPI income.[200] The OECD's Forum on Harmful Tax Practices (the OECD Forum) represents one such effort.[201] Established in April 1998, the OECD Forum's purpose has been to examine various ap-

192 Bureau of Economic Analysis, 1994 Benchmark Survey, U.S. Dep't of Commerce, Final Results, U.S. Direct Investment Abroad (1998); see also Treasury FLTS Report, note 26; Bach, note 26, at 46-48.

193 Bach, note 26, at 47.

194 Id. at 48.

195 Id. at 47.

196 Treasury FLTS Report, note 26, at 2.

197 Graetz, note 97, at 1414.

198 OECD, Harmful Tax Competition: An Emerging Global Issue 46-7, ¶¶ 114-17 (1998) [hereinafter OECD 1998 Report].

199 Id. at 37-43; Herman, note 1, at 223-38.

200 OECD 1998 Report, note 198, at 53-55, ¶¶ 140-48; Herman, note 1, at 238.

201 OECD 1998 Report, note 198, at 53-55, ¶¶ 140-48.

proaches that groups of countries might take to collect tax revenues from FPI that flows through offshore financial centers and tax havens and to control the growth of so-called "harmful preferential tax regimes" within the developed world.[202] Estimates suggest that the value of deposits in offshore financial centers and tax haven countries exceeds $5 trillion.[203] Since 2000, the OECD has successfully obtained commitments to share information internationally from a number of jurisdictions traditionally considered tax havens.[204] This success suggests that, at the very least, the threat of coordinated multilateral defensive measures may coerce tax havens into entering into information exchange agreements with OECD countries.

Since 1998, the OECD Forum also has worked to create multilateral norms of transparency of financial transactions, which, in combination with comprehensive information exchange, it believes may substantially reduce the evasion and underreporting of income from international investments.[205] The OECD Forum regards transparency as requiring publicized rates of taxation for enterprises and individuals in a given jurisdiction and the elimination of the ability to negotiate their rate of tax.[206] According to the OECD Forum, "[t]ransparency also requires financial accounts to be drawn up in accordance with generally accepted accounting standards and that such accounts either be audited or filed."[207] Governments also are required to have access to information identifying the beneficial ownership of all types of entities in the country and access to all types of bank information relevant to tax matters.[208] All the information one country gathers should be made available on request to any other national tax authority.[209] The only limitation is that the requesting authority must commit to use "the information obtained and provided . . . only for the purposes for which it was [specifically] sought."[210]

In 2000, the OECD Forum compiled a list of 47 jurisdictions that were classified as tax havens based on the factors the OECD had

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202 Id. at 37-59 (setting forth Forum's mandate).

203 Tanzi, note 189, at 1271 (citing UN, Financial Havens, Banking Secrecy and Money Laundering 71 (1998)).

204 Anne-Marie Berthault, A French Perspective on Tax Havens and Bank Secrecy: Is the Future a Transparent One?, 22 Tax Notes Int'l 3171, 3172-73 (June 18, 2001).

205 See, e.g., OECD, The OECD's Project on Harmful Tax Practices: The 2001 Progress Report 10, ¶¶ 28, 36-38 (2001) [hereinafter OECD 2001 Progress Report], available at http://www.sourceoecd.org/content/html/index.htm.

206 Id. at 11, ¶ 37.

207 Id.

208 Id.

209 Id. at 11, ¶¶ 37-38.

210 Id. at 11, ¶ 38.

identified in 1998.[211] The OECD Forum began communicating with these states, which are not OECD members, to explore their potential cooperation in establishing international standards of transparency, fairness, and disclosure in tax practices.[212] The Forum promised to leave off its public list of uncooperative tax havens any jurisdiction that made a public commitment to "adopt a schedule of progressive changes to eliminate its harmful tax practices by 31 December 2005."[213]

In June 2000 the OECD announced that six jurisdictions, Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino, all tax havens, had committed to create mechanisms for international exchanges of information and to improve their practices by 2003 for criminal matters and by 2005 for civil matters.[214] By 2002 31 jurisdictions had made such commitments.[215] The OECD's success in obtaining commitments from these countries suggests that the threat of multilateral coordinated defensive measures by a number of large developed economies can successfully pressure offshore jurisdictions to enter into information exchange agreements.[216]

Another recent OECD report addressed how bank secrecy may be used to hide illegal activities and to escape domestic taxes.[217] The report recommended the elimination of anonymous accounts and a reexamination of the "domestic tax interest" requirement for information exchange.[218] The domestic tax interest requirement, which some countries have applied, provides that a treaty country cannot obtain bank information from a treaty partner unless the country with access to the information itself has an interest in obtaining that

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211 OECD, Towards Global Tax Cooperation: Progress in Identifying and Eliminating Harmful Tax Competition 6, 10 (2000) [hereinafter OECD 2000 Progress Report].

212 The OECD Forum also decided that it would create a List of Uncooperative Jurisdictions comprised of countries that met the tax haven criteria and chose not to eliminate their harmful tax practices after being put on notice by the OECD. The Forum's 2000 Progress Report suggested that OECD members could subject these states to coordinated defensive measures. Id. at 6-7. The OECD Forum published this list in 2002. See OECD, List of Uncooperative Jurisdictions (Apr. 18, 2002), available at http://www.oecd.org/EN/document/0,,EN-document-103-nodirectorate-no-12-28534-22,00.html.

213 OECD 2000 Progress Report, note 211, at 19, ¶ 21.

214 Berthault, note 204, at 3173.

215 List of Uncooperative Jurisdictions, note 212.

216 Some analysts believe that the OECD Forum process will ultimately fail. Peter Manyasz, Tax Havens Outcome of OECD Meeting Disputed; Two Jurisdictions Drop Commitments, Daily Tax Rep. (BNA) at G-8 (Oct. 16, 2003). Nevertheless, the sheer number of offshore jurisdictions involved in the OECD process shows the potential of that process to influence the information exchange practices of offshore jurisdictions.

217 OECD, Improving Access to Bank Information for Tax Purposes (2000), available at http://www.sourceoecd.org/content/html/index.htm. [hereinafter OECD 2000 Report]

218 Id. at 14.

information for its own tax purposes.[219] The OECD report also recommended a reexamination of policies and practices that prevent exchange of information for criminal tax cases and initiatives to achieve access to bank information for civil tax cases.[220]

In 2003, the OECD published an updated version of the OECD Model Tax Convention, which includes a new Article 27 obligating "Contracting States [to] lend assistance to each other in the collection of revenue claims."[221] Article 27 requires contracting states to collect revenue claims for the other contracting state as if the revenue claim were a revenue claim of the state doing the administration and enforcement.[222] Under this article, tax authorities of contracting states would apply their administrative and enforcement mechanisms exactly as if they were collecting their own revenue claims, with one major caveat. The Commentary suggests that under ¶ 6 of Article 27 "no legal or administrative proceedings, such as a request for judicial review, shall be undertaken in the requested state with respect to matters of the existence, validity or amount of a tax claim."[223]

C. *Will Information Exchange Agreements Prevent Underreporting and Evasion?*

In the domestic context, the United States has successfully used information reporting in lieu of withholding to collect income taxes on domestic interest, dividends, and capital gains.[224] In the transnational context, the United States already exchanges tax information with other jurisdictions through U.S. income tax treaties, tax information exchange agreements (TIEAs), and mutual legal assistance treaties (MLATs).[225] Under most U.S. tax treaties and TIEAs, requests for assistance may be made for any civil or criminal tax investigation not barred by the statute of limitations, and information can be exchanged regarding any relevant person.[226] The amount of underreporting of FPI uncovered by the recent Treasury surveys makes clear, however, that current international information exchanges are inadequate to prevent evasion of income tax on foreign income.[227]

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219 Berthault, note 204, at 3172.

220 OECD 2000 Report, note 217, at 14-15.

221 OECD Model Treaty, note 13, at art. 27, ¶ 1.

222 Id. art. 27, ¶ 3.

223 Commentary on the OECD Model Tax Convention Proposed art. 27, ¶ 28.

224 Graetz, note 97, at 1415.

225 Bruce Zagaris, Selected Aspects of U.S. International Exchange of Information, 18 Tax Notes Int'l 1725 (Apr. 26, 1999).

226 Id.

227 See notes 190-97 and accompanying text.

EU nations, however, are now using information reporting as a substitute for withholding with some success.[228] At an April 2000 summit, EU member states reached an agreement requiring source countries either to impose withholding taxes or to engage in information exchange with respect to the taxation of passive income.[229] A number of countries that had been unwilling to impose low-rate withholding taxes were willing to cooperate in extensive information reporting.[230] The success of information reporting within the EU offers hope that a similar regime might be negotiated among all the major developed economies.

The United States has not stood idly by awaiting the implementation of successful multilateral actions directed at enforcement of income taxes on FPI. Since 1997, the Service has attempted to induce foreign financial intermediaries doing business in the United States to cooperate in revealing U.S. persons who earn portfolio income. The basic arrangement is that the United States will grant anonymity to foreign investors of foreign financial intermediaries in exchange for the intermediaries' cooperation in collecting tax owed by U.S. citizens and ensuring that only those foreigners entitled to reductions of U.S. withholding taxes by virtue of a treaty are receiving the treaty benefits.[231] With a major exception for bearer bonds, the goals of the qualified intermediary regime are to identify all U.S. persons receiving income from non-U.S. intermediaries and to curb "treaty shopping" abuses so that only genuine residents of treaty countries obtain treaty benefits. These know-your-customer rules require the foreign financial institution to identify U.S. customers who hold accounts and to withhold taxes due from foreigners.[232]

Obviously, the Service's efforts to enlist foreign financial intermediaries offer only a partial solution to the problem of underre-

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228 Graetz, note 97, at 1415.

229 Id., see also Iain Scoon & Sasha Carter, EU Savings Tax Directive: Saved at Last?, 30 Tax Notes Int'l 1179, 1179-82 (June 23, 2003) (describing the directive the ECOFIN Council of the EU adopted on June 3, 2003 regarding automatic exchange of information or the imposition of a withholding tax in the absence of automatic exchange of information (a transitory option available only to Austria, Belgium, and Luxembourg) with respect to interest payments to, or for the benefit of, resident individuals of EU member states).

230 Graetz, note 97, at 1415.

231 Stephen E. Shay, J. Clifton Fleming, Jr. & Robert J. Peroni, "What's Source Got to Do With It?" Source Rules and U.S. International Taxation, NYU School of Law (Nov. 13, 2003), The David R. Tillinghast Lecture, in 56 Tax L. Rev. 81, 124-28 (2002).

232 Id. The United States also has taken some measures to improve its ability to provide information as part of exchanges of information with its tax treaty partners. See, e.g., Prop. Regs. §§ 1.6049-6 & 1.6049-8(a), as amended by 67 Fed. Reg. 50386, 50388-50389 (Aug. 2, 2002) (requiring reporting of U.S. bank deposit interest paid to resident individuals of Australia, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, and the United Kingdom).

porting. U.S. investors may move their money away from these institutions to others offshore that preserve their anonymity. But enlisting the aid of financial intermediaries is an innovative step toward greater enforcement, one that seems likely to take on greater importance in the years ahead. And perhaps unilateral actions such as these will spur additional multilateral coordination and cooperation.

When foreign portfolio income is earned outside the major developed countries, however, additional problems occur in obtaining effective information exchange and transparency.[233] Vito Tanzi has suggested that obstacles created by language differences, along with the resource burdens on information-providing countries of collecting and organizing the massive flow of information about individual investors, may limit the ability of international information exchange to prevent tax evasion on foreign portfolio income earned in tax havens and developing countries.[234]

More generally, Tanzi identifies three "fiscal termites" specifically related to portfolio investment that he regards as making income taxes increasingly difficult to collect: (1) the pressures arising from the growth of off-shore financial centers and tax havens and the falling transaction costs connected with using their services, (2) the increasing availability of derivatives and hedge funds as vehicles for portfolio investment, and (3) the general difficulty of taxing financial capital as the international capital market becomes more integrated and efficient.[235] Tanzi believes that these "termites," combined with other difficulties related to the increasing mobility of labor and capital, will force the developed economies to become increasingly reliant on taxes that are little affected by these problems, for example, immobile factors of production or resources.[236]

Tanzi observes that hedge funds and new financial products may pose even more intractable problems than standard forms of FPI.[237] He contends that tax authorities may not be able to cope with these complex arrangements, even when they have all the requisite information available.[238] Tanzi points out that with hedge funds utilizing derivatives "the distinction between capital income and capital gains or losses becomes fluid when a contingent claim (gain or loss) can be

[233] Tanzi, note 189, at 1271-72, 1274-75.

[234] Id. at 1279.

[235] Id. at 1271-74.

[236] Id. at 1282.

[237] Id. at 1272-73.

[238] Vito Tanzi & Howell H. Zee, Taxation in a Borderless World: The Role of Information Exchange, in International Studies in Taxation: Law and Economics 321, 328-29 (Gustaf Lindencrona, Sven-Olof Lodin & Bertil Wiman eds., 1999).

created on a structure of certain cash flows (income)."[239] Derivative products made available through hedge funds also can easily manipulate the distinction between dividends and interest.[240] Thus, derivatives and hedge fund investments create significant challenges for the taxation of portfolio income generally, and foreign portfolio income in particular.[241] At least $1 trillion is currently estimated to be channeled through hedge funds, and hedge funds are growing in popularity as a vehicle for portfolio investments among wealthy investors.[242]

We do not completely share Tanzi's pessimism in this regard, but it would be foolish not to acknowledge the difficulties new financial products pose for income tax systems generally. They challenge the notion of a sharp division among dividend, interest, and capital gain income that has been so fundamental to the taxation of both domestic and foreign portfolio income. Addressing the challenges that these innovations pose for income taxation, however, is well beyond the scope of this Article. They require substantive changes in classifications and taxation of income, raising a host of issues far beyond the question we address here of the efficacy of withholding taxes versus information reporting as a potential response to the underreporting of income taxes on FPI. But failing to acknowledge the existence of these challenges would make us seem Pollyannas, which we are not.

Recent OECD experience makes clear that the United States can play a constructive role in establishing information reporting regimes to better serve U.S. national interests. This may be done both through bilateral and multilateral negotiations and through diplomatic efforts by the world's largest economy.[243] It also now seems likely that Europe will press ahead to create international tax reporting standards through OECD and UN processes, regardless of whether the United States participates. Only by engaging information reporting issues at the multilateral level will the United States be able to ensure that agreements eventually reached by developed countries will be consistent with U.S. interests and our legal capacities to comply.

VII. Conclusion

We have demonstrated that the standard analysis of international tax policy, which either has lumped direct and portfolio investment

239 Tanzi, note 189, at 1273.

240 Id.

241 Id.

242 Id. at 1272 (citing Howard Davies, Creeping Growth of the Hedge Funds, Fin. Times, Aug. 15, 2000, at 19).

243 See, e.g., Herman, note 1, at 423 (noting that the United States could use its dominant role in the world's financial system to encourage multilateral cooperation in tax enforcement).

together or has ignored portfolio income altogether, is inadequate. International portfolio income has now become sufficiently important in the world economy to warrant independent analysis.

Indeed, careful analysis has demonstrated that the standard normative criteria most widely used to evaluate international tax policies—CEN and CIN—are inapt for portfolio income. And, the principal concern of CEN—neutrality in business decisions concerning the location of real investment in plant and equipment—is not affected by the taxation of international portfolio income. Moreover, given the wide variation in both corporate and individual tax rates, as well as the variety of policies in integrated tax systems regarding the treatment of foreign shareholders, any attempt to achieve genuine CEN in the taxation of portfolio income would require impractical and undesirable case-by-case distinctions by resident countries for investments in specific foreign countries. Proponents of CEN should focus their attention on redressing the distorting tendencies in the current taxation of direct investments.

When one evaluates the taxation of international portfolio income from the perspective of national well-being—the welfare of U.S. citizens and residents and fairness in their taxation—the case for the current FTC weakens substantially. Indeed, a strong case can be made for replacing the FTC with a deduction for foreign withholding taxes. Ultimately, the goal should be to eliminate altogether source-based taxation of international portfolio income.

The key difficulty for residence-based taxation of international portfolio income results from the widespread underreporting and evasion that now occurs. Any solution to that problem necessarily will require both unilateral and multilateral actions. The good news is that the United States has already taken a major step forward in its information reporting requirements for qualified financial intermediaries, and recent actions in both the OECD and the EU offer promise of vastly improved multinational cooperation. The advent of new financial innovations and the persistence of financial tax havens and bank secrecy ensure, however, that there will be many opportunities for improvement for years to come.