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International Income Taxation

By
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Much of what I will say here today is distilled from articles that I have written and things I have learned in putting together a book called FOUNDATIONS OF INTERNATIONAL TAXATION.[1]

It is difficult enough to fashion sensible tax policy in the domestic arena. The debate, for example, over whether the United States should impose a value-added tax has some international aspects, but it is primarily a debate about domestic policy. This is true generally about the debate over how much we should rely on income versus consumption taxation. This debate amply illustrates how hard it is to obtain agreement on principles when we have, what Fred Goldberg calls, one Caesar claiming the revenues. In international affairs, we have at least two Caesars—two national governments—with legitimate claims to tax the income. We must decide how to divide the tax dollars between the two Caesars. Multinational corporations strive to pay taxes to neither. Disputes are inevitable. It is therefore very important to think about the underlying principles of international taxation and to be explicit about what we are trying to achieve.

The Normative Underpinnings

Unfortunately and importantly, policymakers' longstanding understanding of the normative underpinnings of international tax policy is thoroughly unsatisfactory. I have made this point in detail elsewhere. The essential problem is that at least since 1962, when subpart F was enacted, the Treasury Department and the Joint Committee on Taxation have looked to capital export neutrality (CEN) and capital import neutrality (CIN) or "competitiveness" as a guide to U.S. international tax policy. It is now well known that we cannot have both CEN and CIN simultaneously whenever there are differences in the tax base or tax rates between two countries. What that means is that setting policy becomes free play. If the policy guideline is to compromise between CEN and CIN, that is no guideline at all. You can compromise anywhere.

Several of us have been recently searching for the proper guide to international tax policy. This is a very important quest. Whether Mihir's new idea of "capital ownership neutrality"[2] advances the ball sufficiently remains to be seen, but at least it's an admirable effort. I must, however, admit to some skepticism since this norm is grounded solely on worldwide economic efficiency.

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I believe, and I have written about this a good bit, that the fundamental question we ought to be asking is what policy is in the United States' national interest? What rules will best serve the long-term interests of the American people? That is the question we normally ask about other nontax international policies, and that is the basic question we ought to ask about international tax policy. There is no reason to depart here in favor of worldwide norms.

The great difficulty then becomes knowing what to do—the problem of empirical uncertainty. It is very difficult to get satisfactory information about the consequences of alternative policy decisions. Contested facts inevitably play an important role. For example, does foreign expansion by U.S. multinationals reduce or expand American jobs? We don't know with certainty the extent to which capital used abroad replaces capital that would otherwise be deployed in the United States, or whether instead the capital that is deployed abroad is complimentary to capital in the United States and will increase U.S. jobs. These are empirical questions. We need better information about them in order to make a firm judgment about international tax policies—for example, about the effect of substituting an exemption system for our credit system—on the welfare of the American people.

Looking to advance the well-being of the American people does not necessarily mean that we should always adopt policies advancing the competitiveness of U.S. multinationals. What is good for General Motors is not always good for Uncle Sugar. Advancing the competitive position of U.S. multinationals may or may not be the right answer, depending on the issue and the circumstances.

Taxing Business Income

We have talked here today a lot about taxing active business income and in particular about the debate between a credit system and an exemption system. I want to make a few comments about this. If you go back to the origins of U.S. international tax policy—and I think looking at this history is quite useful—you will discover that the foreign tax credit was not put into the Code to promote capital export neutrality. It was enacted for mercantilist reasons. It was the policy of the U.S. to encourage U.S. companies to go abroad and trade. The limitation on the foreign tax credit was put in the law a few years later to protect U.S. taxation of U.S. source income. An unlimited credit would allow taxpayers to escape U.S. tax on U.S. source income. The principle that T.S. Adams, who was the person who designed our foreign tax credit system, had in mind in the case of business income was that the prime claim between the two Caesars to the tax revenue is the claim of the country of source. Adams insisted that the country where the income is produced is the country in which income tax should be levied, and the country from which the capital is supplied should defer to the country where the income is produced. The primacy of source-based claims to income taxes on active business income has been a feature not only of the U.S. system, but of all OECD tax systems, since 1918. The other principle that motivated the system introduced in the United States in 1918 and 1921 and the League of Nation's model treaty in 1928 was that we should avoid double taxation. If the source country claims the tax on income, the residence country should not tax it again. T.S. Adams also thought that we should be worried about zero taxation.

The best empirical evidence to date suggests that most foreign active business activity is complimentary to U.S. business activities and not a substitute for it. This means that where active business income is involved, there is considerable evidence that the activities abroad of U.S. multinationals usually enhance U.S. welfare and promote U.S. jobs. There is more work to be done on this question, but producing abroad is often how U.S. companies exploit a whole host of advantages in terms of both proprietary intangibles and economies of scale and scope.

Given our system for taxing active business income, where we concede the primacy of source-based taxation, an exemption system and our credit system with deferral generally for active business income are not terribly far apart. One of the lessons of the work on exemption that Paul Oosterhuis and I did was to demonstrate how the two approaches are very close, although they differ in a few important respects.[3]

One major difference is that with an exemption system there is no cost for repatriations, for bringing money back to the home country. Under a credit system, there often is much tax planning, as everyone here knows well, to avoid incremental U.S. income tax when money is brought back into the United States. I believe the major advantage of an exemption system is to eliminate that burden.

I personally favor slightly an exemption system over our credit system, but there are questions that must be answered with an exemption system. Should we exempt all foreign source income or exempt only income that has been previously taxed, and, if so, taxed at what rate? With exemption, we clearly would have to maintain a subpart F equivalent for passive income. That inevitably raises the questions, which we discussed here all morning, relating to the treatment of subpart F base-company income and the like.

One critical point is that U.S. businesses generally do not like an exemption system. You might think, given all the noise about international competitiveness, that U.S. businesses would embrace a system that would exempt their foreign business income from U.S. taxation. But they do not embrace it. The reason is that with an exemption system the United States would tax foreign source royalty income, which it does not now tax because in practice such income can be sheltered through the use of foreign tax credits. So the U.S. multinational community says, "Thank you very much, but we don't want it. Please don't exempt our income abroad."

The simplification advantages that are claimed for an exemption system are often overstated, particularly if Congress decreases the number of baskets for foreign tax credits from nine to two. We surely have a more complicated foreign tax credit system than we need. Thinking about an exemption system does point to some potential simplifications of the foreign tax credit, and decreasing the number of baskets is one of them, but I do not think that simplification is a good reason to move to an exemption system.

Taxing Portfolio Income

Another piece of the international tax puzzle is the taxation of portfolio income. I have recently written an article with Itai Grinberg on this subject.[4] The previous literature almost completely ignores portfolio income. Virtually all of the literature is about taxing business income.

The taxation of portfolio income was, after all, only a small consideration in 1918 and 1921. There were no doubt a few wealthy people who had some international portfolio income, but taxing business income drove the design of our system for taxing international income. The experts have not thought much about taxing portfolio income. The recent growth in international portfolio income, however, is very dramatic. The numbers are staggering regarding the international flows of portfolio income. We need to re-examine this issue.

Many of the features of direct investments are not present for portfolio income. In particular, neither capital export neutrality nor capital import neutrality are important, because portfolio investors do not decide the locations of plant or equipment. Capital ownership neutrality, to the extent I understand it, is also not relevant because it is concerned with the management of the firm and, therefore, addresses only direct investment. So none of the criteria we talk about most in international taxation apply to international portfolio income.

Portfolio income flows very differently from the way direct investments operate. Portfolio investments move much more rapidly. They leave when the milk becomes sour. We have seen this in the outflows prompted by the Mexican and Asian financial crises.

In my view, there is a strong argument for the primacy of residency-based taxation for foreign portfolio income. Otherwise, the residence nation loses the ability to tax people on their ability to pay if residents can avoid progressive taxation simply by moving their portfolio income abroad. Those who believe in the primacy of residence-based taxation for portfolio income should take seriously the idea of allowing only a deduction for foreign withholding taxes rather than a credit.[5]

The real problem with portfolio income, which is related to today's discussions about the real problems with transfer pricing, is the residence nations' inability to collect tax on foreign portfolio income. There is a lack of information flowing between countries. The critical question is whether multilateral cooperation, multilateral innovations, and expanded information reporting will get us to a point where we can collect tax on portfolio income earned abroad. Greater multilateral cooperation is essential.

This is related to the pervasive problem of enforcement inadequacy generally. The IRS is able to engage only in limited enforcement. IRS efforts, for example, to determine who has foreign bank accounts by looking at debit cards in foreign banks were well-publicized, but after the IRS found all these people—which was a shocking number—there was not much it could do about collecting the tax owed because of inadequate resources. It is impossible to enforce an income tax in the modern world if Congress doesn't give the IRS the resources to do its job.

Outdated Concepts

Let me make two other general comments. The first is about outdated concepts. We have an international income tax system built on concepts that are no longer relevant, if they ever were.

Corporate residence is perhaps the best example. The idea of income taxation of a multinational corporation turning on its residence seems bizarre in today's world. Corporate residence may have made sense in the early 20th century, when our international tax rules were put in place, but it makes no sense in the 21st century. We need to decrease or eliminate those income tax consequences that depend on where a corporation is resident.

Our source classifications—although we have not talked about this here today—also suffer major shortcomings in a world where financial derivatives are commonplace. The idea that we can readily distinguish interest, dividends and capital gains is tenuous. E-commerce also obviously imposes important challenges for source rules. The source rules need to be re-thought. That work has not yet really begun.

I also want to say a few words about transfer pricing, which everyone agrees is a crucial problem. The argument to date has been between arm's-length approaches on the one hand, and formulary approaches on the other. This argument is, I think, archaic for several reasons. The formulary methods of apportionment that the states rely on to apportion their taxes have nothing specifically in their formulas for intangibles. As we all know, intangibles have become crucially important to the production of income. Perhaps sales, to some extent, play a role in substituting for a specific value for intangibles. This may be why some analysts have called for allocating some income to the country of consumption.

As an alternative to the states' formulas, the profit-split methods of the Code Sec. 482 regulations have began to give us some new ideas that move toward new formulary-type apportionments. We should ask whether new profit-split methods might also help solve the critical source questions. There may be an opportunity for profit-split ideas to help in solving source questions as well as addressing transfer pricing issues. There seems to be some genuine promise here.

To return to David Rosembloom's earlier example, my fundamental question is whether the correct number for income in Bermuda is really $25. If it is really $25 of income earned in Bermuda and it is really active business income, then whether to impose an income tax is up to Bermuda. But I don't believe the number is $25. I believe it's closer to $5. That debate goes to the heart of David's question.[6]

The Role of International Organizations

One issue that has not been mentioned at all here today and that we generally are not sufficiently alert to in the United States is the increasing role of international organizations in the international tax arena. The World Trade Organization (WTO) has made its relevance apparent with its adverse ETI decision. But, with the exception of the WTO, we have not thought enough about how international organizations are operating and how they potentially will affect our international tax policies.

Take the EU, for example, and in particular the way the Europe Court of Justice (ECJ) has been affecting the income tax arena. Under current EU treaties and the new draft constitution of the EU, the ECJ has the power to strike down income tax laws. But there is no power within the EU to create income tax laws absent unanimous agreement of the member states. The retreat from imputation credit methods of corporate integration in the EU was, in my view, prompted in substantial part by decisions of the European Court of Justice. Recent ECJ decisions on earnings stripping threaten the ability of nations within the EU to collect corporate taxes whenever corporate structures are heavily debt-financed. The treatment of foreign losses by the ECJ is a further example. We need to pay attention to these developments because as European nations change their tax systems in response to ECJ decisions, they may well change policy calculations for us. The ECJ is becoming a new source of pressure on our own international income tax policies.

This development also may undermine to some significant degree the OECD's longstanding role as the arbiter of international tax rules. The OECD's efforts to address what it labeled harmful tax competition may be an instance of the OECD's waning authority, not only in setting substantive rules, but also in inducing multi-lateral enforcement cooperation, which also is currently being questioned. This threat to multi-lateral enforcement is no accident. The U.S. proponents of inhibiting the OECD's ability to promote information exchanges for foreign capital income include, for example, entities, such as the Heritage Foundation and the Cato Institute, who have been urging that we should not have an income tax in the United States and that capital income should not be taxed. The link between these two positions is apparent. If globalization means that governments cannot collect the income tax on capital income, it becomes difficult to keep the in-

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25 Tax Notes 453, 469–70, 472–73 (1984). According to that discussion, Code Sec. 1091(e)(1) was enacted to address the following transaction: A cash-method taxpayer enters into a short-against-the-box transaction by buying stock and simultaneously selling it short. If the stock rises in value at year-end, the taxpayer sells the long position at a gain and purchases new stock to close the short position at a loss in such a manner that the trade date for those transactions falls at the end of one year and the settlement date in the following year. Under the law at the time, the gain on the long position was deferred to the following year, while the loss on the short position was taken into account in the first year. *See* Rev. Rul. 70-344, 1970-2 CB 50; Rev. Rul. 78-270, 1978-2 CB 215; Rev. Rul. 82-227, 1982-2 CB 89; Rev. Rul. 93-84, 1993-2 CB 225 (declaring Rev. Rul. 70-344, Rev. Rul. 78-270 and Rev. Rul. 82-227 obsolete). If the stock fell in value at year-end, the taxpayer would close the transaction in the same manner and both gain and loss (under the wash sale rules) would be deferred until the following year. Code Sec. 453(k)(2) now generally provides that both gain and loss on such transactions must be taken into account in the first year.

[84] *W. Doyle*, CA-7, 61-1 USTC ¶9237, 286 F2d 654 (1961).

[85] Rev. Rul. 59-418, 1959-2 CB 184, addresses a transaction that is similar to *Doyle*, except that the taxpayer entered into a forward contract to sell the stock rather than a short sale. The ruling holds that the taxpayer disposed of the shares at the time he entered into the forward contract. The current validity of this ruling is quite dubious, as it contradicts the normal tax treatment of forward contracts with no apparent authority for doing so, and the Seventh Circuit in *Doyle* later rejected exactly the same argument with respect to the short sale in that case.

[86] Note in this regard that the issue of whether the taxpayer is economically "long" or "short" is completely different from the issue of whether the taxpayer has purchased or sold the option. A taxpayer may be "long" stock (make money if the stock rises, lose money if it falls) by purchasing a call option or by selling a put option. A taxpayer may be "short" stock (make money if the stock falls, lose money if it rises) by purchasing a put option or by selling a call option.

[87] *See* Code Sec. 1233(b) (flush language) ("For purposes of this section, the acquisition of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered as a closing of such short sale"); Reg. §1.1233-1(c)(3) (same); *see also Hoover Co.*, 72 TC 206, Dec. 36,032 (1979) ("short" foreign currency forward contracts treated as short sales for purposes of Code Sec. 1233). The close relationship between the wash sale and short sale rules is primarily derived from the fact that they use the same definition of "substantially identical." *See* Reg. §1.1233-1(d).

[88] *See, e.g.*, TAM 7730002 (Apr. 14, 1977) (Code Sec. 1091 cannot apply to a situation in which an option writer closes out an option since the grantor does not "acquire" property within the meaning of Code Sec. 1091); LTR 8517029 (Jan. 29, 1985) (Code Sec. 1234, rather than Code Sec. 1091, governs situations in which an option writer closes out his or her previously issued call option). Some practitioners believe that if the old and new call are written with the same counterparty, however, there may be a nonstatutory basis for deferring the loss.

[89] The portfolio rules of Reg. §1.246-5(c)(1) may seem like an odd model, given that they qualify as an example of some of the problems with writing complex rules. Notwithstanding that, the rules are quite reasonable as a big picture matter, meaning that it is appropriate to treat baskets of small numbers of stock or securities on an instrument-by-instrument basis and to deal with larger baskets on a portfolio basis. The problem with the Reg. §1.246-5(c)(1) rules is in the details. Many of those problems might have been identified and fixed if the IRS had proposed those rules in their current form and allowed taxpayers to comment on them.

[90] *See* note 65, *supra*, for a discussion of possible approaches to determining whether it is likely that an option will be exercised.

[91] *See* Reg. §1.382-4(d).

[92] *See* Reg. §1.1092(c)-4(e) and the discussion in note 65, *supra*.

[93] Reg. §1.1001-3(e)(4) provides that there is a change in payment expectations if an obligor's ability to pay prior to a transaction is adequate, and it becomes speculative as a result of the transaction, or *vice versa*.

[94] This recommendation is not novel. *See, e.g.*, New York State Bar Association Tax Section, *Report on Proposed Straddle Legislation*, at Part VII.A (Mar. 17, 2000). Legislation currently pending in the Senate provides for such a change.

[95] *M. Hanlin*, *supra* note 21, at 430.

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brainwashing (I'm already a member of the law and economics choir; see my dissent in *Clajon Gas Co., L.P.*, 119 TC 197, Dec. 54,919, at 215–17 (2002), *rev'd*, CA-8, 2004-1 USTC ¶50,123, ___ F3d ___), are answered by the comment in Advisory Opinion No. 67 that:

> The education of judges in various academic disciplines serves the public interest. That a lecture or seminar may emphasize a particular viewpoint or school of thought does not in itself preclude a judge from attending. Judges are continually exposed to competing views and are trained to weigh them.

But see S. 787, the "Fair and Independent Judiciary Act of 2003," introduced by Senators Kerry and Feingold on April 8, 2003, and referred to the Committee of the Judiciary, which, in addition to restoring cost-of-living increases in federal judges' salaries, would have imposed severe restrictions on seminars for federal judges. The bill was not reported out of Committee. A prior bill containing similar restrictions, S. 2990, the Kerry-Feingold "Judicial Education Reform Act of 2000," introduced July 27, 2000, was disapproved by the Judicial Conference of the United States and the Board of the Federal Judicial Center, and was the subject of a disapproving speech by the Chief Justice at the ALI Annual Meeting in Washington, D.C., May 14, 2001.

[8] *B.W. Kanter Est.*, CA-7, 2003-2 USTC ¶50,605, 337 F3d 833.

[9] *Gulf Oil Corp.*, 89 TC 1010, Dec. 44,341 (1987).

[10] *Wilkes-Barre Carriage Co., Inc.*, 39 TC 839, Dec. 25,991 (1963), and cases cited at 845–46, *aff'd*, CA-2, 64-2 USTC ¶9518, 332 F2d 421, *cited with approval*, *H.W. Smith*, 56 TC 263, at 291, note 17, Dec. 30,773 (1971).

[11] See *Montgomery*, 122 TC —, No. 1 (2004).

[12] *J.D. Shea*, 112 TC 183, at 207–09, Dec. 53,318 (1999).

[13] *A Dialogue Between Tax Court Judges*, 46 Tax Law. 665, 672–77 (1993).

[14] Let the record show at this point that Judge Beghe interpolated a line from his investiture speech, attributed to Golda Meier: "Don't be so humble; you're not that good."

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come tax in force. If we do not have multilateral enforcement cooperation, we will see something of an international race to the bottom in terms of the taxation of income from capital. We do not need cooperation in setting tax rates, but we must have cooperation on information sharing and tax collection. There is considerable pressure internationally on tax rates and within the United States a real effort to move us away from taxing income toward taxing only consumption.

Conclusion

Let me close with this observation. I believe the United States has the wrong mix of taxes. I have written about this at some length. We rely much too heavily on the income tax and not nearly enough on consumption taxes in the United States. I do not believe we should rely entirely on a value-added tax or other consumption tax. Nor am I persuaded that we should eliminate the income tax altogether. Instead, I would enact a 10- to 14-percent value-added tax to finance a $100,000 exemption from the income tax as well as a reduction in the top income tax rate to 25 percent for both individuals and corporations. I have detailed this proposal in a YALE LAW JOURNAL article.[7] The numbers actually work. You don't need sunsets and phase-ins and all the other gimmicks now common in Congress in order to make this proposal work. It would have the great advantage of freeing about 150 million Americans from having to file tax returns. And it would be a much more coherent tax system. It would allow us to collect taxes on sales in the United States through the value added tax even when we are experiencing slippage in our ability to collect the income tax.

There are important reasons to take seriously a fundamental restructuring of the U.S. tax system domestically. We also need a fundamental re-thinking of the international tax regime. This conference has been an excellent opportunity for us to begin to debate these issues. Thank you.

ENDNOTES

* This speech took place on November 14, 2003, and has been edited and annotated.

1 MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION (2003); Michael J. Graetz and Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX LAW REV. 537 (2003); Michael J. Graetz and Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, LIV NAT'L TAX J., 4, at 771 (Sept. 2001); Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income—Inadequate Principles, Outdated Concept, and Unsatisfactory Policy*, 54 TAX LAW REV. 261 (2001), *also published at* 26 BROOKLYN J. INT'L LAW 1357 (2001); Michael J. Graetz and Michael O'Hear, *The "Original Intent" of U.S. International Taxation*, 51 DUKE LAW J. 1021(1997).

2 Mihir A. Desai, *New Foundations for Taxing Multinational Corporations*, TAXES, Mar. 2004.

3 *See* Graetz and Oosterhuis, *supra* note 1.

4 *Id.*

5 *Id.*, at 568–75.

6 H. David Rosenbloom, *Thinking About Subpart F: The Domestic Base Company*, TAXES, Mar. 2004.

7 Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE LAW J. 261 (Nov. 2002).

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of reported domestic profitability. In fact, the United States receives greater tax revenue from the foreign operations of American companies by taxing individual dividend income that it does by taxing corporate income. For example, Hines finds that for $100 of after-tax foreign profits generates $50 more dividends to domestic shareholders than does $100 of after-tax domestic profits.

While fears of runaway plants or a runaway tax base are overblown, runaway headquarters is a real concern. Measured by deal value, over the 1998 to 2000 period, 73 to 86 percent of large cross-border mergers and acquisitions involving U.S. companies have been structured so that the merged company has its headquarters abroad. In the case of Daimler-Chrysler, U.S. taxes were specifically identified as a significant factor in determining the location of the new parent firm. U.S.-based multinationals have most of their jobs and funds invested in their parent firms, losing the parents becomes more of a concern than simply increasing the amount of investment in foreign-owned affiliates.

Conclusions

Multinational corporations are an integral part of the U.S. economy, and their foreign activities are part of their domestic success. Accordingly, we must ensure that U.S. tax rules do not impact the ability of U.S. multinationals to compete successfully around the world. Policymakers should continue to review carefully the U.S. international tax system, including fundamental reforms like a territorial system, with a view to removing biases against the ability of U.S. multinationals to compete globally. Such reforms would enhance the well-being of American families and allow the United States to retain its world economic leadership. These gains should contribute to the growing interest in fundamental tax reform.

ENDNOTES

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