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All of a Piece Throughout: The Four Ages of U.S. International Taxation

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ALL OF A PIECE THROUGHOUT: THE FOUR AGES OF U.S. INTERNATIONAL TAXATION

Reuven S. Avi-Yonah*

This paper divides up the history of U.S. international taxation into four periods, on the basis of what was the basic theoretical principle underlying the major legislative enactments made in each period. The first period lasted from the adoption of the Foreign Tax Credit in 1918 to the end of the Eisenhower Administration, and was dominated by the concept of the right to tax as flowing from benefits conferred by the taxing state. The second period lasted from 1960 until the end of the Carter Administration, and was dominated by the concept of capital export neutrality and an emphasis on residence-based taxation. The third period lasted from 1981 until 1997, and was driven by the need to preserve the competitiveness of the U.S. economy in an increasingly globalized marketplace, resulting in an emphasis on source-based taxation, albeit with significant exceptions. The last period began with the decision to cooperate with the OECD's harmful tax competition project in 1998, and is marked by a continuous attempt to coordinate residence and source taxation to prevent both double taxation and double nontaxation.

Three general observations can be made on this evolution: (1) In some ways surprisingly little has changed in the course of the last hundred years: U.S. international taxation is still dominated by the need to balance the desire to prevent both double taxation and complete tax avoidance with sustaining the competitive position of U.S. businesses. (2) Although it is possible to detect some measure of cyclicity, in that the emphasis shifts from source to residence to source and back to residence again, the underlying balance does not shift very significantly, and the various theories advanced appear more as convenient support

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for pre-existing policy preferences than the real reason for policy changes. (3) On the basis of the history, it seems unlikely that the U.S. will in the near future make a clean break with the past either by abandoning all source-based taxation of foreigners or all residence-based taxation of U.S. persons.

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If the truth were known, the authors doubt the validity of any economic analysis in view of the generally poor quality of the available statistics and the general ability of authors in the field to use statistics for the support of their personal views.¹

¹ Alan G. Choate et al., *Federal Tax Policy for Foreign Income and Foreign Taxpayers—History, Analysis and Prospects*, 44 TEMP. L.Q. 441, 443 n.3 (1971).

I. INTRODUCTION

Periodization is a notorious problem for historians. At least since Alexis de Tocqueville's *L'Ancien Régime et la Révolution*,² historians have been aware that even a well-established dividing line like 1789 is fraught with difficulty and masks underlying continuities. Without periodization, however, history risks becoming "just one damn fact after another," lacking in both of Lytton Strachey's two requirements for good historical writing — selectivity and a thesis.

This paper represents a preliminary attempt to periodize the history of U.S. international taxation, and thereby also both presents a thesis on its evolution and some tentative predictions of its future course. This is uncharted territory for the historian, because with the exception of Graetz and O'Hear's important article on the early years, no meaningful historical work has been done on the topic.³ I hope that this preliminary attempt at defining the contours of the subject will help spur more work on this interesting area, comparable to the work Steven Bank and others have been doing on the history of the corporate tax.⁴

In what follows, I divide up the history of U.S. international taxation into four periods, on the basis of what I believe was the basic theoretical principle underlying the major legislative enactments made in each period. For each period, I try to identify the main principle, the major players (restricted to people who held policy-making positions), and some major developments that exemplify the application of the principle in practice.

The first period lasted from the adoption of the Foreign Tax Credit (FTC) in 1918 to the end of the Eisenhower Administration, and was dominated by the concept of the right to tax as flowing from benefits conferred by the taxing state. This, as Graetz and O'Hear point out, resulted in an emphasis on source-based taxation, although I believe they exaggerate the extent of that emphasis as well as the relative importance of Thomas Adams, while downplaying the contribution of Edwin Seligman.

The second period lasted from 1960 until the end of the Carter Administration. It was dominated by the concept of capital export

² ALEXIS DE TOCQUEVILLE, *L'ANCIEN RÉGIME ET LA RÉVOLUTION* (1856).

³ Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997) [hereinafter Graetz & O'Hear].

⁴ In particular, the Stanley Surrey papers at Harvard Law School cry out for an examination similar to what Graetz and O'Hear did for the Adams papers at Yale.

neutrality, an emphasis on residence-based taxation, as well as the personality of Stanley Surrey. These ideas still had an impact in the Tax Reform Act of 1986 (1986 Act) and beyond, but after 1981 they were subjected to increasing criticism, which is still reflected in current work by both academics and practitioners.⁵

The third period lasted from 1981 until 1997. The principal idea dominating developments in this period was the need to preserve the competitiveness of the U.S. economy in an increasingly globalized marketplace. This resulted in an emphasis on source-based taxation, albeit with significant exceptions designed to attract foreign capital into the U.S., and a decrease in residence-based taxation.

It could be argued that the ideas developed in the third period are still dominant, and they certainly continue to resonate in debates in Washington, DC.⁶ However, I would argue that beginning with the decision to cooperate with the Organization for Economic Cooperation and Development's (OECD) harmful tax competition project in 1998, and continuing (surprisingly) into the Bush Administration, a new period has started that is marked by a continuous attempt to coordinate residence and source taxation to prevent both double taxation and double nontaxation. This type of coordination is a different kind of response to globalization than the typical competitive move of the third period, and therefore justifies marking post-1998 developments as a new period.

There are three general observations that can be made on this evolution. The first is that in some ways surprisingly little has changed in the course of the last hundred years: U.S. international taxation is still dominated by the same kind of concerns that troubled Adams and Seligman in the 1910s and 1920s, namely how to balance the desire to prevent both double taxation and complete tax avoidance with sustaining the competitive position of U.S. businesses. The second one is that although it is possible to detect some measure of cyclicity,

⁵ See, e.g., William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income from 1909 to 1989: How a Tilted Playing Field Developed*, 43 TAX NOTES 1379 (June 12, 1989) (describing the pre-1960s period as a *golden age* and decrying the continuing influence of Surrey's ideas); Michael J. Graetz, *Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001); James R. Hines, Jr., *The Case Against Deferral: A Deferential Reconsideration*, 52 NAT'L TAX J. 385 (1999).

⁶ See, for example, the papers presented at the recent conference on "The U.S. International Tax Regime: Confronting the Challenge of the Evolving Global Marketplace," organized by the Tax Council Policy Institute in Washington, DC (Feb. 10-11, 2005), available at www.tcpi.org [hereinafter TCPI Conference Papers].

in that the emphasis shifts from source to residence to source and back to residence again, the underlying balance does not shift very significantly, and the various theories advanced appear more as convenient support for pre-existing policy preferences than the real reason for policy changes. Finally, on the basis of this history, it seems unlikely that the U.S. will in the near future make a clean break with the past either by abandoning all source-based taxation of foreigners (as suggested by some fundamental tax reform proposals such as the Flat Tax) or all residence-based taxation of U.S. persons (as suggested by some advocates of complete territoriality).⁷ Instead, we are likely to see gradual reforms of the existing system, perhaps with some increased measure of coordination with other countries.

II. THE AGE OF BENEFITS (1918-1960)

The formative period of the U.S. international tax regime, as well as the overall international tax regime, was (as Graetz and O'Hear first pointed out) the period between the two World Wars. However, the first period can legitimately be extended through the end of the Eisenhower Administration, since the 1954 Internal Revenue Code embodies, with very few changes, the consensus reached in the 1920s and 1930s.

A. Principle

The major principle underlying the U.S. international tax regime in this period was the idea that taxing jurisdiction should be based on benefits conferred by the taxing state. This may seem surprising since in the domestic context the shift from personal property taxation to income taxation was accompanied by a shift in the underlying rationale of taxation from benefits to ability to pay, as illustrated by the work of Seligman and others.⁸ However, in the international context, "ability to pay" immediately raises the question "whose ability?", and to answer this question, tax analysts then and today refer to the notion of benefits.

This emphasis can be found in the work of all three principal

⁷ See *supra* note 6 for a discussion of both proposals.

⁸ For a discussion of this shift, see RICHARD J. JOSEPH, *THE ORIGINS OF THE AMERICAN INCOME TAX: THE REVENUE ACT OF 1894 AND ITS AFTERMATH* (2004); Dennis J. Ventry, Jr., *Equity Versus Efficiency and the U.S. Tax System in Historical Perspective*, in *TAX JUSTICE: THE ONGOING DEBATE* 25 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002).

American figures of this period — Thomas Adams, the Yale economics professor who was the principal international tax adviser to the U.S. Treasury in the 1910s and 1920s; Edwin Seligman, the Columbia economics professor who was the guiding spirit behind the 1923 “four economists” report to the League of Nations (1923 Report), which laid the foundations for the international tax regime; and Mitchell Carroll, the lawyer who founded International Fiscal Association (IFA) and was involved in the League’s early model tax treaties.

Thomas Adams, as Graetz and O’Hear pointed out, clearly emphasized the costs imposed by business as a justification for taxing business at source: “[B]usiness ought to be taxed because it costs money to maintain a market and those costs should in some way be distributed over all the beneficiaries of that market.”⁹ This emphasis on benefits taxation led Adams to justify source-based taxation: “Every state insists upon taxing the nonresident alien who derives income from source [sic] within that country, and rightly so, at least inevitably so.”¹⁰

However, in my opinion Graetz and O’Hear exaggerate Adams’ preference for source-based taxation. Adams thought that it was generally justified on benefits grounds to tax at source, although the last cite suggests that it may have been more the practical inevitability of source taxation than its theoretical justification that led him to this emphasis. But Adams was never an advocate of pure source taxation; he was, after all, the main architect of the FTC, which was explicitly based on a rejection of pure source taxation, i.e., a continental European-type exemption system. Adams’ preference for the credit was grounded explicitly in his concern that pure source-based taxation would lead to double nontaxation: “[T]he state which with a fine regard for the rights of the taxpayer takes pains to relieve double taxation, may fairly take measures to ensure the person or property pays at least one tax.”¹¹ Moreover, Adams acknowledged that

⁹ Thomas S. Adams, *The Taxation of Business*, PROC. 11TH ANN. CONF., NAT’L TAX ASS’N 185, 186 (1917); Graetz & O’Hear, *supra* note 3, at 1036.

¹⁰ Graetz & O’Hear, *supra* note 3, at 1037 (quoting Thomas S. Adams, *International and Interstate Aspects of Double Taxation*, PROC. 22D ANN. CONF. ON TAX’N, NAT’L TAX ASS’N, 193, 197 (1929)). The same recognition of the inevitability of source taxation is reflected in *Report on Double Taxation Submitted to the Financial Comm.*, League of Nations Doc. E.F.S. 73 F.19, 40 (1923) [hereinafter 1923 Report].

¹¹ Graetz & O’Hear, *supra* note 3, at 1039 n.72 (quoting Thomas S. Adams, *Interstate and International Double Taxation*, in LECTURES ON TAXATION 112–13

progressive taxation, which he supported since his Wisconsin days, was not possible in an exclusively source-based system.¹²

Graetz and O'Hear also mischaracterize the views of Edwin Seligman, whom they portray as an advocate of pure residence-based taxation.¹³ While it is true that the 1923 Report, of which Seligman was the principal author, rejects the "exchange" (benefits) theory of tax in favor of the "faculty" (ability to pay) theory, this is merely a background, theoretical preference, similar to modern economists' theoretical preference for pure residence taxation.¹⁴ In practice, the 1923 Report acknowledges the inevitability of source-based taxation, and moreover, attempts to ground both source *and* residence taxation in a benefits-based concept, "economic allegiance." Consider, for example, the following:

[T]he taxes, though measured by things, eventually fall upon persons and ought to fall upon them in the aggregate according to the total resources of the individual. . . . [W]hen the money has left the pocket of the individual, its destination is not a single one but is due to all those governments to whom the individual owes economic allegiance. . . .

In the attempt to discover the true meaning of economic allegiance, it is clear that there are three fundamental considerations: that of (1) production of wealth; that of (2) possession of wealth; that of (3) disposition of wealth. We have to ask where wealth is really produced, i.e., where does it really come into existence; where is it owned; and, finally, where is it disposed of?

By production of wealth we mean all the stages which are involved up to the point of the wealth coming to fruition, that is, all the stages up to the point when the physical production has reached a complete economic destination and can be acquired as wealth. The oranges upon the trees in California are not acquired wealth until they are picked, and not even at

(Roswell Magill ed., 1932)).

¹² *Id.* at 1040.

¹³ *Id.* at 1035.

¹⁴ 1923 Report, *supra* note 10, at 18. For the position of modern economists, see, e.g., Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, in TAXATION IN THE GLOBAL ECONOMY 11 (Assaf Razin & Joel Slemrod eds., 1990); Joel B. Slemrod, *Free Trade Taxation and Protectionist Taxation*, 2 INT'L TAX & PUB. FIN. 471 (1995).

that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the consumer can use them. These stages, up to the point where wealth reaches fruition, may be shared in by different territorial authorities. By disposition of wealth we mean the stage when the wealth has reached its final owner, who is entitled to use it in whatever way he chooses. He can consume it or waste it, or re-invest it; but the exercise of his will to do any of these things resides with him and there his ability to pay taxes is apparent. By possession of wealth we refer to the fact that between the actual fruition of production into wealth and the disposing of it in consumption there is a whole range of functions relating to establishing the title to wealth and preserving it. These are largely related to the legal framework of society under which a man can reasonably expect to make his own what has been brought into existence. A country of stable government and laws which will render him those services without which he could not enter into the third stage of consumption with confidence is a country to which he owes some economic allegiance.¹⁵

This definition of “economic allegiance” is clearly based on a benefits theory of taxation, which is used to justify both what we would regard as source-based taxation (“production of wealth”) and what we would regard as residence-based taxation (“possession of wealth” and “disposition of wealth”).

Finally, Mitchell Carroll’s primary innovation, the idea that profits should be apportioned among taxing states but no state should tax business profits that were not earned through a “permanent establishment,” likewise rested on the notion that taxation of business is justified by the benefits conferred by the taxing states and that, in the absence of a permanent establishment, those benefits are too minute to justify taxation.¹⁶

¹⁵ 1923 Report, *supra* note 10, at 20, 22–23.

¹⁶ Mitchell B. Carroll, *International Tax Law: Benefits for American Investors and Enterprises Abroad*, 2 INT’L LAW. 692, 701 (1968); Graetz & O’Hear, *supra* note 3, at 1088.

B. Players

Graetz and O'Hear consistently emphasize the role of Adams, whom they describe as the "founder" of the U.S. system of international taxation.¹⁷ They also argue that previous writers have overemphasized the role of Seligman and the 1923 Report, which (they argue) had no real impact on the subsequent development of the treaty regime by the League.¹⁸

There is no question that Adams played the principal role in forming U.S. international tax policy in the late 1910s and early 1920s, and Graetz and O'Hear made an important contribution in bringing that role to light and in using the Adams papers at Yale to reveal many interesting facts about the "original intent" of U.S. international taxation. However, I believe they both exaggerate the role played by Adams, and undervalue the role of the 1923 Report and of Seligman.

Adams was clearly the guiding spirit behind both the original adoption of the FTC in 1918 and the adoption of the overall limitation in 1921 (designed, it should be noted, to preserve U.S. residence-based taxation of its residents on U.S. source income). However, as Graetz and O'Hear describe it, the FTC was miraculously adopted by Congress merely because of Adams' proposal, at a time when revenues were badly needed for the war. As they note, "[t]he FTC represented what was an extraordinarily generous measure for its time Such generosity was virtually unprecedented."¹⁹ They then state that "[t]o Adams' surprise, the FTC provoked little opposition (or indeed notice) and became law in 1919."²⁰

It seems to me highly unlikely that the FTC was adopted primarily due to Adams' influence. Instead, I would suggest that the main reason for the difference between the U.K., which argued for pure residence-based taxation, and the U.S., which adopted the FTC, had to do with the different relationships between business and government in the two countries. In the U.K., the government's position reflected the revenue concerns of a capital exporting country. In the U.S., Congress is much more amenable to lobbying by businesses, and in the post-war atmosphere (the 1918 Act was actually enacted in 1919) was particularly open to arguments about double

¹⁷ Graetz & O'Hear, *supra* note 3, at 1027.

¹⁸ *Id.*

¹⁹ *Id.* at 1045–46.

²⁰ *Id.* at 1047; *see also id.* at 1072 (listing three factors behind the U.S. position in favor of the FTC, two of which are based on Adams' views, but not mentioning the views of U.S. business interests).

taxation, given the high post-war tax rates in Europe.

Nor do I think that Adams himself was immune to such practical considerations. Much of his post-war work was done through the International Chamber of Commerce, and he was generally receptive to competitiveness arguments.²¹ His 1921 unsuccessful effort to enact an exemption regime for “foreign trade corporations” (the first in a long list of dubious export subsidies) shows both his affiliation with pro-business interests, and the limits of his influence even in a Republican Congress (the provision was defeated under attack by Senator LaFollette, arguing that it represented an inequitable tax break for the wealthy and that it would encourage the flight of capital and jobs abroad).²²

On the other hand, I believe Graetz and O’Hear underestimate the importance of the 1923 Report and of its principal author, Edwin Seligman. It is true, as they argue, that the ultimate League models were drafted by a committee of technical experts, who relied on the work of earlier treaty drafters and paid little attention to the theoretical arguments of the 1923 Report. However, the 1923 Report contained two crucial innovations that laid the groundwork for all subsequent work by the League. First, the 1923 Report (building on earlier examples, including the U.S. source rules) laid great emphasis on the classification of income into various categories, primarily active and passive. Second, and crucially, the 1923 Report was the first work by representatives of capital exporting and importing countries to lay out the fundamental compromise underlying the treaty network, under which active (business) income should be taxable primarily at source, while passive (investment) income should be taxable primarily at residence. This compromise is reflected theoretically in earlier work by Adams,²³ but its adoption by the four economists in the 1923 Report was primarily due to the influence of Seligman, who mediated successfully between the extreme positions taken by the representatives from capital importing countries (Italy and Belgium) and capital exporting countries (the U.K.).²⁴ This compromise was reflected in the later positions of the League technical experts and in

²¹ *Id.* at 1049–50.

²² *Id.* at 1062.

²³ Graetz & O’Hear, *supra* note 3, at 1036–41.

²⁴ 1923 Report, *supra* note 10, at 45–51; Graetz & O’Hear, *supra* note 3, at 1065 (“The personal income tax is laid upon the individual in his capacity of consumer, and is paid where he resides; whereas the business income tax is paid by men in their productive or commercial capacity at the place where the income is earned.”) (quoting Adams, *supra* note 9, at 193).

the League models, and it is highly unlikely that it was reached in that context without regard to the earlier agreement embodied in the League-sponsored 1923 Report.

Finally, more credit than Graetz and O'Hear give should be bestowed on Carroll, who was not just "Adams' assistant" but was the author of the most important pre-war study of the allocation of income among taxing jurisdictions, as well as a principal mover behind the main limitation on source taxation in the League models, namely the permanent establishment.

C. Applications

Many of the major foundation stones of the current international tax regime were laid in this period, and they all reflect the impact of the predominant benefit theory of taxation. The FTC, as we have seen, resulted from Adams' belief in the (benefits-based) justification of source-based taxation, added to his refusal to allow double nontaxation. The overall limitation, enacted in 1921, resulted from the reality of higher foreign tax rates and Congress's disinclination to permit the FTC to override U.S. taxation of U.S. residents on U.S. source income, which again reflected a benefits view.

The 1923 compromise and the subsequent model treaties reflected Seligman's view that while pure residence-based taxation may be an ideal for the future, in practice source-based taxation would persist and therefore there should be a division between source and residence jurisdictions based on the degree of benefits accorded different types of income.²⁵ The concept of "economic allegiance" itself was based, as we have seen, on a benefits analysis that justified both source and residence taxation.

The permanent establishment limitation on source taxation likewise reflects Carroll's view that in the absence of a permanent establishment, the benefits accorded were too tenuous to justify taxation by the source state.²⁶ Carroll's work on apportionment of profits among taxing jurisdictions likewise reflected the benefits principle.²⁷

These innovations continued to form the major building blocks of U.S. international taxation through the end of the 1950s. Attempts to eliminate the FTC in the 1930s were defeated, although the overall

²⁵ 1923 Report, *supra* note 10, at 40–42, 45–51.

²⁶ See, e.g., Carroll, *supra* note 16, at 701, 705–06.

²⁷ *Id.* at 703–06.

limitation was replaced in 1932 with the more restrictive per country limitation to prevent averaging. The only major new ideas were the introduction in 1935 of final gross-based withholding taxes on passive income earned by nonresidents, which was motivated by administrative necessity, and the introduction of the foreign personal holding company regime in 1937, which prefigured later developments but was justified purely on equity grounds. Overall, as McClure and Bouma point out, the “playing field” in 1959 (when a proposal to grant partial exemption to some domestic corporations was soundly defeated) was essentially the same as that established in the early 1920s.²⁸

III. THE AGE OF NEUTRALITY (1961-1980)

As both Graetz and O’Hear and McClure and Bouma emphasized (from different perspectives), the advent of the Kennedy Administration brought about a profound change in the nature of the principle underlying U.S. international taxation. Gone was the old emphasis on benefits and fairness; instead, the argument was henceforward based on the economic concept of efficiency, which in the international context translated into neutrality (and in particular, capital export neutrality). This shift marked the emergence of a new orthodoxy that was to become dominant in the 1960s and 1970s, and that was still evident (albeit under constant attack) as recently as 2000.

The principal author of this shift, and the principal (albeit unnamed) target of the critiques of both Graetz and O’Hear and McClure and Bouma, was the Harvard law professor who became the first Assistant Secretary for Tax Policy, Stanley Surrey. Surrey’s spirit hovers over current debates on the proper direction of U.S. international taxation much more prominently than those of either Adams or Seligman. When both Graetz and O’Hear and McClure and Bouma criticized the emphasis on residence taxation and on neutrality in the late 1970s and early 1980s, it is Surrey who is the true target of their attacks, rather than Seligman. When they come to make practical suggestions for reform, it is Surrey’s Subpart F, rather than Adams’ FTC or Seligman’s distinction between active and passive income that was the object of the attack.

²⁸ See generally McClure & Bouma, *supra* note 5.

A. Principle

The shift to the new principle of neutrality can be seen most clearly in Secretary Dillon's 1961 address to the Committee on Ways and Means, proposing to end deferral by taxing currently all income of foreign corporations controlled by U.S. persons. Secretary Dillon justified the proposal in the following terms:

It is sometimes contended that if U.S. firms are to compete successfully abroad they must enjoy as favorable a tax treatment as their foreign competitors. I believe that this argument has been overly stressed. A difference in tax rates, I said before, should not handicap companies producing abroad, although it may slow the rate of expansion. But even if this argument were fully valid, it could not be a decisive objection to our proposal. As long as the tax systems of various countries differ—and I venture to predict that this will be the case for years to come—we must make a firm choice. Either we tax the foreign income of U.S. companies at U.S. tax rates and credit income taxes paid abroad, thereby eliminating the tax factor in the U.S. investor's choice between domestic and foreign investment; or we permit foreign income to be taxed at the rates applicable abroad, thereby removing the impact, if any, which tax rate differences may have on the competitive position of the American investor abroad. Both types of neutrality cannot be achieved at once. I believe that reasons of tax equity as well as reasons of economic policy clearly dictate that in the case of investment in other industrialized countries we should give priority to tax neutrality in the choice between investment here and investment abroad.²⁹

The two types of neutrality referred to were of course what came to be known as “capital export neutrality” (CEN) (neutrality in location of investment) and “capital import neutrality” (CIN) (neutrality in source of investment). Both types, as well as the preference for CEN over CIN, were first developed by the economist Peggy Richman (later Peggy Musgrave) in her 1963 book, *The*

²⁹ President's Tax Message Along With Principal Statement, Detailed Explanation, and Supporting Exhibits and Documents: Hearing Before the House Comm. on Ways and Means, 87th Cong. 30 (1961) (statement of Douglas Dillon, Treas. Sec'y).

Taxation of Foreign Investment Income.³⁰ In drafting Dillon's statement, Surrey decided to use the more scientific economist's terms, rather than the traditional emphasis on equity or fairness, as the major argument in favor of the proposal to end deferral.

Arguably, there was no need in 1961 to rely on CEN as a justification for ending deferral. The actual mechanism proposed by the Kennedy Administration to achieve this aim, namely a deemed dividend of the earnings of "controlled foreign corporations" (CFCs) to their U.S. shareholders, was the same one Congress adopted in 1937 for "foreign personal holding corporations" (FPHCs) on pure equity grounds.³¹ Assuming that the Administration and Congress believed in taxing U.S. corporations on a residence basis, the same equity argument (that it is unfair to distinguish between U.S. corporations earning only U.S. source income and U.S. corporations earning some foreign source income through their subsidiaries) could have been made in 1961 as well.

Moreover, a careful reading of Secretary Dillon's statement reveals what contemporary observers like David Tillinghast have also stated, namely that the principal reason for the proposal to end deferral had little to do with CEN, and a lot to do with concern over the U.S. balance of payments, which had deteriorated rapidly in the late 1950s as U.S. multinationals expanded their operations abroad.³² In an era in which every dollar was supposed to be backed with gold reserves, this deterioration posed a real threat that foreign holders of dollars could cause a "run" on Fort Knox. Dillon's statement devotes over three pages to discussing this problem, compared to the single paragraph devoted to CEN.³³ Moreover, the adoption of Subpart F was followed in 1963 by the interest equalization tax, which was aimed directly at another aspect of the balance of payment problem — the higher interest rates available overseas.

However, the emphasis on CEN "stuck" and became the mainstay of U.S. international tax policy. For example, in the 1977 Blueprints for Basic Tax Reform (written primarily by the late Republican economist David Bradford), CEN was given as a major reason for

³⁰ PEGGY B. RICHMAN, *TAXATION OF FOREIGN INVESTMENT INCOME: AN ECONOMIC ANALYSIS* (1963). The ideas behind this book were circulating before 1960, and it is widely recognized as the source of both CEN and CIN in Dillon's address.

³¹ Revenue Act of 1937, Pub. L. No. 75-377, 50 Stat. 813. §§ 201-207.

³² David R. Tillinghast, *The Passage of the Revenue Act of 1962: Subpart F at its Birth*, presented at TCPI Conference Session 1, *supra* note 6, at 5-6.

³³ See President's Tax Message, *supra* note 29.

preferring residence-based over source-based taxation.³⁴ The same emphasis can be found in numerous Treasury publications in the 1970s and 1980s.³⁵ As late as the 2000 Treasury Study of Subpart F, CEN is still defended as the mainstay of U.S. international tax policy.³⁶ After 1960, neutrality became the dominant normative argument, while what was arguably the main reason for enacting Subpart F, namely the balance of payment issue, disappeared after President Nixon's 1971 decision to cease backing the dollar with gold reserves.

B. Players

The dominant player in the 1960s was undoubtedly Stanley Surrey. As the Assistant Secretary for Tax Policy from 1961 to 1969, he was behind every major tax initiative of the Kennedy and Johnson Administrations, including in particular Subpart F (1962), the Foreign Investment Tax Act (1966), and the transfer pricing regulations (1968). Nor did Surrey's influence disappear after he returned to Harvard. The Tax Reform Act of 1969 was clearly influenced by him, as was the tax expenditure budget (1974), and even the 1986 Act could still be seen as implementing his ideas (especially in regard to the FTC and the "baskets"). Outside the U.S., Surrey was also a major player in international organizations like the OECD (which issued its model tax treaty in 1963 and its transfer pricing guidelines in 1977, both heavily influenced by Surrey) and the UN (Surrey was the major force behind the UN 1980 model tax treaty). As Stanley Langbein has cleverly shown, Surrey's hand can be detected in many official publications that do not mention him as their author.³⁷

Despite the overt emphasis on CEN, it could be argued that Surrey's main goal was not so much the achievement of CEN, but rather the prevention of double nontaxation. This emphasis can be seen already in his 1959 fight against ratification of the treaty with

³⁴ U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 98-100 (1977).

³⁵ See, e.g., THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 383 (1985) ("The longstanding position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions.").

³⁶ U.S. DEP'T OF THE TREASURY, THE DEFERRAL OF INCOME EARNED THROUGH U.S. CONTROLLED FOREIGN CORPORATIONS: A POLICY STUDY (Dec. 2000).

³⁷ Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625 (Feb. 17, 1986).

Pakistan, which contained a tax sparing provision. Surrey argued that this would result in an unacceptable reduction in U.S. taxation of its residents on U.S. source income, and that it was inconsistent with the purpose of the FTC and equivalent to tax exemption.³⁸ The result was that the Senate rejected the treaty, and that the U.S. thereafter adopted its inflexible position (which remains in force today) in opposition to tax sparing as a means of fostering development.

The same emphasis on preventing double nontaxation can be seen in some of the provisions of Subpart F, especially the base company rules and the branch rule.³⁹ In both cases, U.S. multinationals were using low tax jurisdictions (especially Switzerland) to avoid both U.S. and foreign taxation of the same income. Surrey took the view that this was inconsistent with CEN and with the concept of worldwide taxation of residents.⁴⁰ The same idea underlay his emphasis on transfer pricing enforcement as well, since a major purpose of the transfer pricing regulations was to bolster the Internal Revenue Service (Service) in cases like *DuPont* (involving a base company in Switzerland).⁴¹

Moreover, Surrey, like Adams before him, emphasized the role of the U.S. in achieving international cooperation in preventing double nontaxation. His major innovations, Subpart F and the transfer pricing regulations, were copied by other countries and became a new international baseline through the OECD.

Surrey's principal assistant at the Treasury in the early years was David Tillinghast, who effectively was the first International Tax Counsel. Through his work at the Treasury and later at IFA, Tillinghast was a major force in implementing some of Surrey's ideas in the 1960s and later. Other Surrey protégés such as Paul McDaniel and Hugh Ault likewise played important roles in maintaining Surrey's influence after he left public office.

C. Applications

The principal application of the new principle of CEN was obviously Subpart F, enacted in 1962 after a major fight in Congress

³⁸ Stanley S. Surrey, *The Pakistan Tax Treaty and "Tax Sparing,"* 11 NAT'L TAX J. 156 (1958).

³⁹ I.R.C. § 954(d); see also U.S. DEP'T OF THE TREASURY, *supra* note 36, at xiii-xiv.

⁴⁰ See President's Tax Message, *supra* note 29.

⁴¹ *E.I. Du Pont de Nemours and Co. v. United States*, 1978 WL 3449 (Ct.Cl. Trial Div.).

over the competing claims of CEN and competitiveness. It is common to assert that Subpart F as enacted represented a compromise between CEN and competitiveness, in that the Administration gave up on taxing CFCs on all of their income. While that is true, in practice the Administration got over 90% of what it wanted, because (as David Tillinghast has emphasized) in the early 1960s the vast majority of active U.S. investment abroad went to high tax countries in Europe and to Canada.⁴² Given that state of affairs, the Administration could give up on taxing active business income of CFCs without diminishing CEN, since the taxes foregone by the U.S. were in fact collected by other countries.⁴³ Those situations in which active business income could be earned without foreign tax were explicitly dealt with by special provisions like the base company rules and the branch rule.⁴⁴ It is also telling that while income that was subject to foreign tax at 90% or more of the U.S. rate was excluded from the reach of Subpart F,⁴⁵ there was no corresponding provision that included low-taxed income, precisely because active income was unlikely to be low-taxed.

It is also common to assert that CEN, as applied by Surrey, resulted in a preference for residence over source-based taxation. This is Graetz and O'Hear's principal argument why the "original intent" of U.S. international taxation, as developed by Adams, was different from post-1960 development under Surrey and his successors.⁴⁶ However, just as it appears to me that Graetz and O'Hear underplay the role of residence taxation for Adams, they understate the importance of source taxation to Surrey. Both the 1966 Foreign Investors Tax Act (1966 Act),⁴⁷ which invented the concept of "effectively connected" income and thereby drew some foreign source income into the U.S. taxing jurisdiction of nonresidents, and the 1968 transfer pricing regulations,⁴⁸ were designed to bolster U.S. source taxation. (Admittedly, the 1966 Act also weakened source taxation by eliminating the force of attraction

⁴² Tillinghast, *supra* note 32.

⁴³ *Id.*

⁴⁴ I.R.C. § 954(d); *see also* U.S. DEP'T OF THE TREASURY, *supra* note 36, at xiii–xiv.

⁴⁵ I.R.C. § 954(b)(4); *see also* U.S. DEP'T OF THE TREASURY, *supra* note 36, at 149.

⁴⁶ *See* Graetz & O'Hear, *supra* note 3, at 1041–60 (discussing Adams' work regarding the FTC and source-based taxation).

⁴⁷ Foreign Investors Tax Act of 1966, Pub. L. No. 89-809, 80 Stat. 1539.

⁴⁸ Treas. Reg. 1.482-2 (1968).

rule, but this was done under budgetary pressure to attract foreign passive investors.) Moreover, while Surrey was fully cognizant of the U.S. interests as a capital exporting country, he was also clearly in favor of source-based taxation, especially in the case of developing countries, as shown by his work on the UN model treaty.⁴⁹

I would argue that Surrey's principal positions, including the prevention of double nontaxation by imposing residence tax on low-taxed income of CFCs, and his defense of source-based taxation via the transfer pricing regulations, were entirely consistent with the positions taken by Adams in the FTC area and in the developments leading to the 1920s compromise. What changed from 1920 to 1960 was not so much the policy, but rather the underlying principle, with Adams emphasizing benefits and Surrey emphasizing neutrality.

IV. THE AGE OF COMPETITION (1981-1997)

A. Principle

As we have seen, Surrey's emphasis on neutrality, and especially CEN, lasted well into the 1980s and even beyond. In some ways, the 1986 Act can be seen as the culmination of Surrey's ideas, both in its general emphasis on base-broadening measures, and in the details of its international provisions, such as the limitations on cross-crediting via the basket regime, the expansion of Subpart F, the PFIC regime, and the "super royalty" rule of section 482.⁵⁰ Indeed, the best defense of the international aspects of the 1986 Act was written by Charles Kingson in his article, *The Coherence of International Taxation*, which is also the best contemporary academic exposition of Surrey's point of view.⁵¹

However, from about 1980, CEN began to be subjected to increasing criticism as an idea that was too attuned to global welfare and not sufficiently cognizant of U.S. interests.⁵² In an era of increasing globalization, it was felt that the U.S. should pay more

⁴⁹ U.N. DEP'T OF INT'L ECON. & SOC. AFFAIRS, U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980).

⁵⁰ See generally Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

⁵¹ Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151 (1981); see also Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 AM. J. TAX POL'Y 1 (1991).

⁵² See, e.g., McClure & Bouma, *supra* note 5; Graetz, *supra* note 5; Hines, *supra* note 5.

attention to the competitiveness of its multinationals in the face of increasing foreign competition. In addition, the need to attract increasingly mobile foreign capital led the U.S. to reduce source-based taxation of foreign investment income, while at the same time the increased emphasis on source taxation and budgetary pressures led to increased source-based taxation of business income.

While some of the arguments were couched in neutrality terms (such as CIN), the predominant emphasis of this period was on competitiveness and competition.⁵³ Tax competition, and especially competition for headquarters of multinational firms, was considered either as a positive development or at least as something the U.S. had to contend with. The new phenomenon of tax arbitrage (exploiting differences in the tax rules of two countries to create double nontaxation) was likewise considered a normal expression of different country interests.

B. Players

While no U.S. policymaker dominated this period as much as Adams or Surrey dominated theirs, three people stand out as providing the principal theoretical rationales for the new unilateralist, U.S.-first attitude that characterized U.S. international taxation in this period: Charles McLure, David Rosenbloom, and Michael Graetz.

McLure was the Deputy Assistant Secretary for Tax Policy in the early 1980s, and his main role was to formulate policy on state tax issues and the formulary apportionment debate. He also played a significant role in enacting the portfolio interest exemption, although he later came to regret some of its effects, especially on capital flight from Latin America. However, his main contribution in this context is his theoretical work, both in defense of tax competition, and in his vision of a world without income taxes to which tax competition could lead.⁵⁴

Rosenbloom was International Tax Counsel in the Carter Administration and wrote an important article on U.S. treaty policy in the early 1980s. His major contribution to the competitiveness literature came in his 1998 Tillinghast lecture at New York University, in which he launched an extensive attack on the notion of an

⁵³ *Id.*

⁵⁴ Charles E. McLure, Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm*, 45 NAT'L TAX J. 145 (1992); Charles E. McLure, *Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander?*, 39 NAT'L TAX J. 341 (1986).

“international tax system” in the name of U.S. sovereignty, and an extensive defense of tax arbitrage as the natural result of different policy preferences among countries.⁵⁵

Finally, Graetz was Deputy Assistant Secretary for Tax Policy in the first Bush Administration. His major contributions in that role were domestic, including the Treasury integration study, which led to the adoption of partial integration in 2003, and the “Graetz plan” for exempting most middle-class taxpayers from the income tax and substituting a value-added tax.⁵⁶ However, Graetz learned enough about the importance of international taxation at the Treasury to remake himself as the most prominent advocate of unilateralism and source-based taxation and the most thorough critic of CEN in the 1990s. His main contributions in this vein were his attack on CEN in his Tillinghast lecture (1997), his advocacy of territoriality, and last but not least, his historical studies of the Adams period, which he used as a vehicle to call for an abandonment of Surrey’s emphasis on CEN and residence-based taxation in favor of equity and source-based taxation.⁵⁷

C. Applications

The new emphasis on competition and unilateralism was already evident in the Foreign Investment in Real Property Tax Act (FIRPTA),⁵⁸ enacted in the waning days of the Carter Administration as a way to “get” foreign (especially Japanese) investors who allegedly profited from U.S. economic malaise in the 1970s to buy U.S. real

⁵⁵ H. David Rosenbloom, *The David R. Tillinghast Lecture: International Tax Arbitrage and the “International Tax System,”* 53 TAX L. REV. 137 (2000).

⁵⁶ See U.S. DEP’T OF TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEM: TAXING BUSINESS INCOME ONCE (Jan. 1992); U.S. DEP’T OF TREASURY, A RECOMMENDATION FOR INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (Dec. 1992); Michael J. Graetz & Alvin C. Warren, Jr., *Integration of the U.S. Corporate and Individual Income Taxes: An Introduction*, TAX NOTES TODAY (Sept. 27, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit., 1999 TNT 186-89) (examining Treasury reports relating to integrating individual and corporate taxes in the U.S.).

⁵⁷ Michael J. Graetz, *The David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 TAX L. REV. 261 (2001); Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537 (2003); Graetz & O’Hear, *supra* note 3; Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 NAT’L TAX J. 771 (2001).

⁵⁸ Foreign Investment in Real Property Tax Act of 1980, Pub. L. No. 96-499, 94 Stat. 2682.

property at “fire sale” prices. A similar emphasis on “leveling the playing field” with foreigners can be seen behind the branch profit tax provisions of the 1986 Act (including a statutory treaty override)⁵⁹ and in the earnings stripping limitations on the deductibility of interest,⁶⁰ enacted in 1989 amid anxiety about foreign debt-financed takeovers of U.S. firms.

The emphasis on competition, however, can be seen most clearly in two trends that began in 1984. On the one hand, the budget deficit and the increased mobility of capital led to a series of steps that reduced U.S. source-based taxation of foreign investors, beginning with the portfolio interest exemption (1984),⁶¹ continuing with the source rule for derivatives (1991),⁶² and the expanded safe harbor for passive investors in securities and commodities (1997).⁶³ The portfolio interest exemption led to a world-wide trend toward exempting foreigners from withholding taxes in the name of attracting mobile capital.

On the other hand, increasing theoretical critiques of CEN and the “tilted playing field” it produced for U.S. multinationals, reflected, for example, in McClure and Bouma’s article, led to a significant reduction in the scope of Subpart F from 1994 to 1997.⁶⁴ This began with the abolition of the short-lived section 956A in 1994, continued with the nonapplication of the PFIC regime to CFCs in 1996, and culminated with the banking and insurance exceptions, enacted over President Clinton’s veto in 1997.⁶⁵ In addition, in an (arguably) unplanned development, the extension of the “check the box” rules to foreign entities in 1997 led to widespread avoidance of the base company rules by using “disregarded entities.”⁶⁶

Overall, the result of these developments has been a cutting back on U.S. residence-based taxation of U.S. multinationals. In addition, while in some ways there has been more emphasis on source-based taxation of active income, in practice most of the new provisions (FIRPTA, the branch profit tax, and earnings stripping) proved easy to avoid, while competitive considerations led to significant erosion in

⁵⁹ I.R.C. § 884.

⁶⁰ I.R.C. § 163(j).

⁶¹ I.R.C. § 871(h).

⁶² Treas. Reg. 1.863-7 (1991).

⁶³ I.R.C. § 864(b)(2).

⁶⁴ See generally McClure & Bouma, *supra* note 5.

⁶⁵ U.S. DEPT OF TREASURY, *supra* note 36, at 131–62 (listing the significant amendments to Subpart F since 1962).

⁶⁶ T.D. 8697, 1997-1 C.B. 215.

U.S. source-based taxation of passive income.

V. THE AGE OF COOPERATION? (1998-)

A. Principle

Periodization becomes more and more difficult as one approaches the present. In some ways, it can be argued, we still live in the age of competitiveness, as indicated for example by the American Jobs Creation Act of 2004 (AJCA),⁶⁷ which cut back on some of the measures adopted in 1986 and earlier (repeal of PFHC regime, worldwide interest expense allocation, reduction of the FTC baskets). In my opinion, however, the AJCA changes were mostly justified simplification measures, and the law is more remarkable for what it did not do, namely enact any permanent move toward territoriality or significant further reduction in the scope of Subpart F. This is surprising because AJCA was enacted with the Republicans dominating both houses of Congress and the White House, and with unprecedented pressure from groups like the National Foreign Trade Council (NFTC) toward a territorial regime in the name of competitiveness.

Instead, I would argue that a new period began with the decision of the Clinton Administration to cooperate with the OECD's harmful tax competition initiative from 1998 onward. This period is marked by a different response to globalization than unilateral competition — acting in concert with our major trading partners to reduce both double taxation and double nontaxation. Because the emphasis is on concerted action, this move promises a way out from the need to balance U.S. international tax policy goals with competitiveness considerations. It thus has the potential of beginning a truly different approach to integrating the U.S. and international tax regimes.

What is surprising is that when one examines in detail the changes wrought by the Bush Administration, one discovers that (at least after September 11, 2001) their underlying policy is consistent with the goals pursued by the Clinton Administration. While the major push towards cooperation is coming from the E.U., the U.S. has been more receptive to this trend than some of the Administration's allies would like. It may be that the Administration will in the future join in the push toward unilateralism and territoriality in the name of competitiveness, but so far it has shown few signs of doing so.

⁶⁷ American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418.

B. Players

The major players in this period are Hugh Ault, Joseph Guttentag, and Philip West. Ault is the principal heir of Surrey's mantle as an architect of the international tax regime, and was the main theoretician behind the OECD's harmful tax competition initiative. Guttentag was Deputy Assistant Secretary for Tax Policy and International Tax Counsel in the Clinton Administration, and thereafter chaired the OECD Committee on Fiscal Affairs. West wrote a major article critical of tax arbitrage and implemented some of his views as International Tax Counsel and chair of the OECD's harmful tax competition forum in the later years of the Clinton Administration.⁶⁸

C. Applications

The most obvious examples of the new principle of cooperation in practice are the OECD's harmful tax competition initiative⁶⁹ and the E.U.'s Code of Conduct⁷⁰ and Savings Directive.⁷¹ The OECD's harmful tax competition initiative was aimed at both preferential tax regimes within OECD member countries and at the tax havens. The E.U.'s initiative was likewise aimed at preferential regimes within the E.U. and at the taxation of interest earned by E.U. residents.

Both initiatives have, in my opinion, scored significant successes. Most preferential regimes have been abolished within OECD countries, and most tax havens have agreed to some degree of information exchange. The Savings Directive is in force and requires E.U. member countries to either cooperate in exchange of information or impose high withholding taxes on interest paid to E.U. residents.

However, both efforts are incomplete. Preferential regimes flourish outside the OECD, the cooperation of the tax havens is limited, and the Savings Directive does not apply to nonresidents. But

⁶⁸ Philip R. West, *Foreign Law in U.S. International Taxation: The Search for Standards*, 3 FLA. TAX REV. 147 (1996).

⁶⁹ Organization for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Apr. 9, 1998).

⁷⁰ The Code of Conduct was set out in the conclusions of the Council of Economics and Finance Ministers (ECOFIN) meeting on December 1, 1997. Code of Conduct for Business Taxation, 1998 O.J. (C 2) 3-5.

⁷¹ Council's directive on taxation of savings income in the form of interest payments. Council Directive 2003/48/EC, 2003 O.J. (L 157) 38-48.

even this partial success seemed impossible to attain when the Bush Administration expressed its opposition to the whole endeavor in early 2001. The need to cooperate after September 11, 2001 changed the outlook and enabled the OECD and E.U. efforts to go forward. For example, the Bush Administration scaled back, but did not withdraw, regulations proposed by the Clinton Administration that require U.S. banks to collect information on interest payments exempt from withholding. This cooperation enabled the E.U.'s Savings Directive, which was held back by U.K.'s fears of capital flight to the U.S., to go into force.

Similarly, the two most prominent pronouncements of the Clinton Treasury to combat double nontaxation, Notices 98-5 and 98-11, have both been withdrawn.⁷² But Congress has enacted measures (section 901(k), as expanded in AJCA) to combat the FTC abuses that were the target of Notice 98-5, and the Bush Administration has repeatedly committed itself to prevent use of the FTC when there is no threat of double taxation. Moreover, the approach underlying Notice 98-11 has been continued in both recent proposals by the Joint Committee on Taxation and in recent pushes by the Service to combat abuses of the check the box rule. The principle underlying the Notices, that double nontaxation is wrong even when the principal tax avoided is a foreign tax, seems alive and well.

Another example of cooperation is the enactment of Code section 894(c). This provision was designed to combat an arbitrage transaction involving both entity and instrument arbitrage to achieve double nontaxation. It overrides treaties (specifically, it was aimed at the Canadian treaty) and was overwhelmingly passed by a Republican Congress concerned that U.S. withholding taxes should not be reduced when there is no corresponding tax by the residence country.

Finally, it is remarkable that a series of recent U.S. treaties, including the U.K. and Australian treaties, negotiated by the Bush Administration and ratified by a Republican Senate, contain explicit provisions designed to prevent double nontaxation.⁷³ Specifically, these recent U.S. treaties condition reduction of withholding taxes upon taxation by the residence country.

In my opinion, the combination of these developments signals

⁷² Notice 98-5 was withdrawn in 2004-11 I.R.B. 606. Notice 98-11 was withdrawn in 1998-27 I.R.B. 1.

⁷³ Convention for the Avoidance of Double Taxation and Prevention of Fiscal Evasion, U.S.-U.K., July 19, 2002, S. TREATY DOC. NO. 107-19; Protocol Amending Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, U.S.-Austl., Sept. 21, 2001, S. TREATY DOC. NO. 107-20.

that despite some public pronouncements to the contrary, the Bush Administration is in fact continuing the trend begun under Clinton of addressing the pressures of globalization not through competition, but through cooperation. If that proves to be a lasting change, it could mark the most significant turning point in U.S. international tax policy since the 1920s. Instead of unilateral emphasis on residence or source taxation, we could have a regime of cooperation with our major trading partners to preserve both residence and source taxation, uphold the 1920s compromise, and avoid competitive pressures on our multinationals.

VI. CONCLUSION

What can be learned from this brief historical outline? Three points suggest themselves as potential lessons.

First, despite the shifting emphasis on residence or source, and despite the changing nature of the underlying theoretical principles, there has been a remarkable degree of continuity in U.S. international taxation from 1918 to the present. The fundamental problem facing Adams in 1918 was how to prevent both double taxation and double nontaxation. This was the same problem Surrey grappled with in the 1960s, and we are still facing the issue today. Nor is the argument that we need to do more to preserve the competitiveness of U.S. businesses a new one — the same complaints were heard in the 1920s. Thus, it would appear that previous writers (McClure and Bouma, Graetz and O'Hear) overemphasize the discontinuities of U.S. international taxation (and especially the sharp break that came with Surrey's appearance in the 1960s) over the continuities.

Second, I would argue that the theoretical principles developed above, and especially the economic theories (economic allegiance, CEN, CIN, or nowadays CON, "capital ownership neutrality") were really post-facto justifications for underlying policy results, rather than the main drivers of legislation.⁷⁴ Fundamentally, politicians are interested in concrete policies that affect their constituents (and their prospects for re-election). It seems unlikely that any of the players identified above, including even the academics, were driven primarily by theoretical concepts, even though the changing nature of these concepts marks convenient dividing points in the periodization proposed above. The quote from 1971 that begins this paper still

⁷⁴ For capital ownership neutrality (CON), see Mihir A. Desai & James R. Hines, Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT'L TAX J. 937 (2004).

holds true today: economic concepts can be manipulated too easily to be the primary basis of policy outcomes, and this is just as true for “obsolete” concepts like CEN as for new-fangled ones like CON.

Because of this, I believe Surrey made a mistake in adopting CEN as the major rationale for his policies. Subpart F can be defended as a simple extension of the desire to tax U.S. corporations on worldwide income, which in turn stems (in my opinion) from the need to have a tool to regulate U.S. corporate activity and limit managerial power. This was obvious in 1961 (in fact, Dillon refers to the proposal as an equity-based measure) and there was no need to introduce CEN into the picture.

Finally, the relative stability of U.S. international taxation described above may be coming to an end. With the new century and increasing globalization, the time may indeed have come to abandon the 1920s regime and the bilateral treaties that embody it. The question is what will replace it — a renewed emphasis on unilateral competition and territoriality, which might ultimately lead to McLure’s vision of a world without income taxes, or an increased emphasis on multilateral cooperation and mutual adjustment of the claims of source and residence countries in a way that prevents both double taxation and double nontaxation.

At the beginning of another new century, it may thus be appropriate, in this context, to slightly alter John Dryden’s epitaph:

*All, all of a piece throughout:
Thy chase had a beast in view;
Thy [debates] brought nothing about;
Thy [theories] were all untrue.
‘Tis well an old age is out,
And time to begin a new.*⁷⁵

⁷⁵ John Dryden, *The Secular Masque* (1700), available at <http://eir.library.utoronto.ca/rpo/display/poem748.html>.