From Income to Consumption Tax: Some International Implications

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הנכתב על ידי: תקציתו של השופט והשופטים
כ"צ הנה הכלא משך
הסיעה לס היוזמות, והיאברטיסטה מבית הלימודים
ששוד - 2005
The international tax regime is based on a delicate consensus among nations, which has developed gradually since the 1920s. This regime has evolved, since the end of World War II, into an elaborate system of widely accepted compromises embodied in tax treaties. The system's main purpose is to prevent double taxation of the same item of income of the same taxpayer by two jurisdictions. Such double taxation can arise, for example, when a taxpayer who is a resident of country A derives some income from a source in country B, and countries A and B both assert jurisdiction to tax that income.

To prevent such double taxation, a compromise has been reached between source and residence jurisdictions: the right to tax active business income is granted mostly to the source country, while the right to tax passive (non-business) income is granted mostly to the residence country. The residence country bears the responsibility of avoiding double taxation of active income by either crediting the source country tax against its own tax liability, or by exempting foreign source active business income altogether. On the other hand, the source country has the

1 Irwin I. Cohn Professor of Law, the University of Michigan Law School. This article is a revised and updated version of an article by the same name in 33 San Diego L. Rev. 1329 (1996) (reprinted with permission).

2 For a general description of this compromise and some of its limitations see Reuven S. Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification," 74 Texas L. Rev. 1301 (1996), and the sources cited therein.
responsibility to avoid double taxation of passive income by reducing its taxation of such income when it is taxed in the residence country.

The current consensus is far from perfect, and in particular, faces two major problems relating to the two main types of income (active business income and passive income). The main problem regarding active business income, which is taxed primarily by the source country, is to determine the source of that income: if two (or more) countries claim the income derives from sources within them, the tax treaty network will not address the ensuing double (or triple, etc.) taxation.

The main problem regarding passive income, which is taxed primarily by the taxpayer's country of residence, is enforcing the tax, especially when the residence jurisdiction does not have adequate resources to collect taxes from its residents. In recent years, this problem has been exacerbated because several significant taxing jurisdictions (including the U.S.) have entered into a competition to attract foreign investment and have, therefore, abolished their withholding taxes on certain types of passive income (primarily interest).

Notwithstanding these problems, the existence of the consensus described above is remarkable given the sensitivity of the issue involved; after all, the ability to collect taxes is an essential attribute of sovereignty and giving up any tax revenue for a theoretical ideal of avoiding double taxation is hard for any politician to propose (as Senator Long has observed, taxing foreigners has been a perennially popular idea).

The consensus relies on the premise that participants share a common set of tax bases, including, in particular, the personal and corporate income taxes, which are the main focus of tax treaties. This premise, however, may no longer be valid. Specifically, there are now three major proposals under serious consideration in the United States which would abolish the U.S. corporate and personal income taxes and implement in their place a type of consumption tax. The main purpose of this article is to consider some possible implications of such a development for the international tax regime.

3 "Don't tax you, don't tax me, tax that fellow behind the tree," Jeffrey L. Yablou, "As Certain as Death - Quotations About Taxes," 94 Tax Notes Today 225-112 (Nov. 17, 1994), available in LEXIS, Taxana Library, TNT File (statement of Senator Russell B. Long (D. La.)). See also Report on Double Taxation, League of Nations Doc. E.F.S.73 F.19 at 40 (1923) ("A survey of the whole field of recent taxation shows how completely governments are dominated by the desire to tax the foreigner.").

4 For other discussions of this issue see Harry Grubert & T. Scott Newlon, "The International Implications of Consumption Tax Proposals," 48 Nat'l Tax J. 619 (1995); Reuven S. Avi-
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The article is divided into four parts. Part I briefly describes the three main proposals to replace the corporate and personal income tax with a type of consumption tax: the national sales tax (NST), the flat tax, and the unlimited savings allowance (USA) tax, with emphasis on their international aspects. Under all three proposals the effective tax rate on new investment in the United States will be zero. Part I suggests that, solely from an international tax perspective, a destination-based tax like the USA tax or the NST is superior to an origin-based tax like the flat tax, primarily because a destination-based tax addresses the transfer pricing problem, which is a major challenge to the current system.

Part II describes the potential international implications of the three consumption tax proposals. It concludes that, under all three proposals, direct and portfolio investors in both the U.S. and foreign countries will have an incentive to shift their investment activities into the United States. This shift will exacerbate the two major problems facing the current regime. First, multinationals will have an incentive to shift their income into the U.S., which will make it more difficult to reach a consensus on the source of active business income. Second, passive investors will be able to derive tax-free income from the U.S., which will make it more difficult for their residence jurisdictions to tax that income, especially if the United States ceases to cooperate in information exchange programs.

The more difficult task is to try to predict the reaction of other countries to these likely developments. Part II tentatively suggests that two types of possible reactions exist. Countries that have relatively little bargaining power and that depend on foreign investment (which may not be forthcoming if they maintain higher effective tax rates than the U.S.) may follow the U.S. lead and abolish their income taxes, either replacing them with an increase in their existing consumption taxes or cutting government spending. On the other hand, countries that can rely on some level of inbound investment even while maintaining a

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higher effective tax rate (i.e., our major trading partners) may react to the abolition of the U.S. income tax base by attempting to capture the revenues foregone by the U.S. This could in turn lead to a "tax war" as the international tax regime is replaced by increased competition among tax jurisdictions for those tax revenues.

Part III discusses the possible impact of tax reform on the U.S. tax treaty network and concludes that our treaty partners would be entitled to terminate their treaties with the U.S. if it abolished the income tax. Also, some of our major treaty partners may not be interested in maintaining their treaties with the U.S. if the U.S. income tax is replaced by a consumption tax. The reasons for this possible outcome are: (a) there would be no U.S. source-based taxation of active business income, so that treaties would not be needed to prevent double taxation; (b) either there would be no U.S. taxation of passive investment (under two of the three consumption tax proposals) or other countries may not want the U.S. to reduce its withholding taxes on such investment given the incentive for their residents to invest in the U.S.; and (c) other countries may wish to be able to discriminate against U.S. investors in an attempt to capture the tax base foregone by the United States.

Finally, Part IV addresses the question whether the effect of the consumption tax proposals on the international tax regime will be positive or negative. The answer to this question depends to a large extent on the answer to the question posed in Part II, namely how other countries would react to such a move by the U.S. If most countries were to shift to a consumption tax base, there may be relatively few negative effects from abandoning the current international tax regime. If, on the other hand, many significant countries attempted to preserve an income tax base, the most likely result would be intensified tax competition and reduced cooperation, and it may not be possible to maintain the delicate balance underlying the regime. The outcome in that case may be increased double taxation as well as increased opportunities for avoiding all taxation and more tax-induced distortions in global investment flows. In that case, the question will be what steps the U.S. can take to mitigate those negative effects.

I. The International Aspects of the Three Reform Proposals

There are three major proposals currently on the table to achieve fundamental tax reform, by replacing the personal and corporate income taxes with some type of consumption tax. These are, in increasing order of complexity, the proposal to
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abolish the income tax and replace it with the NST, espoused by (among others) Chairman Archer and former presidential candidate Senator Lugar; the flat tax, proposed by (among others) Representative Anney and former presidential candidate Steve Forbes; and the USA tax proposal for a progressive consumption tax, sponsored by (among others) Senators Nunn and Domenici. The rationale for these proposals has been examined extensively throughout the relevant academic literature, and therefore, it will not be elaborated upon here.

A. A Brief Description of the International Aspects of the Three Proposals

1. The National Sales Tax

The NST proposal is by far the simplest, as well as the most straightforward, of the three proposals mentioned above. Rep. Archer and Sen. Lugar would abolish both the corporate and individual income taxes and replace them with a national retail sales tax (in addition to the sales taxes levied by most


7 See H.R. 3039. For an examination of this proposal see Bartlett, supra n. 6.
of the states). Since the sales tax would, by definition, apply only to consumption, any savings would be exempt from tax until consumed.

From an international perspective, the NST (as envisaged in H.R. 3039) is destination-based, i.e., it applies to imports but not to exports, like the value added taxes (VATs) of our major trading partners. Specifically, the NST applies to the use, consumption, or enjoyment in the United States of any taxable property or service, whether produced or rendered within or without the United States, but it does not apply to any property or service exported from the United States for use, consumption, or enjoyment outside the United States. Clearly, there would be no taxation of inbound investment into the U.S. under the NST, either in the form of an income tax or withholding taxes.

2. The Flat Tax

The flat tax proposal is more complicated than the NST, and some of its details have not been fully worked out. Nevertheless, it is possible to extrapolate the main international aspects of the proposal from the bills filed by Representative Armey and Senator Shelby, and from the description of the flat tax by Robert Hall and Alvin Rabushka, who originated the idea.

Instead of the current income tax system, Armey and Shelby propose to substitute two flat rate consumption-based taxes: an individual tax and a business tax. The individual tax, at a rate between 17% and 20%, would apply only to earned income (generally, compensation for personal services, such as wages earned by an employee) less a relatively high standard deduction ($21,400 per joint return, plus $5,000 for each dependent). Dividends, interest, capital gains, and other forms of investment income would not be taxed.

Ordinarily, the tax would be collected from the seller, but in the case of a taxable good or service purchased outside the U.S. for use, consumption, or enjoyment in the U.S., it would be collected from the purchaser. Special rules are provided for financial intermediation and transportation services. See H.R. 3039; JCT Report, supra n. 5, at 214.


H.R. 2060 101 (proposed amendment to I.R.C. 63); S. 1050 101 (proposed amendment to I.R.C. 63).

H.R. 2060 101; S. 1050 101.
The business tax, at a rate identical to the individual tax rate, would apply to all businesses (including sole proprietorships and partnerships as well as corporations) on a cash flow basis, i.e., businesses would be allowed to deduct all expenses for business inputs (goods and services) and tangible personal and real property on a current basis. In addition, businesses would be allowed a deduction for compensation. Financial income, such as dividends and interest, would be excluded and no deduction would be allowed for interest.

The flat tax would be territorial at both the business and personal levels. The business tax would apply to revenue from sales in the United States plus the value of exported products; deductions would be allowed for business inputs in the United States as well as the value of imported inputs. If a U.S. firm sends parts to a plant in Mexico and imports the finished product, the value of the exported parts would be included in income and the value of the imported product allowed as a deduction. Similarly, the wage tax would only apply to earnings from work performed in the United States, whether by U.S. citizens and residents or by non-residents, but would exempt earnings from work performed abroad (as well as, of course, all unearned income, whether foreign or domestic).

While the business tax resembles a subtraction method Value Added Tax (VAT), it differs from it in one crucial component, namely the deductibility of wages. (It may, indeed, be thought of as a subtraction method VAT, with employees being registered VAT taxpayers so that payments to employees are subject to VAT and deductible by the payor.) Because of this difference the flat tax cannot be made border adjustable under the GATT, i.e., it cannot be imposed on imports and rebated on exports. However, most other countries that use a VAT do not allow a

12 H.R. 2060 102 (proposed amendment to I.R.C. 11); S. 1050 102 (proposed amendment to I.R.C. 11).
13 H.R. 2060 102 (proposed amendment to I.R.C. 11(d)(1)(B)); S. 1050 102 (proposed amendment to I.R.C. 11(d)(1)(B)).
14 H.R. 2060 102 (proposed amendment to I.R.C. 11(c), (d)); S. 1050 102 (proposed amendment to I.R.C. 11(c), (d)).
15 H.R. 2060 101, 102 (proposed amendments to I.R.C. 63(a)(1)(A), 11(c)(2)(A)); S. 1050 101, 102 (proposed amendments to I.R.C. 63(a)(1)(A), 11(c)(2)(A)).
16 Proposed amendment to I.R.C. 11(d)(1)(A) does not appear to limit deductions in this manner. H.R. 2060 102; S. 1050 102.
17 Hall & Rabushka, supra n. 9, at 76.
18 H.R. 2060 101 (proposed amendment to I.R.C. 63(a)(1)(A)); S. 1050 101 (proposed amendment to I.R.C. 63(a)(1)(A)).
19 I owe this observation to Oliver Oldman.
deduction for wages and make the VAT border adjustable (as permitted under GATT). The flat tax proposal is an origin-based tax; most of our trading partners have a destination-based VAT. However, this feature of the flat tax by itself should not be a problem, as trade economists agree that exempting exports from taxation and imposing taxes on imports has no major effect on the balance of trade, even if the trading partner adopts an origin-based tax system.\(^\text{20}\)

From an international perspective, the crucial point regarding the flat tax is that the U.S. income tax base is abandoned as thoroughly as in the NST proposal. There is no withholding tax on inbound portfolio investment, and no tax is imposed on investment income from sources outside the United States. For business entities the expensing of capital investments means that the effective rate of tax on marginal returns is zero, even though infra-marginal returns may be subject to tax because of the origin principle (this point is elaborated further below).

3. The USA Proposal: A Progressive Consumption Tax
The USA proposal is by far the most thoroughly elaborated and carefully thought out of the three proposals currently on the table. Not only has an extensive description and explanation of the "Unlimited Savings Allowance Income Tax System" been published (hereinafter referred to as the "USA Tax Description" or, simply, the "Description"), but an elaborate bill with specific legislation to replace most of the Internal Revenue Code has been introduced as Senate Bill 722.\(^\text{21}\) The following discussion is based on these two sources, and where they diverge, the differences will be identified. As will be seen, the USA proposal does avoid some of the specific pitfalls that face the two proposals discussed above.

The essence of the USA proposal is as follows. Business is subject to a flat 11% tax rate, which applies to all forms of business (whether or not incorporated), with an immediate deduction for capital investments.\(^\text{22}\) Financial receipts and payments (such as interest and dividends) are excluded from income and are not deductible, nor (unlike the flat tax proposal) is compensation deductible.\(^\text{23}\) The

\(^\text{22}\) S. 722 301 (proposed amendments to I.R.C. 201(b), 204(a), 205(a)).
\(^\text{23}\) Id. (proposed amendments to I.R.C. 202, 203).
business tax is territorial: businesses are not subject to tax on receipts from sales made or services provided outside the United States. It is also border adjustable: receipts from export sales are excluded, while imports are subject to an import tax at the same rate as the business tax (or, in the case of imported services, are not deductible).

Individuals are subject to tax at graduated rates (from 8% to 40%, according to the legislative proposal) on their worldwide income, just like under the current income tax. However, individuals can deduct all net savings (including bank accounts and other forms of savings) at the end of the year and must include in income all dissaving (reduction in net savings accumulated in previous years). Individuals who also own a business must file two separate returns, one for themselves and one for the business.

The business tax is equivalent, in all material respects, to a subtraction method VAT: All inputs other than compensation are deductible (if made to business tax payers, i.e., registered VAT taxpayers) or subject to tax (if made to persons not subject to the tax, such as foreigners in the case of imports). All receipts from sales of goods or services (but not financial receipts) are includible. These characteristics mean that the tax is most likely border adjustable under the GATT, i.e., it is a destination-based VAT, like those imposed by our trading partners.

As in the flat tax, the effective rate of tax on new business investment in the U.S. will be zero because of the expensing of capital investments.

For U.S. citizens and residents the tax is imposed on world-wide income. World-wide savings are likewise deductible. The proposal preserves the foreign

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24 Id. (proposed amendment to I.R.C. 203(a)).
25 Id. (proposed amendments to I.R.C. 265, 266, 267, 286).
26 Id. 201 (proposed amendments to I.R.C. 1, 15).
27 Id. (proposed amendment to I.R.C. 50).
28 Id. 201 (proposed amendment to I.R.C. 205).
29 Id. (proposed amendment to I.R.C. 203).
30 It is likely, but not certain, that the exclusion of export receipts in the USA tax would survive a GATT challenge because of the similarity to a destination-based VAT, although the attempt to label the USA tax as a business tax and not a VAT is unlikely to be helpful. See Eric Toder, "Comments on Proposals for Fundamental Tax Reform," 66 Tax Notes 2003 (1995).
31 S. 722 201 (proposed amendment to I.R.C. 3(a)).
32 Id. (proposed amendment to I.R.C. 53). As Shay points out, this provision means that the actual effect on the USA tax proposal on domestic savings depends on the attractiveness
earned income exclusion currently embodied in I.R.C. 911 (currently, up to $70,000). According to the USA Tax Description, the foreign tax credit is abolished (but a deduction is allowed for foreign taxes imposed on wages earned abroad), but under the legislative proposal (which was filed later) the foreign tax credit is preserved.

The legislative version of the USA proposal also takes a different view on the taxation of non-resident aliens deriving income from sources within the United States. The USA Tax Description does not address the latter, except by implication, because it envisages repeal of the source rules contained in I.R.C. 861-865. Since taxing non-residents on passive ("fixed, determinable, annual or periodic") income from the U.S. depends on the source rules, the Description seems to envisage abolishing these withholding taxes. This is consistent with the de facto repeal of the effective taxation of dividends, interest, and other forms of the return on savings, granted it is consistent only by virtue of the deductibility of net savings in the first place.

Senate Bill 722, however, retains the withholding system of current law. A 30% tax is levied on amounts received by nonresident alien individuals "from sources within the United States" as FDAP. This, of course, means that the source rules have to be retained. The portfolio interest exemption is likewise retained. There is even an attempt to tax non-resident aliens who receive dividends, interest, or wages from business operations conducted in the U.S., although the U.S. has never succeeded in collecting such "second order" tax on distributions from foreign corporations to their shareholders, creditors, or employees. (The legislation does not retain the branch profit tax, which is an effective, but complicated, solution to this problem). There is also an attempt to

of foreign savings options, and on the ability to attract foreign portfolio investment. Shay, supra n. 4, at 2.2.3; Zodrow & McLure, supra n. 20, at 451-52.
33 S. 722 201 (proposed amendment to I.R.C. 4(a)(8)). The value of the exclusion is increased, however, because of the steep rate schedule of the proposal (income above $24,000 on a joint return is taxed at the top 40% rate). Shay, supra n. 4, at 2.2.4.
34 O'Neill & Lutz, "Description," supra n. 5, at 1524; S. 722 201 (proposed amendment to I.R.C. 20(a)(1)).
35 O'Neill & Lutz, "Description," supra n. 5, at 1540.
36 S. 722 201 (proposed amendment to I.R.C. 131).
37 Id. (proposed amendment to I.R.C. 131(b)(4)).
retain the tax on expatriates in current section 877, although the Treasury has admitted that this tax is almost never enforceable.38

Moreover, as Steve Shay points out, the effect of the withholding provisions of Senate Bill 722 will probably be nil, and the above problems will disappear unless the legislative language is changed. That result obtains because the withholding rules as drafted only apply to individuals and not to offshore investment companies.39 Dividends and interest paid to such entities would also not be subject to the business tax because a financial intermediation business conducted entirely outside the U.S. is not subject to the tax.40 If these provisions are unchanged the U.S. has effectively "given away the store," and inbound portfolio investment will be completely untaxed, because any individual could set up an offshore investment vehicle to qualify for the exemption.

B. Destination vs. Origin-Based Taxes

From an international perspective, the principal difference between the flat tax, on the one hand, and the USA tax and the NST, on the other hand, is that the former is origin-based (i.e., completely territorial - only U.S. source income is taxed), whereas the latter are destination-based (imports are taxed and exports are exempt, as in current VATs). As has been pointed out repeatedly, it is a fallacy to assume that a destination tax encourages exports more than an origin-based tax. That is because, as pointed out most recently by Grubert and Newlon,41 if capital is immobile and trade must balance at any given moment of time, a tax on imports would be the same as a tax on exports because imports must be exchanged for exports. When capital is mobile, foreign assets can be acquired for exports, and the net exports will be included in the origin principle base but not in the destination principle base. However, on the margin, every extra dollar of foreign investment will finance future imports (purchased with the income

38 Id. (proposed amendment to I.R.C. 131(c)); see Samuel's "Testimony at Finance Hearing on Expatriate Taxation," 95 Tax Notes Today 56-40 (March 22, 1995), available in LEXIS, Taxana Library, TNT File. Section 877 has been modified in 1996 in an attempt to address these problems; whether the modest modifications will achieve this goal remains to be seen.

39 S. 722 201 (proposed amendment to I.R.C. 131); Shay, supra n. 4, at 2.3.3.

40 S. 722 301 (proposed amendment to I.R.C. 242(c)(2)).

41 Grubert & Newlon, supra n. 4, at 628.
from the investment) with a present value of one dollar, because trade must balance in the long run. That is, the return to the foreign investment is paid out in future imports (included in the destination tax base) that is equal in present value terms to the exports that financed the foreign investment (included in the origin tax base). Thus, at the margin, the origin and destination bases are equal because taxing the current marginal export is equal in present value terms to taxing the stream of future imports generated by that export.

However, a destination-based tax is superior to an origin-based tax because of the administrative complexity involved in an origin-based tax. Specifically, an origin-based business tax does nothing to resolve the transfer pricing problem, which has been vexing the IRS for many years and is likely to continue as a major source of difficulty in years to come, despite the adoption of new regulations to deal with the problem.

This can be illustrated by an example given by Hall and Rabushka of a U.S. firm that sends parts to Mexico and re-imports the finished product. The value of the exported parts would be included in income, and the value of the imported product allowed as a deduction. If the Mexican entity is controlled by the U.S. exporter/re-importer, there would be a strong incentive to value the goods as low as possible on their way out and to buy them for as much as possible on their way back in as finished products, with the profit remaining in Mexico (where it may or may not be taxed, depending on the vicissitudes of the Maquiladora regime). There is no I.R.C. 482 in House Bill 2060 to combat this problem. Thus, it is not enough to say, as Hall and Rabushka do, that it would be easy to value imports based on "the actual amount paid for them in the country of their origin"; if that amount is paid to a related entity, it may bear little relation to actual value, but it would be quite hard to prove this, as the IRS has found out under the present Code. While this problem exists under present law, it would be exacerbated under a territorial system that never taxes foreign profits.

42 *Id.* at 628; see also JCT Report, *supra* n. 6, at 290-92, 296-97. But see Hines, *supra* n. 4, who notes some of the limitations of this analysis in the short run.

43 *Hines, supra* n. 4, agrees with this point but argues that transfer pricing abuse is unlikely given the low U.S. tax rate under the flat tax. Nevertheless, transfer pricing abuse is an issue under any positive rate if the alternative is to locate profits in a tax haven or a country with a tax holiday. Moreover, rates are subject to change.

44 *Hall & Rabushka, supra* n. 9, at 76.

45 *Id.*
In addition, McLure and Zodrow have pointed out that because interest expense is not deductible and interest income is excluded under the flat tax, there will be a significant incentive to shift interest expense to other forms of deductible expenses and to shift other forms of income to interest income when the other party to the transaction is indifferent because they are subject to a traditional income tax. This incentive could significantly reduce receipts from the business portion of the flat tax. For example, assume a U.S. firm (USCo) that sells its products to a foreign firm (ForCo) and simultaneously either lends money to ForCo or borrows money from ForCo. In the first case (i.e., a loan to ForCo), USCo has an incentive to reduce the price of its products (thus reducing taxable receipts) while raising the interest rate on the loan (thus earning exempt income); ForCo is indifferent since both expenses are deductible. In the second case (a loan from ForCo), ForCo would be willing to obtain a lower interest rate on its loan to USCo, compensated by the lower sales price of the products; USCo benefits from lower taxable receipts, while the interest expense is not deductible. The same analysis applies, with the roles reversed, when USCo buys products from ForCo; in this case, USCo will seek to increase the deductible inputs while decreasing the non-deductible interest expense or increasing the excludible interest income.

Some of the problems in the flat tax can perhaps be fixed with appropriate technical modifications. For example, the interest income and expense issue can be solved by including in income all borrowings (principal and interest) and allowing a deduction for all repayments (principal and interest), i.e., moving to a cash flow tax, which in present value terms is equivalent to the current proposal of excluding interest income and disallowing interest deductions. However, that would reinstate one of the most vexing problems in current law, namely how to distinguish between interest expense (deductible) and dividends (non-deductible in both systems). Similarly, the transfer pricing issue can perhaps be solved by extensive auditing and coordination with customs valuations where the incentive is to reduce value, although the experience with these methods under the income tax has been far from promising. However, these changes would mean that the resulting system would, in practice, be far from the simple, tax-return-on-a-postcard ideal envisaged by the sponsors of the flat tax.

46 McLure & Zodrow, supra n. 4, at 80.
47 Id. at 17.
A destination-based VAT like the USA business tax (and the NST) eliminates both of these problems. As the sponsors of the USA proposal claim, it would not be advantageous to inflate the price of deductible inputs from related parties because that would result in a higher import tax being levied on the same inputs. However, as discussed below, transfer pricing will still be significant from the perspective of our trading partners, and this could lead to unfavorable repercussions for U.S. businesses.

In addition, this feature of the USA business tax solves McLure and Zodrow's interest problem. In the case of a U.S. importer, there would be no advantage to increasing the price of (deductible) imported goods in exchange for a lower interest rate on borrowed funds or a higher rate on funds lent to the seller because the imports would be subject to import tax; exports are not a problem since the system ignores both receipts from exports and interest income and expense. The USA tax is therefore significantly superior to the origin-based flat tax on administrative grounds.

There are several additional reasons for preferring a destination-based tax. In an origin-based tax there is some incentive for multinational corporations ("MNCs") to locate production in low tax countries in an attempt to avoid U.S. tax on super-normal, infra-marginal returns. This tax arises because, as Grubert and Newlon pointed out, the destination and origin principles are only equivalent if the investment abroad earns normal returns. Assume that a U.S. person sells $1 of goods abroad and invests the dollar in foreign assets. The export sale would be taxed under the origin principle but exempt under the destination principle. If the investment abroad results in future imports with a present value of $1, the destination and origin principles would result in the same tax in the long run. If, on the other hand, the investment results in future imports with a present value of $2 (i.e., if it earns above normal returns), these returns would be taxed under the destination principle (which taxes all imports), but not under the origin principle. However, if the investment were domestic, the full return (including any super-normal returns) would be taxed under both the origin and destination principles.

In addition, the transition effects of an origin-based tax would confer a windfall on U.S. persons holding foreign assets. That is because (in the absence of special

49 McLure & Zodrow, supra n. 4.
50 Grubert & Newlon, supra n. 4, at 629; JCT Report, supra n. 6, at 294.
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transition rules), if a U.S. person holds foreign assets acquired prior to the adoption of an origin-based tax, the return on those earnings in the form of future imports would escape tax, even though the exports used to acquire these assets were not taxed (because they occurred before the enactment of the origin-based tax). On the other hand, under a destination-based tax, the future imports would be taxed. ³¹

There are some problems associated with a destination-based tax (which are grounds for preferring an origin-based tax), but they seem less compelling than its advantages. Under a destination-based tax, it is necessary to identify non-deductible foreign services and to distinguish them from deductible domestic services, giving rise to a transfer pricing issue. Moreover, it will be necessary under a destination-based tax to allocate the service fees of financial intermediaries between foreign and domestic sources. These problems do not exist in an origin-based tax. However, they seem no more difficult than the many sourcing issues which arise under the current income tax, or under the destination-based VAT, as adopted throughout the world, and they are narrower than the problems identified above with origin-based taxes. ³²

A destination-based consumption tax also creates incentives to shop abroad and to emigrate because foreign consumption is exempt from tax. However, these incentives can perhaps be countered through adequate customs enforcement and through imposing a tax upon emigration. Moreover, as Hines pointed out, Americans have traditionally showed little inclination to emigrate en masse in response to tax incentives. ³³

II. The Impact of Tax Reform on Inbound and Outbound Investment

A. The Likely Reaction of Taxpayers

To assess the likely reaction of taxpayers to the three consumption tax proposals, it is necessary first to briefly summarize some of the main features of the current international tax regime. ³⁴ There are two major types of tax jurisdiction: jurisdiction based on the residence of the taxpayer and jurisdiction based on the source of the income. The first type typically applies to foreign source income of

51 Grubert & Newlon, supra n. 4, at 629-30.
52 Id. at 630.
53 Hines, supra n. 4.
54 This summary is based on Avi-Yonah, supra n. 2.
all residents of the taxing jurisdiction, whereas the second applies to income
derived from the taxing jurisdiction by non-residents. In general, the trend in
international taxation has been to tax portfolio income and wages, most of which
is earned by individual taxpayers, on a residence basis, while active business
income, much of which is earned by corporations, is taxed primarily on a source
basis. In both cases, however, there is residual taxation on a source basis of
portfolio income (as indicated by the retention of low withholding taxes in tax
treaties), and residual residence-based taxation of business income (as indicated
by Subpart F and similar provisions aimed at taxing business income derived
from tax havens on a residence basis).

The three consumption tax proposals, if enacted, would tend to undermine
both of these types of jurisdiction to tax, from the perspective of an income tax.
Let us consider first the implications for inbound portfolio investment. The ability
of foreign countries to implement effective residence-based taxation of their
residents has always been limited by the existence of tax havens, but tax havens
do not offer the same investment opportunities as a major industrialized economy,
and some progress has been made in curbing the use of tax havens through
limitations on treaty benefits and information exchange programs.

Were the U.S. to abolish income taxation and implement one of the three
consumption tax proposals, there would likely be no effective withholding tax
on new inbound portfolio investment. In the case of the NST and the flat tax,
withholding taxes are abolished. As for the USA tax, the proposal abandons the
withholding tax, but the legislative version retains it in order to induce other
countries to enter into treaties with the United States. Indeed, the withholding
taxes are abolished for residents of any foreign country that does not levy similar
taxes on U.S. residents, and has a tax information sharing agreement with the
United States.\footnote{S. 722, 104th Cong., 1st Sess. 201 (1995) (proposed amendment to I.R.C. 133(c)).}
We shall discuss the question of treaties further below, but there
is a problem with the withholding tax as proposed (even disregarding the technical
point identified by Steve Shay, which can perhaps be fixed by changing the
statutory language). Since foreigners get no deduction for their U.S. savings (they
have no net U.S. tax liability and savings are not deductible against the gross
withholding tax), U.S. residents would end up having a much lower tax burden
on investments in the U.S. than foreigners (except to the extent the portfolio

\footnote{S. 722, 104th Cong., 1st Sess. 201 (1995) (proposed amendment to I.R.C. 133(c)).}
interest exemption applies). This situation, in addition to being discriminatory and arguably violating the very treaties it is designed to salvage, also could drive a wedge against foreign investment in the U.S. Why should a U.S. corporation be willing to reimburse a foreign investor against withholding taxes imposed on dividends or interest when there is no need to similarly reimburse a U.S. investor who pays no effective tax? Moreover, it seems strange for a tax that is intended to apply to consumption, but not savings, to operate precisely the opposite way when it comes to non-residents. While a French citizen visiting the United States may consume as much as she desires without being subject to the USA tax, the same person would be subject to tax when she invests her savings in the shares of a United States corporation. It would seem more consistent with the purposes of the USA proposal to refrain from taxing such investments from abroad. Thus, it seems unlikely that the withholding tax would survive under the USA proposal and its abolition seems more consistent with the goals of that proposal as set out in the Description.

Ever since the U.S. unilaterally abolished withholding on portfolio interest investments by foreigners in 1984, a significant portion of the world’s capital flight has found itself channeled to the U.S. The result has been an acute lack of capital in many developing countries, whose elites found it much safer to invest tax-free in the U.S. than to invest in taxable (or even tax-free, but riskier) projects back home. This phenomenon will likely be amplified many times over if the income tax is entirely abolished. Since the U.S. will not tax funds spent on consumption outside its boundaries, while consumption goes effectively untaxed in many other jurisdictions, much of the world’s mobile capital may be invested

56 It could be argued that the portfolio interest exemption and other current loopholes in the withholding regime mean that abandoning withholding taxes will not attract much new investment into the United States. Nevertheless, the U.S. does collect some $2 billion in withholding taxes each year, and in the case of dividends, the change would be significant.

57 Admittedly, similar situations exist currently; for example, foreigners typically pay a higher rate of tax for investments in countries that grant shareholders integration credits for corporate taxes, because such credits are typically granted only to domestic shareholders. But the gap is usually smaller than the 30%+ wedge (between a zero effective rate and a 30% rate on the gross payment) that would exist under the USA tax.

58 S. 722 101(a).

59 Foreign portfolio investment in the U.S. has risen from $25.7 billion in 1980 to $202.5 billion in 1994, compared to a rise in foreign direct investment from $16.9 (1980) to only $49.4 (1994). By comparison, U.S. portfolio investment abroad has also risen, but at a much slower rate (from $ 54.4 billion in 1980 to $81.5 billion in 1994), while U.S. direct
tax-free in the U.S., but consumed outside its borders. The likely outcome for both outbound and inbound direct investment would be similar: a net increase in investment in the U.S. and a net decrease in investment in other countries. That is because under all three proposals the effective rate of tax for the normal returns on new investment in the U.S. would be zero. For U.S. corporations, who currently benefit from deferral of the foreign source active income of their subsidiaries (and therefore seek to increase such foreign source earnings), the main goal would become to shift as much of their world-wide profit as possible to the U.S. This can be achieved, e.g., by transfer pricing manipulation (i.e., by inflating the cost of goods sold by U.S. entities to related parties abroad), and by repatriating as much earnings as possible from foreign subsidiaries as deductible interest or royalty payments. The end result would likely be a distortion of capital flows, with increasing investment by U.S.-based multinationals in the U.S., even if (but for taxes) other areas of the world are more promising.

As far as inbound foreign direct investment is concerned, the likely outcome from abolishing the income tax will be a repetition of the scenario for outbound direct investment, but in the reverse: foreign-based multinationals will seek to expand their investments in the U.S., possibly by buying U.S. corporations and shifting taxable profits to them in the same ways outlined above.

To sum up, the likely effects of abolishing the income tax and replacing it with a consumption tax would be to attract significantly more investment into the U.S. Foreign portfolio investment may flow in, at significant costs to the ability of other countries to effectively tax their residents. Both U.S. and foreign corporations would likely attempt to shift taxable profits to the U.S. These conclusions, however, may be affected by the likely reaction of other countries.

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60 Grubert and Newlon agree with this conclusion, but note that the effect may be dampened if the move to a consumption tax reduces U.S. interest rates. Grubert & Newlon, supra n. 4, at 632-35. See also JCT Report, supra n. 6, at 318-22.

61 As Grubert and Newlon conclude, "MNCs would likely shift tangible investment, intangible assets, and R&D to the United States." Grubert & Newlon, supra n. 4, at 620. But as discussed below, this conclusion may not take sufficiently into account the reaction of other countries.
B. The Likely Reaction of Our Trading Partners

When discussing the likely reaction of other countries, it is necessary to distinguish between our major trading partners, which have developed economies that can expect investment by MNCs even when their tax rates are higher than the U.S. rate, and the rest of the world, which cannot expect to compete for investment in the absence of a favorable tax regime. For developing and transition economies, a shift by the United States to a consumption tax (and in particular, the abolition of withholding taxes on portfolio investment and of the corporate income tax) may effectively force them to abandon residence-based income taxation altogether, which may or may not be consistent with their long-term interests and policy preferences.

As for developed countries, the question is how they are likely to react to the increase in U.S.-bound investment by both American and foreign MNCs. There are two possible reactions. In the first, the reduction of taxes by the U.S. will force other countries to reduce their taxes on capital as well, and perhaps adopt similar reforms, as envisaged by McLure. Grubert and Newlon seem to consider this the most likely outcome, and state that the overall effect on global efficiency is unclear: while the distortionary tendency to shift capital to the U.S. would be muted, other countries may have to raise other taxes to make up for the lost revenue, which could lead to other types of distortion. The choice facing those other countries may be more politically difficult than envisaged by Grubert and Newlon: countries which have a VAT already tax consumption at much higher rates than the U.S., and individual income tax rates also tend to be higher. Thus, countries with little leverage may have no choice but to reduce taxes on capital without replacing the foregone revenue, with significant policy effects.

However, there is another possible reaction, especially for developed countries like our major trading partners. Those countries could try to capture the tax revenue unilaterally foregone by the U.S. "Taxation abhors a vacuum". In the past, whenever situations arose that enabled MNCs to channel their profits to

62 For a view advocating this result as advantageous to developing countries (on a consensual, not forced, basis) see Zodrow & McLure, supra n. 20.

63 But see Grubert & Newlon, Reply, supra n. 4, at 269 (arguing that other countries do have scope to raise consumption taxes). I believe such a choice would be very difficult politically, whatever the data on taxes as a percentage of GDP.
low-tax jurisdictions, the members of the OECD took steps (like the adoption of Subpart F by the U.S. and thereafter by other OECD members) to capture the tax on those profits. In the case of foreign MNCs, the reaction of foreign countries would be relatively simple: to extend the world-wide taxation of their resident MNCs to capture the U.S. source profits. In that situation, the U.S. will ironically have to make the same argument that it has consistently ignored in refusing to grant tax sparing credits in its treaties: that other countries are essentially transferring revenue from its fisc to their own, thus nullifying the effect of the tax holiday granted by the U.S. Other countries may then reply, as the U.S. has consistently since the 1960s, that the U.S. should not have made the tax holiday possible in the first place.

The reason foreign countries with major MNCs (i.e., the other OECD members) are likely to adopt this attitude is that they are unlikely to be harmed by it, in the sense of losing investments by their MNCs to the U.S. From the point of view of a foreign MNC, the adoption of consumption taxation and the abolition of the U.S. corporate income tax (except on super-normal returns, under an origin-based tax) represent a pure windfall, which would lead it to expand investment in the U.S. The imposition of home country tax on that income would restore the situation to the status quo before the windfall and investment patterns would return to their normal state. Grubert and Newlon consider this option unlikely and believe investment in the U.S. would increase even if (as is likely) no credit is given abroad for the consumption-based taxes, because of deferral and cross-crediting. However, deferral is unlikely to be granted to the U.S. given that the effective U.S. tax rate will be zero, and even countries that currently exempt active foreign income may rethink this position in the face of such a tax haven; while cross-crediting can be eliminated by the simple expedient of a per-country limitation for the U.S. (since all U.S. income from capital will be taxed at the zero rate, no internal averaging is possible).

As for U.S.-based MNCs, other developed countries, which can count on some level of continued U.S. direct investment, may be able to capture some of the revenue foregone by the U.S. on those entities as well. Grubert and Newlon point out the likely imposition of transfer pricing rules and thin capitalization requirements by foreign governments as a reaction to the adoption of consumption

64 Grubert & Newlon, supra n. 4.
tax reform by the U.S.; in addition, changes in the source rules are possible to make more income of U.S. MNCs sourced in the foreign countries where they conduct business. Once again, the U.S. MNCs may refrain from penalizing foreign countries by pulling out altogether as long as the overall effect of those changes is simply to reverse the windfall resulting from the abolition of the U.S. corporate income tax. The end result is less distortion in the allocation of global capital investment than in the absence of such reactions by foreign governments, but also a direct transfer of funds from the U.S. fisc to those of our trading partners.

In conclusion, the likely reaction of other governments to tax reform in the United States depends on their relative strength in attracting inbound investment. Countries with small or underdeveloped markets may be forced to follow the U.S. in abandoning income taxation and either replace it with higher taxes on consumption or abandon some of the policy goals for which they need the tax revenues from the income tax. Other countries, with more leverage, may react by entering into another form of tax competition, in which they try to capture the tax base foregone by the U.S.

### III. The Impact of Tax Reform on the U.S. Tax Treaty Network

The income tax treaty network is one of the most significant achievements of 20th century international law. Through more than 1,200 bilateral treaties conforming in general to the OECD or UN models, most countries have agreed to follow a broad consensus about the proper allocation of taxable income among taxing jurisdictions. This consensus has been described above. In treaty terms, it can be summarized as follows: active business income is taxable by the jurisdiction in which it is earned (the source jurisdiction) if the activities of the taxpayer in that jurisdiction are significant enough to rise to the level of a "permanent establishment." Passive income, on the other hand, is taxable primarily in the jurisdiction in which the taxpayer resides (the residence jurisdiction), with only a relatively low withholding tax being payable to the source country.

While this consensus has several unsolved problems (as described above), overall it has proven to be extremely resilient and has been maintained through

65 Id.
66 See generally Avi-Yonah, supra n. 2.
fifty years of immense economic and technological changes. However, if a major player in the world economy unilaterally abandons income taxation, the survival of the consensus is far from assured, and the likely replacement if the consensus collapses is far from clear.

The simplest case to consider in this regard is again the NST proposal to completely abolish the income tax and replace it with a sales tax. Obviously, this reform would render all existing U.S. income tax treaties obsolete. There would be a highly significant enticement for both portfolio capital and direct investment to flow into the U.S., and there would be no reason other than competition for capital for countries not to tax inbound U.S. investment. Thus, there would be little incentive to keep the treaty regime in place.

The situation would not be much different under the other two regimes considered above. First, as a purely legal matter, neither the flat tax nor the USA tax likely qualify as "income taxes" under the U.S. definition of the term, because they both deny a deduction for interest expense. (Nor would the situation change if loans were included in income and principal and interest were deductible, because the inclusion of loans would violate the realization requirement that defines an income tax under U.S. rules). Thus, in both cases, the United States has no right to expect that other countries would maintain their income tax treaties with it after tax reform is enacted, unless it is in their interest to do so, because the tax that the U.S. would levy is not an income tax. Fundamentally, income tax conventions apply to taxes on "income and capital," therefore, taxes on consumption are not covered.

Under the flat tax regime, the U.S. tax system is completely territorial, has very low effective corporate and individual tax rates, and does not tax passive

67 See I.R.C. 901 (West Supp. 1996); Treas. Reg. 1.901-2(b)(4) (1983). The author has been involved in trying to persuade the U.S. Treasury that a Bolivian tax that was similar to the USA business tax, except that it included loans in income and permitted deductions of principal and interest, was a creditable tax, to no avail.

68 For a more optimistic view, see ICT Report, supra n. 6, at 334-47, which takes the view that the reaction by treaty partners depends in large part on the form of the tax reform in the United States. On the other hand, Grubert & Newlon, Reply, supra n. 4, at 270, views U.S. tax reform as no different from other countries that have in the past lowered their taxes on capital (e.g., through accelerated depreciation). I believe moving to a consumption tax in the U.S., with all the attendant rhetoric about abolishing the income tax, is fundamentally different, if only because it will be politically very difficult to re-adopt an income tax.
income (i.e., there is no withholding). As far as direct investment is concerned, the effect is similar to abolishing the corporate income tax, because there is no effective tax on the normal returns to new investment. Thus, large foreign countries would have the same incentive to capture the residual income foregone by the U.S. For portfolio investment, the result under the flat tax is identical to the abolition of the income tax, because there is no taxation of passive income flowing out of the United States. Thus, in practice, foreign countries that have the ability to attract American business would have no incentive to renegotiate tax treaties with the U.S. to cover the flat tax (especially since there is no taxation of U.S. investment abroad); instead, as outlined under the sales tax scenario, they would expand their tax base of direct investment, while a race to the bottom would develop for portfolio investment.

Finally, the USA proposal, especially in its legislative form, makes an effort to save the income tax treaty system, but that effort seems unlikely to succeed. First, in regard to direct investment, the effect of the USA proposal is the abolition of the corporate income tax and its replacement by a destination-based VAT. Thus, there would be no reason for our treaty partners to maintain their treaties with the U.S. for corporate income taxation, because the U.S. will not have a corporate tax base. Second, for portfolio investment, the USA proposal maintains world-wide taxation of U.S. residents and (nominally) withholding taxes on non-residents. However, residents are effectively exempt from U.S. taxation of their domestic investments because of the deduction for net savings and therefore would not invest abroad unless the effective tax rate on their investment at source is zero. In this situation, foreign governments are unlikely to want to maintain a treaty network with the U.S., because they would have to reduce their withholding at source to zero to attract U.S. investors even in the absence of a treaty, and if they do so, the U.S. withholding tax would likewise disappear (or else the U.S. could not attract foreign capital). The end result is, therefore, likely to be similar to that described for the other two cases: an expansion of foreign taxation of direct investment to capture the tax base abandoned by the U.S. and the abolition of all taxation at source for portfolio investment.

Grubert and Newlon argue counter-intuitively that even though the flat tax and USA tax are not income taxes and thus would entitle foreign governments to terminate the treaties with the U.S., they would not do so because of their fear that, in the absence of a treaty, the U.S. would impose its high statutory withholding rate on investments from the foreign country into the U.S., while
retaining the treaty would force the U.S. (because of the non-discrimination provision) to impose no withholding taxes on foreign investment, because no tax is imposed on domestic investment. 69

This point seems inconsistent with the rest of Grubert and Newlon’s argument. The whole thrust of their article up to the point in which they make this argument has been to show that foreign residents (especially MNCs) would have significant incentives to move their investments into the U.S. because of the effective zero tax rate. Foreign governments presumably would not welcome this development, and may indeed (as Grubert and Newlon state) face considerable pressure to reduce their own tax rate to counter it. 70 Thus, it seems unlikely that foreign governments would object to high U.S. withholding taxes on foreign direct investment, which would at least reduce, if not eliminate, the incentive to shift investment into the U.S. Foreign governments may terminate their treaties precisely to achieve the imposition of withholding taxes, as well as to have the right to discriminate against U.S. investment in the case of a tax war; for the same reasons, the U.S. seems unlikely to want to impose such taxes. In fact, none of the current proposals envisage retaining the thirty percent withholding rate for corporations, while individuals already benefit from no withholding on portfolio interest investment. 71

Grubert and Newlon, as well as Hines, make one further argument for the proposition that tax treaties will be retained: foreign governments might not wish their own statutory withholding rates to apply to U.S. investors, since that would make their country even less competitive with the U.S. 72 But surely, if they wish to do so, foreign governments can abolish their own withholding taxes on U.S. investors, even in the absence of a treaty, just as the U.S. did when it adopted the portfolio interest exemption in 1984. 73 Thus,

69 Grubert & Newlon, supra n. 4.
70 Id.
71 Stephen Shay also notes that the point made by Grubert and Newlon would only apply to countries that export more capital to the U.S. than they import from it. Many OECD members, and almost all non-OECD member countries, currently import more capital from the U.S. than they export into it, especially when portfolio investment (which is generally not subject to withholding taxes) is excluded; although this relationship could shift if the U.S. adopts a consumption tax. Shay, supra n. 4.
72 Grubert & Newlon, supra n. 4; Hines, supra n. 4.
73 Hines also points out that other countries may not wish to terminate their tax treaties with the U.S. because of their general diplomatic relationship with the U.S. government. While
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it seems unlikely that the U.S. treaty regime would survive a move to a consumption tax base by the United States.

**IV. Conclusion**

The discussion above suggested that the adoption of any of the consumption tax proposals by the U.S. would have significant international implications and may lead to the dismantling of the current international tax regime, as embodied in the treaty system. The remaining question is: would that development be positive or negative, and if the latter, what can the U.S. do to mitigate any adverse effects?

The answer to this question is difficult, because it depends not only on the likely reactions by taxpayers to the reform, but also to the reactions of foreign governments, which are much more difficult to predict with any accuracy. Fundamentally, one can envisage two scenarios: positive and negative.

Under the positive scenario, fundamental tax reform in the U.S. is followed by a shift to consumption taxes by most, if not all, other countries in the world. Whether that would be a positive development from the perspective of either equity or efficiency lies beyond the scope of this article. However, as McClure pointed out, such a development has definite potential for drastically simplifying the international tax regime, as evidenced by the current situation with respect to VAT.  

In the case of VAT, because all countries follow the destination principle, the allocation of the tax base among countries is much less complicated than in an income tax, and there is no need for an elaborate network of tax treaties to resolve disputes in that regard. Thus, if one can envision a world with no income taxation, as does McLure, it certainly has some appeal from an international tax perspective, if only in reduced transaction costs.

On the other hand, the situation is less promising if a significant number of countries wish to retain the income tax. In the case of developing countries, as outlined above, this may be very difficult to achieve if the U.S. abolishes the...
income tax because those countries do not have the leverage to attract the investment that will flow into the U.S. This will be especially true if the U.S. abandons its current cooperation in information exchange programs, which are the only means by which such countries can enforce residence-based taxation on the U.S. income of their citizens.

In the case of developed countries, as discussed above, if they retain their income tax, there will be a significant incentive to abandon their tax treaties with the U.S. and enter into a "tax war," in which each country attempts to capture the income tax base foregone by the U.S. Such a development may not have a negative effect if all it does is restore the status quo, by effectively inducing MNCs to shift investments back to the pattern that existed before the U.S. abolished the corporate income tax. On the other hand, in the absence of a tax treaty system, one could envisage situations in which several countries try to tax the same U.S. source profits simultaneously (e.g., by allocating the same profits to domestic sources), which could lead to increased circumstances of double taxation.

Assuming that tax reform is adopted, the key issue therefore is: what should the U.S. be doing to prevent negative consequences from tax reform? Three points may be suggested in this regard. First, in regard to the taxation of portfolio investment, the U.S. should maintain and seek to expand its exchange of information program, to enable other countries to impose residence-based income taxation on U.S. source income of their residents. The exchange of information article has recently enabled the U.S. to enter into several tax treaties with developing countries, even with the portfolio interest exemption in place, and the same trend could continue following tax reform. This, however, would mean that the IRS and its information collecting capacity (which is the most advanced in the world) should be retained, contrary to the desire of some current tax reformers.  

Second, in regard to direct investment, we may want to maintain some ways for U.S.-based MNCs to use the U.S. government to prevent double taxation of their profits, even in the absence of a tax treaty. While the current competent authority mechanism depends on the tax treaty, it may be possible to maintain those links, for example, under the aegis of friendship, commerce, and navigation treaties, which do not depend on both countries sharing the same tax base.

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75 See, e.g., H.R. 3039, 104th Cong. 2d Sess. (1996), which would forbid appropriations to the IRS after the year 2000.
Third, the U.S. could use its leverage in other contexts to prevent other countries from launching measures that discriminate against U.S. residents, even in the absence of a tax treaty. In particular, the World Trade Organization, in which there is the ability for discussing many issues simultaneously, may offer a potential venue in this regard. 76 Indeed, it may be that, in an increasingly competitive world, the role of the bilateral tax treaty is over and that a multilateral system that can address tax together with other issues is needed to resolve the types of potential conflict addressed in this article.

ADDENDUM: A RESPONSE TO WEISBACH

In his article "Ironing Out the Flat Tax," Prof. David Weisbach mounts a trenchant critique of all aspects of the Flat Tax proposal. 77 All, that is, except one - the international dimension. In its international aspects, Weisbach writes, "most of the implementation issues ... are not that serious, which is important given that some have claimed that these issues are significant." 78 Since the only person he cites as those "some" is myself, I would like to take this opportunity to respond to some of his critique (which is based on an earlier version of this article).

1. Transfer Pricing

The first point Weisbach raises as a potential issue is transfer pricing. Since the Flat Tax is an origin-based system, Weisbach acknowledges that transfer pricing would be an issue, for the reasons stated above. However, he states, "[i]t is likely that the transfer pricing regime in the Flat Tax would be similar to current law in both scope and complexity." 79 Therefore, it is not a reason not to adopt the Flat Tax.

This argument is wrong for two reasons. First, since the Flat Tax is territorial, transfer pricing applies to both inbound transactions (sales by foreign corporations to related domestic corporations) and outbound transactions (sales by domestic corporations to related foreign corporations). Our current system, however, is in principle global, so that the transfer pricing issue applies primarily to inbound matters to the jurisdiction of the WTO.

76 Note, however, that in the Uruguay Round the U.S. steadfastly refused to submit tax matters to the jurisdiction of the WTO.

77 David Weisbach, "Ironing Out the Flat Tax", 52 Stanford L. Rev. 599 (2000) (henceforth "Weisbach").

78 Weisbach, 641.

79 Weisbach, 642.
transactions. For outbound transactions, it is true (as Weisbach notes) that transfer pricing is an issue under current law because we grant deferral to most forms of active income earned by subsidiaries of US corporations. 80 But crucially, we do not grant deferral to those outbound transactions that raise the most important transfer pricing concerns, i.e., base company transactions (in which goods are sold from the US to a tax haven subsidiary and then resold at a hefty markup to non-tax haven subsidiaries or to consumers in high-tax countries). These rules were enacted in 1962 in response to the Dupont case, which took the IRS twenty years to litigate. 81 Adopting a territorial system (either as part of the Flat Tax or otherwise) would invite massive shifting of profits to overseas subsidiaries in tax havens, which would dwarf the significant shifting that takes place currently. 82 Thus, it is not accurate to say that "[a]t most, more enforcement or a slightly stronger set of regulations might be needed." 83 A territorial system like the Flat Tax would require much more transfer pricing enforcement (as well as more enforcement of sourcing rules) than our current system. In addition, our current regime could be improved dramatically from this perspective by eliminating deferral altogether, which would leave transfer pricing as a problem only for inbound transactions.

Second, Weisbach is wrong here because he ignores the existence of a much better alternative—a destination-based consumption tax, like all current VATs. A destination-based tax does not give rise to transfer pricing issues. Even David Bradford, who otherwise favors the Flat Tax (or a variant thereof, the "X-Tax"), has recently come out in favor of modifying the origin-based system in order to address transfer pricing concerns. 84 In evaluating the Flat Tax, it should not only be compared to the current income tax; it should also be compared to other consumption tax alternatives (like a VAT or the USA tax, both of which are destination-based), as well as to possible reforms of the income tax (like abolishing deferral).

80 Ibid.
81 E.I. Dupont de Nemours and Company v. United States, 608 F.2d 445 (Ct. Cl. 1979). The case was won by the IRS only because it discovered a "smoking gun" memorandum, cited ibid. n. 4. It is unlikely the IRS would have such luck in future cases.
83 Weisbach, 642.
2. Creditability of the Flat Tax

Weisbach does not believe the creditability of the Flat tax is a "very serious" issue.\textsuperscript{85} For marginal (risk-free) returns to capital, he argues, non-creditability is not an issue because on a present value basis the Flat Tax rate is zero, so the fact that other countries may not credit it is irrelevant. For inframarginal (above normal) returns, he argues that if they are specific to the US, the foreign investor has to be in the US in any case, and therefore the lack of a credit will not affect the decision where to invest. Thus, the issue only arises if there are inframarginal returns not specific to the US, and that "is unlikely to be a large category."\textsuperscript{86}

Weisbach is clearly right to say that to the extent the Flat Tax imposes a zero rate on marginal returns to capital income, the fact that it is not creditable should not matter. In that case, there is no double taxation; instead, the foreign country may just step into the vacuum and levy its own tax on the return the US refrains from taxing. The net result is a transfer of revenue from the US to the foreign Treasury, which I am not sure is what the supporters of the Flat Tax have in mind.

Weisbach is also correct in pointing out that if inframarginal returns can only be earned in the US, the investor is likely to earn them here even if they are subject to full double taxation. It should be noted, however, that unless it has a monopoly, the foreign investor may have to compete with US investors that only bear the burden of US taxation on the same inframarginal returns. It has recently been argued that this situation could lead to the foreign investor being forced out of the US market.\textsuperscript{87}

Where I disagree with Weisbach on this point is in his assessment of the frequency with which foreign investors are likely to earn inframarginal returns that are not specific to the US. There exists a huge literature on why multinational enterprises exist, and most of it suggests that they exist because they can earn inframarginal returns by internalizing costs that would have to be borne in arm's length transactions.\textsuperscript{88} Moreover, most of these inframarginal returns are not specific to any country; they result from the multinational possessing, for example, intangible assets that can be utilized in many places. That is the key to the existence

\textsuperscript{85} Weisbach, 643.
\textsuperscript{86} Weisbach, 643.
of tax competition, in which multinationals conduct an auction among several countries that are otherwise equivalent to see which one will grant them the biggest tax breaks. The whole point of the competition is that the multinational can earn inframarginal returns in more than one country. Thus, if those returns are subject to double taxation in the US but to single or no taxation elsewhere, the multinational will not invest in the US. Contrary to Weisbach's assessment, this is likely to be a frequent occurrence.

3. Treaties

Weisbach argues that I am wrong in concluding that existing US treaties will not apply to the Flat Tax, since "income taxes are not defined in treaties. While the Flat Tax would tax consumption, not income, it is not labeled a consumption tax, which seems to be the key factor." He points out that there were periods in US history in which accelerated depreciation led to the effective rate on capital income being zero (e.g., 1981-1982), and that other countries did not abrogate their treaties.

While it is true that treaties were not abrogated in the early 1980s, the Reagan Administration did not label the adoption of accelerated depreciation as fundamental tax reform, and it retreated from the zero rate within one year because of its dire budgetary consequences. If the Flat Tax were adopted, it would be intended as a permanent measure, and everyone would be aware that the US has explicitly abandoned the income tax in favor of a consumption tax. It seems highly unlikely that this would not lead other countries to reconsider their income tax treaties with the US, especially if (as argued above) the US reform leads to a significant capital outflow from those countries to the US. There are no tax treaties for VATs, and there is no reason to maintain treaties for the Flat Tax, which is (as everyone, including Weisbach, acknowledges) a form of VAT. Moreover, as Weisbach also acknowledges, countries would have no reason to renegotiate their treaties because the Flat Tax unilaterally abolishes our main negotiating leverage, the withholding tax.

90 Weisbach, 643.
91 Ibid.
92 Weisbach, 644.
4. **U.S. as Tax Haven**

Weisbach argues that my prediction that the US will become a tax haven is "simply incorrect" because "[t]he United States previously has had a very low, even negative, tax on capital income, and problems with foreign investors sheltering income in the United States were not sufficient to cause serious international concerns."\(^9\) This ignores three facts: first, the previous period of zero or negative rates on capital income in the US was very short (1981–1982). Second, capital mobility now is much higher than it was in the early 1980s. And finally, European economists have documented that the Reagan tax cuts of 1981 did in fact have very serious negative consequences for Europe and the world economy, including rising European unemployment and a sharp rise in the value of the dollar that forced a concentrated intervention to bring it down in 1987.\(^9\) I believe these negative consequences will be dwarfed if the US were to permanently adopt a zero tax on marginal returns to capital. It is hard to imagine that any country could continue to tax capital income, just like the unilateral abolition of withholding on portfolio interest by the US in 1984 forced all other countries to do the same.\(^8\) Some, of course, would welcome the end of the income tax, but I do not share their enthusiasm, and neither do some other thoughtful observers.\(^6\)

5. **Simplification**

Weisbach argues correctly that adoption of the Flat Tax could lead to dramatic simplification of the international tax rules, because both the anti-deferral and foreign tax credit rules could be eliminated.\(^7\) The same degree of simplification can be achieved by adopting a territorial income tax, so this is not just a feature of the Flat Tax. The price to be paid, however, is significantly increased avoidance potential, as US multinationals shift their income overseas through transfer pricing and similar planning techniques. Simplification, as many observers have noted,

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93 Weisbach, 644.
97 Weisbach, 644-645.
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is not the only criterion for a well functioning tax system. Efficiency and equity are also relevant, and both are decreased under a territorial system.

6. Summary of International Issues
Weisbach concludes by stating that "[d]espite the complexity of the economic issues, the design considerations for international taxation under the Flat Tax are mostly good news."98 For the reasons given above, I respectfully disagree.

98 Weisbach, 645.