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Article

The Structure of International Taxation: A Proposal for Simplification

Reuven S. Avi-Yonah*

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* Assistant Professor of Law, Harvard Law School. B.A. 1983, Hebrew University; Ph.D. 1986, J.D. 1989, Harvard University. I have benefited tremendously from comments on previous drafts of this Article by the participants in the 1994 Harvard Seminar on Current Research in Taxation (especially Michael Graetz, Louis Kaplow, Diane Ring, and Alvin Warren) and in workshops at Bar-Ilan University and Tel-Aviv University Law Schools, and by members of the Washington International Tax Group, as well as by Hugh Ault, Charles Kingson, Linda Swartz, and Philip West. My grateful thanks go to all of them, as well as to my research assistants, Greg Lubkin and Jeff Hall, and my administrative assistant, Christiane Wollaston-Joury. This Article could not have been written without the love and support of Orli and Michael Avi-Yonah.

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The current international tax regime is a flawed miracle.¹ It is a miracle because taxes are the last topic on which one would expect sovereign nations to reach a consensus. International taxation is, to some extent, a zero-sum game: one country's gain in revenue is another's loss. If income is derived by a resident of one country from sources in another, and if both countries have a legitimate claim to tax that income and the ability to enforce that claim, then either country will lose revenue by agreeing to grant the other the primary right to tax that income.

Nevertheless, and contrary to *a priori* expectations, a coherent international tax regime exists that enjoys nearly universal support and that underlies the complexities of the international aspects of individual countries' tax systems.² This regime was first developed in the 1920s, when the League of Nations first undertook to study ways to avoid international double taxation,³ and has been embodied both in the model tax treaties developed by the Organization for Economic Co-operation and Development (OECD) and the United Nations and in the multitude of bilateral treaties that are based on those models.⁴ The existence of this

1. The literature on international taxation is immense and can only be highlighted here. The best recent surveys of the entire international tax regime are SOL PICCIOTTO, *INTERNATIONAL BUSINESS TAXATION: A STUDY IN THE INTERNATIONALIZATION OF BUSINESS REGULATION* (1992), which, as its name indicates, focuses mostly on corporate tax issues, and ADRIAN OGLEY, *THE PRINCIPLES OF INTERNATIONAL TAX: A MULTINATIONAL PERSPECTIVE* (1993), which provides a brief but excellent general overview. See also Ricard J. Vann, *International Income Taxation*, in *TAXATION IN DEVELOPING COUNTRIES* (Victor Thuronyi ed., forthcoming) (examining international income tax regimes and focusing on developing countries and countries in transition from centrally planned to market economies). An important recent article on the issues related to the taxation of multinationals is Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18 (1993), and an important recent proposal for reforming the United States international tax system from an economist's perspective is GARY C. HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM (1992). An older but still useful article is Charles I. Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151 (1981). Of the treatises on United States international taxation, the most useful are JOSEPH ISENBERGH, *INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME* (1990) and JOEL D. KUNTZ & ROBERT J. PERONI, *U.S. INTERNATIONAL TAXATION* (1992).

2. The existence of a coherent regime can be demonstrated by the many books and articles which survey various aspects of the regime on a comparative basis. See, e.g., ARVID A. SKAAR, *PERMANENT ESTABLISHMENT: EROSION OF A TAX TREATY PRINCIPLE* (1991) (discussing the basis for taxing foreign businesses and considering whether the established method is appropriate for every country in the modern world); see also RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 411 (1995) (noting the existence of an international consensus on jurisdiction to tax); FEDERAL INCOME TAX PROJECT, AMERICAN LAW INST., *INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II, PROPOSALS ON UNITED STATES INCOME TAX TREATIES 5* (1992) (stating that certain provisions are included in almost all tax treaties). A review of the proceedings of the congresses of the International Fiscal Association, see, e.g., Avv. Pietro Adonnino, *Non-discrimination Rules in International Taxation*, 78b CAHIERS DE DROIT FISCAL INTERNATIONAL 19 (1993), or the comparison of any two bilateral tax treaties will also suffice to reveal a common underlying international tax structure.

3. *Report on Double Taxation*, League of Nations Doc. E.F.S. 73 F. 19 (1923).

4. See, e.g., ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEV., *MODEL TAX CONVENTION ON INCOME AND CAPITAL*, 1 Tax Treaties (CCH) ¶ 191 (Sept. 1, 1992) [hereinafter OECD MODEL

regime shows that despite each country's claim to sovereignty in tax matters, it is possible to reach an internationally acceptable consensus that will be followed by the majority of the world's taxing jurisdictions. This international tax regime, based on voluntary consensus, can be regarded as one of the major achievements of twentieth-century international law.⁵

Yet the miracle is flawed. The current regime suffers from significant weaknesses, especially in two areas in which the development of the world economy has made the principles that were agreed upon in the 1920s and 1930s obsolete: the growth of internationally mobile capital markets for portfolio investment and the rise of integrated multinational enterprises (MNEs).⁶ Thus, as this century nears its end, it is time to re-examine the prevailing international tax regime and ask whether a new consensus can be reached to remedy the regime's major weaknesses and ensure its continued viability in the next century.

This Article seeks to do so in four parts. Part I describes the structure of the international tax regime and how this structure reflects a consensus about the allocation of taxable income among taxing jurisdictions.

TREATY] (proposing a model convention that includes a provision for eliminating double taxation); UNITED NATIONS DEP'T OF INT'L ECONOMIC & SOCIAL AFFAIRS, UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980) [hereinafter U.N. MODEL TREATY] (setting forth a model treaty to encourage the formation of tax treaties without protracted negotiations); INTERNAL REVENUE SERVICE, U.S. TREASURY DEP'T CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND _____ FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL, 1 Tax Treaties (CCH) ¶ 211 (June 16, 1981) [hereinafter U.S. MODEL TREATY] (covering most federal income taxes and certain excise taxes), *withdrawn by* Treasury Dep't News Release NB-1990 (July 17, 1992), *reprinted in* 1992-13 Stand. Fed. Tax Rep. (CCH) ¶ 46,416. There are currently over 1200 bilateral tax treaties, and almost all OECD member countries have tax treaties with each other. UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT, WORLD INVESTMENT REPORT 1993: TRANSNATIONAL CORPORATIONS AND INTEGRATED INTERNATIONAL PRODUCTION 34 (1993) [hereinafter UNCTAD WORLD INVESTMENT REPORT].

5. Indeed, much of the international tax regime can be regarded as customary international law. Customary international law can be defined as "a general and consistent practice of states followed by them from a sense of legal obligation," RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 102 (1987), and can be derived from a general pattern found in treaties. *See, e.g.,* Anthony A. D'Amato, *Treaties as a Source of General Rules of International Law*, HARV. INT'L L. CLUB J., Apr. 1962, at 1, 5 (arguing that the treaties provide a basis for customary international law separate from "the classic usage-into-custom pattern"); Richard R. Baxter, *Multilateral Treaties as Evidence of Customary International Law*, 41 BRIT. Y.B. INT'L L. 275 (1968) (discussing the weight given to treaties in determining customary international law); Ibrahim F.I. Shihata, *The Treaty as a Law Declaring and Custom-Making Instrument*, 22 REVUE EGYPTIENNE DE DROIT INT'L 51 (1966) (evaluating the role of treaties in formulating general rules for all countries). An open question is whether a taxpayer can rely on customary international law in challenging a national law that contravenes the agreed-upon consensus. *See* Chantal Thomas, Customary International Law and State Taxation of Corporate Income: Separate Accounting vs. Formulary Apportionment (unpublished manuscript, on file with the *Texas Law Review*).

6. These two problem areas are also emphasized by HUFBAUER, *supra* note 1, at 4-8. *See also* Green, *supra* note 1 (emphasizing the problem of taxing multinationals).

Specifically, the international consensus allocates active business income to the jurisdiction from which it derives (the source jurisdiction) and passive income to the jurisdiction in which the investor resides (the residence jurisdiction). Part I also discusses two possible alternatives to this consensus—taxing all income in either the residence jurisdiction or the source jurisdiction—but concludes that the current consensus is superior to both. Part II describes how the international aspects of United States tax law fit the international tax regime outlined in Part I and suggests ways in which details of the United States regime that are incongruent with the international consensus may be modified unilaterally. Part III of the Article identifies the two principal weaknesses of the current regime: the difficulty of enforcing residence-based taxation of individuals and the difficulty of allocating the income of MNEs among source jurisdictions. Part III then explains why these problems can only be resolved by multilateral action and describes the recommended solutions: enforcement of residence-based taxation through backup withholding by source jurisdictions and agreement on a unitary method to be used to allocate the profits of MNEs in the absence of comparable transactions. Finally, Part IV describes an alternative international tax regime that is based on the current international consensus, but incorporates the solutions identified in Part III and is considerably simpler than the present structure. Part IV also identifies the implications of the proposal for United States tax law and discusses ways in which the proposal may be applied by jurisdictions that adopt an integrated approach to the taxation of corporations and their shareholders.

I. The Structure of International Taxation

A. *The Active or Passive Distinction in International Taxation*

1. *Historical Development.*—In 1923, a committee of four economists submitted a report to the League of Nations that set out the basic principles underlying international tax jurisdiction for the first time.⁷ The report pointed out that an income tax based on ability to pay does not answer the question of whose ability to pay is to be considered in each taxing jurisdiction.⁸ To answer this question, the report developed the “doctrine of economic allegiance,” which underlies modern discussions of jurisdiction to tax.⁹ Fundamentally, the report endorsed two bases for economic allegiance, which justify a country’s imposition of tax: where

7. *Report on Double Taxation*, *supra* note 3.

8. *Id.* at 18-20.

9. *Id.* at 20-22.

income is produced (the source jurisdiction) and where it is consumed or saved (the residence jurisdiction).¹⁰

The 1923 report also addressed the issue of double taxation: as between the source and residence jurisdictions, which one has the prior claim to tax income deriving from one jurisdiction by a resident of the other and which one has the obligation to prevent double taxation by giving up its claim? On practical grounds, the source jurisdiction should have the prior right because it can generally impose its taxes on income deriving from within it first.¹¹ However, the 1923 report recommended that in future negotiations between tax jurisdictions, income items should be classified according to whether the primary economic activity giving rise to the income takes place in the source country or in the residence country and that the prior right to tax the income should be divided accordingly between them.¹²

2. *Present Consensus and the International Tax Treaty Network.*—

These principles underlie the development of the current consensus regarding the proper allocation of taxable income among taxing jurisdictions. Although the source country is granted the prior right to tax all income and the residence country has the primary obligation to prevent double taxation,¹³ this is only a concession to the source country's ability to impose taxes first and does not reflect the optimal allocation. Instead, the ultimate goal underlying the international tax regime is that active business income should be taxed in the country in which it originates (the source country) and passive income should be taxed in the country in which the recipient of the income resides (the residence country).¹⁴

10. *Id.* at 25. The report identifies four bases for economic allegiance: where wealth is produced, where it is finally located, where rights over it can be enforced, and where it is consumed or otherwise disposed of; the first and fourth bases—source and residence, respectively—were identified as the most important. *Id.*

11. *Id.* at 40 (“A survey of the whole field of recent taxation shows how completely Governments are dominated by the desire to tax the foreigner. . . . From this flows the consequence that, when double taxation is involved, Governments would be prepared to give up residence rather than origin as establishing the prime right.”).

12. *Id.* at 40–42. The report discussed four methods of avoiding double taxation: taxation based entirely on source (with residual residence-based taxation); taxation based entirely on residence; formulary allocation; and taxation based on source or residence, depending on the type of income. The report rejected the first option, considered the second as an ideal unlikely to be realized, and opted for the fourth, possibly modified by the third, as the most practical option. *Id.* at 45–51. This conclusion retains much of its value today. See *infra* Part IV.

13. See, e.g., I.R.C. § 901 (1994) (upholding a residence country's obligation to prevent double taxation by unilaterally granting a credit for all foreign income taxes up to the United States tax rate).

14. See generally Hugh J. Ault, *Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices*, 47 TAX L. REV. 565, 565 (1992) (noting that the “classical” system of corporation taxation dictates that the source country impose a tax on “corporate cross-border investments” and that “[t]he residence country generally tax[es] the remainder of corporate

This consensus can best be seen in operation by examining the extensive tax treaty network.¹⁵ Tax treaties reflect the active or passive distinction in two ways. First, they define what constitutes an active business operation in a given country (a "permanent establishment") and give the source country the primary right to tax the profits from that operation.¹⁶ The residence country is required to exempt those profits from tax, at least to the extent they were taxed by the source country, either by exempting foreign source business income from tax or by granting a foreign tax credit with respect to that income.¹⁷ Second, the tax treaties seek to reduce as much as possible the taxes levied by the source country on passive income (such as income from dividends, interest, and royalties) derived from within it, leaving the right to tax that income to the residence country.¹⁸

The tax treaties do not completely achieve their goal of dividing the worldwide taxing jurisdiction between source and residence countries along active or passive lines. First, the permanent establishment concept reflects a compromise: not all active business income is taxable primarily in the source country but rather only income that is attributable to a permanent establishment; otherwise, international business would be subject to burdensome administrative requirements of filing returns and paying tax in every country in which it has a minimal presence.¹⁹ However, the threshold of what constitutes a permanent establishment is quite low: a single office, or even a single agent with authority to conclude sales, is generally sufficient.²⁰ Second, the taxation of passive income at its source

income"); Alvin C. Warren, Jr., *Alternatives for International Corporate Tax Reform*, 49 TAX L. REV. 599, 599-600 (1994) ("The conventional division of the international income tax base . . . is that the source country has primary jurisdiction over corporate taxation, while the residence country has primary jurisdiction over investor taxation."). For a discussion of the rationale for this division, see *infra* subpart I(B).

15. See, e.g., OECD MODEL TREATY, *supra* note 4, arts. 7, 10, 11 (providing that interest and dividends may be taxed by the residence country while business profits are taxed in the source country); U.N. MODEL TREATY, *supra* note 4, arts. 7, 10, 11 (following in large part the OECD Model Treaty in its treatment of passive and active business income); see also KEES VAN RAAD, MODEL INCOME TAX TREATIES (2d ed. 1990) (providing a direct textual comparison of OECD, U.N., and United States model tax treaties).

16. See, e.g., OECD MODEL TREATY, *supra* note 4, arts. 5, 7; U.N. MODEL TREATY, *supra* note 4, arts. 5, 7 (both providing a detailed definition of "permanent establishment" and stating that a country may tax profits attributable to a permanent establishment within its jurisdiction). On the changing interpretation of these provisions, see SKAAR, *supra* note 2, at 71-101.

17. See, e.g., OECD MODEL TREATY, *supra* note 4, arts. 7, 23; U.N. MODEL TREATY, *supra* note 4, arts. 7, 23 (both providing two methods for the residence country to avoid double taxation of business profits from permanent establishments in other countries).

18. OECD MODEL TREATY, *supra* note 4, arts. 10-12; U.N. MODEL TREATY, *supra* note 4, arts. 10-12 (both addressing dividends, interest, and royalties respectively).

19. OECD MODEL TREATY, *supra* note 4, art. 7; U.N. MODEL TREATY, *supra* note 4, art. 7.

20. OECD MODEL TREATY, *supra* note 4, art. 5; U.N. MODEL TREATY, *supra* note 4, art. 5; see also SKAAR, *supra* note 2, at 571-74 (noting the gradual erosion of the permanent establishment concept

is not completely abolished, but it is reduced in most treaties to the lowest possible levels. For example, the 1992 OECD Model Income Tax Treaty recommends tax rates of 5% to 15% on dividends, 10% on interest, and 0% on royalties; the 1981 United States Model Income Tax Treaty recommends tax rates of 5% to 15% on dividends, and 0% on interest and royalties.²¹ These low withholding tax rates represent a compromise between the desire of the source country to levy some tax on income derived by foreigners from within the country and the international consensus that such income should be taxed primarily in the residence country. In the absence of a treaty, much higher withholding tax rates may apply,²² but these rates reflect the fact that in the absence of a treaty, the source country has no assurance that the income will in fact be taxed by the residence country, and therefore the source country arrogates to itself the taxes that should otherwise be paid to the residence country.

3. *Reasons for the Distinction.*—Nevertheless, the distinction between active and passive income is a fundamental element of the current regime. Does this distinction reflect a real difference? There are three arguments that it does. First, from an economic perspective, one may conceive of the pool of worldwide income as being produced by value-adding firms. A firm is a joint venture of persons who invest in it, seeking returns.²³ The value added by each firm is the sum of its undistributed profits and the dividends, interest, royalties, and rents that it pays; these last four represent the different ways of distributing the firm's income among the

as the threshold becomes lower and lower). Arguably, in the modern world, where business can be conducted by communications equipment that does not require a physical presence, the concept of a permanent establishment is obsolete and should be replaced by a different type of threshold, such as a percentage of the sales of the foreign entity or an absolute monetary *de minimis* amount. *Id.* at 573-74. The current debate in United States state taxation over whether "nexus," which is a constitutional prerequisite to taxation, requires a physical presence reflects this tension. Several recent cases reflect the trend away from reliance on a physical presence test. *See Quill Corp. v. North Dakota*, 504 U.S. 298, 308, 313 (1992) (holding that a mail order business need not have a physical presence within a state for the state to impose a sales tax on its sales, but must have a substantial nexus with the taxing state); *Geoffrey, Inc. v. South Carolina Tax Comm'n*, 437 S.E.2d 13, 18 (S.C. 1993) (holding that neither the Due Process Clause's "minimum connection" test nor the Commerce Clause's "substantial nexus" test, both of which must be satisfied in order for a state to tax the income of a corporation, require a corporation's physical presence in the taxing state). The approach taken in Part IV would replace the permanent establishment concept with the elements of a formula that will determine liability to tax in a given jurisdiction.

21. OECD MODEL TREATY, *supra* note 4, arts. 10-12; U.S. MODEL TREATY, *supra* note 4, arts. 10-12 (both covering dividends, interest, and royalties respectively).

22. *See, e.g.*, I.R.C. § 871(a)(1) (1994) (taxing nonresident alien individuals at a 30% rate on income not connected with a United States trade or business); *id.* § 881(a) (taxing foreign corporations at a 30% rate on income not connected with a United States trade or business).

23. *See, e.g.*, RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 5 (4th ed. 1991) ("[A] firm which acts in its stockholders' interest should accept those investments which increase the value of their stake in the firm.").

persons who invest in it.²⁴ The investment may be in the form of equity capital, debt capital, or tangible and intangible assets; the distinction among these forms of investment is the level and type of risk that the investor is willing to undertake.²⁵ From this perspective, the taxation of active business income represents the taxation of the profits of the firm, and the taxation of passive income represents the taxation of the division of those profits among investors in the firm. The active or passive distinction in international taxation reflects this economic analysis.

Second, the active or passive distinction reflects, to some extent, the degree of control exercised over the activity.²⁶ Active business income is generally derived from economic activities under the taxpayer's direct control; in the international sphere, this income is derived from "foreign direct investment."²⁷ Passive income, on the other hand, is frequently derived from activities in which the taxpayer has only a very small degree of voting control, such as a small shareholder in a corporation or an unrelated lender with voting control. However, passive income (in the sense of distributions of a firm's earnings) may also be earned by persons who control the underlying operations, such as a controlling shareholder who is paid dividends or interest by her corporation. This second type of passive income is frequently treated differently from passive portfolio income,²⁸ but under the current consensus, it is still taxed primarily in the country of residence of the controlling shareholder and not in the country where the corporation engages in business.²⁹ In the following discussion,

24. Cf. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290 (1980) ("The firm is just the set of contracts covering the way inputs are joined to create outputs and the way receipts from outputs are shared among inputs."). Wages paid to a firm's employees and other suppliers of human capital are another way of distributing the firm's profits. See IRVIN M. GROSSACK & DAVID D. MARTIN, *MANAGERIAL ECONOMICS: MICROTHEORY AND THE FIRM'S DECISIONS* 14 (1973) (including labor among the inputs used to generate a firm's outputs). Because wages are generally considered to be active income, we shall regard them, however, as active for the purposes of the analysis. For an analysis of current United States law from this perspective, see Yosef M. Edrey, *Taxation of International Activity: FDAP, ECI and the Dual Capacity of an Employee as a Taxpayer*, 15 VA. TAX REV. (forthcoming 1996).

25. Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, AM. ECON. REV., June 1958, at 261, 262 (noting that "[i]nvestment decisions are . . . supposed to be based on a comparison of [the] 'risk adjusted' . . . yield with the market rate of interest").

26. See generally HUFBAUER, *supra* note 1, at chs. 4, 7 (distinguishing portfolio income from business income).

27. For a definition and discussion of foreign direct investment, see, e.g., UNCTAD WORLD INVESTMENT REPORT, *supra* note 4, at 1-25; EDWARD M. GRAHAM & PAUL R. KRUGMAN, *FOREIGN DIRECT INVESTMENT IN THE UNITED STATES* 7 (2d ed. 1991) (formally defining foreign direct investment as "ownership of assets by foreign residents for purposes of controlling the use of those assets").

28. See, e.g., I.R.C. §§ 871(h)(3), 882(c)(3) (1994) (denying shareholders who own 10% or more of a corporation the exemption from United States withholding tax otherwise available for "portfolio interest").

29. See, e.g., U.S. MODEL TREATY, *supra* note 4, art. 10(2)(a), (b) (specifying a lower rate of withholding tax for dividend payments made to 10% shareholders and thereby yielding greater taxing

the term "portfolio income" will be reserved for passive income that is not linked with control.

Third, the active or passive distinction is significant because, to a substantial extent, it overlaps with the distinctions among publicly traded corporations and individuals, close corporations, and other legal entities. Much of the world's active income is earned by large, publicly traded corporations, and in the international context, by MNEs;³⁰ much of the world's passive income is earned directly by individuals or through close corporations or pass-through entities.³¹

B. *Is the Consensus Justified?*

If the active or passive distinction reflects some economic reality, why should active income be taxed on a source basis and passive income be taxed on a residence basis? The 1923 League of Nations report attempted to justify this distinction by analyzing which types of income derive more from activities performed in each jurisdiction, but this type of analysis has been rejected by modern economists, who cast doubt on whether income can meaningfully be said to derive from one source rather than another.³² Instead, a better understanding of the logic behind the active or passive distinction can be reached if one examines the two extreme alternatives: taxing all income in the residence country and taxing all income in the source country.

Robert Green has recently argued for the abolition of source-based taxation because of its incompatibility with the modern notion of the ability to pay.³³ Indeed, because the ability to pay is not accurately measured by

jurisdiction to the recipient's country of residence). The distinction in the model treaties between dividends from direct investment and portfolio dividends is that the former are subject to lower withholding taxes than the latter, perhaps due to the perception that they represent active business profits that have already been subject to tax at the corporate level. See OECD MODEL TREATY, *supra* note 4, art. 10(2)(a), (b); U.N. MODEL TREATY, *supra* note 4, art. 10(2)(a), (b); U.S. MODEL TREATY, *supra* note 4, art. 10(2)(a), (b) (all imposing lower withholding taxes on corporate shareholders with substantial interests than on other dividends).

30. The stock of foreign direct investment reached about \$2 trillion in 1992, and the sales of foreign affiliates of MNEs reached approximately \$5.5 trillion in 1990, compared to only \$4 trillion in world exports of goods and non-factor services. In 1993, the largest 100 MNEs had \$3.2 trillion in global assets. UNCTAD WORLD INVESTMENT REPORT, *supra* note 4, at 13, 22. In 1990, the top 300 MNEs accounted for about a quarter of the world's productive assets. *Multinationals, Back in Fashion*, ECONOMIST, Mar. 27, 1993, at 55, 56.

31. See HUFBAUER, *supra* note 1, at 63-64 (noting the rise of portfolio investment). This empirical distinction is discussed *infra* Part IV.

32. *Report on Double Taxation*, *supra* note 3, at 40-42. For a reaction by an economist to the "scholastic" source of income rules, see HUFBAUER, *supra* note 1, at 98-100. For a general rejection of the idea of source as an economic matter, see 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, 30-31 (Assaf Razin & Joel Slemrod eds., 1990).

33. Green, *supra* note 1, at 29.

income from one source, but rather only by "all income from whatever source derived,"³⁴ it seems difficult to reconcile source jurisdiction with an income tax based on the ability to pay. However, this argument by itself does not explain why the residence jurisdiction should have the sole claim to tax global income. If one focuses on economic allegiance, taxes should be owed to both residence and source countries.³⁵ Each of these jurisdictions has the right to tax the taxpayer on her entire income, which reflects her global ability to pay. However, because this result is impracticable and would result in complete multiple taxation, one sensible route would be to permit each jurisdiction to tax the income derived from within it (that is, on a source basis), resulting in the taxpayer being taxed in the aggregate on her global income according to her ability to pay. Of course, each of the source jurisdictions may have a different tax rate (including a zero rate), but the fact that a taxpayer's income may be taxed at a lower rate in a source jurisdiction does not automatically give the residence jurisdiction the residual right to tax that income.³⁶

1. *Individuals*.—There appear, however, to be several solid grounds for preferring residence over source taxation *for individuals*. The first is a pragmatic ground: individuals can only be in one place at any given time. Thus, residence for individuals is a relatively easy concept to establish, and in fact, it is possible to set down bright-line rules for determining the fiscal residence of individuals.³⁷ On the other hand, determining the source of income is a highly problematic endeavor, and in most cases, income will have more than one source.³⁸ Thus, if one jurisdiction is to be given the primary right to tax individuals, the residence jurisdiction is an obvious candidate.

Second, because most individuals have only one residence jurisdiction and are part of only one society, distributional concerns can be effectively

34. I.R.C. § 61 (1994). The United States policy of taxing its citizens and residents on worldwide income reflects the view that income should not be taxed differently depending on its source. See HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 170 (1938).

35. See, e.g., DAVID R. TILLINGHAST, *TAX ASPECTS OF INTERNATIONAL TRANSACTIONS* 3 (2d ed. 1984) (basing the tax jurisdiction of residence and source countries on the economic benefits conferred on the taxpayer by both governments).

36. One problem would be how to apply a progressive rate structure in these circumstances—whether to base the rate only on the taxpayer's income from sources within the taxing jurisdiction or on her global income. The first approach results in undertaxation and the second in overtaxation. This is another ground for preferring residence-based taxation for individuals. See *infra* text accompanying note 39. Large corporations, however, are generally taxed at a single rate. See I.R.C. § 11(a) (1994) (providing tax rates of 34% for corporations earning between \$75,000 and \$10 million and 35% for corporations earning more than \$10 million).

37. See, e.g., I.R.C. § 7701(b)(3)(A) (1994) (applying a substantial presence test by counting the number of days an individual is present in the United States).

38. See Ault & Bradford, *supra* note 32, at 30-31 (describing the difficulties in identifying a geographical source of income).

addressed only in the country of residence.³⁹ If the personal income tax is to have a significant redistributive function through progressive rates, it is necessary to include all income (including foreign source income) in the measurement of one's ability to pay. There may be no horizontal equity problem in taxing differently two equivalently situated taxpayers, only one of whom invests abroad and earns low-taxed income there, as long as the other has the same choice of investments open to her. There is, however, a significant vertical equity problem in taxing an investor with low domestic earnings and high foreign earnings that are not taxed abroad in the same way that a person with only low domestic earnings is taxed.⁴⁰ This problem can be resolved if the residence jurisdiction is allowed to tax on a residual basis only foreign source income that is not taxed abroad (or is taxed at lower effective rates) and allows a credit for foreign taxes, but it is much simpler to address the issue if the residence jurisdiction is given the exclusive right to tax all income of its residents.

Third, the residence of individuals to some extent overlaps with their political allegiance. In democratic countries, it is considered important for individuals to have a right to participate—through their representatives—in deciding how much tax they have to pay. The converse is even more significant: democratic legislatures have a preference for raising taxes on foreigners precisely because they cannot vote.⁴¹ Thus, taxation based on residence is a useful, though far from perfect, proxy for taxation with representation.

Finally, economists have pointed out that residence-based taxation is compatible with the goal of capital export neutrality (CEN).⁴² This goal requires that the decision to invest in a given location not be affected by tax rates; otherwise, investments that yield the highest returns on a pretax

39. On the importance of distributional concerns in income taxation, see the classic analysis by WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953). For a recommendation to use taxation as a redistributive device in preference to other methods, see Louis Kaplow & Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 677 (1994).

40. For a discussion of the concepts and norms of horizontal and vertical equity, see, e.g., Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989); Paul A. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 605 (1992); and Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990).

41. See, e.g., I.R.C. § 163(j) (1994) (codifying the earnings stripping rule); *id.* § 884 (codifying the branch profits tax).

42. CEN is generally considered by economists to be superior to capital import neutrality (CIN) as a welfare-enhancing principle. See, e.g., Charles R. McLure, Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm*, 45 NAT'L TAX J. 145, 146-47, 153 n.13 (1992) (explaining that CEN is needed to achieve an efficient allocation of the world's investments, while CIN is needed for an efficient allocation of savings, which is considered to be a less important goal); see also HUFBAUER, *supra* note 1, at 65-66 ("[T]he CEN approach still serves as a solid foundation for taxation of income from portfolio investments.").

basis will not be made because the after-tax return will be lower, causing global welfare (based on allocative efficiency) to be diminished.⁴³ In a world with many taxing jurisdictions with varying rates, CEN is best achieved by taxing all investors at their residence country rate.⁴⁴

2. *Multinational Enterprises*.—Why, then, not follow the path of pure residence-based taxation, as suggested by Professor Green?⁴⁵ There are two major reasons. The first is that to implement full residence-based taxation, it is necessary either to determine artificially the residence of corporations or to impute the earnings of publicly traded MNEs to their shareholders (the alternative supported by Professor Green). The difficulty is that residence of corporations cannot be determined the way residence of individuals can be and imputation of earnings to shareholders is a very complex task, which may be administratively impossible.⁴⁶

The second objection to pure residence-based taxation is that it results in more revenue being collected by developed countries and less by developing countries. To illustrate this, it is convenient to refer to a model world made up of only three jurisdictions: a developed country (e.g., the United States), a developing country (e.g., India), and a tax haven (e.g., the Cayman Islands). The residents of the United States earn active income from the United States, earn passive income from investments in the United States and in the Caymans, and earn passive income from investments in X, a MNE headquartered in the United States that does business in India. The residents of India earn active income from India, earn active income from working for X in India, and, in the case of the elite, earn investment

43. See, e.g., HUFBAUER, *supra* note 1, at 49 (describing the rationale and goals of CEN). But see Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581 (1990) (arguing that the CEN versus CIN debate is less relevant in a globalizing economy).

44. See Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q.J. ECON. 793, 796 (1980) ("When the combined tax on international income . . . equals the tax on domestic income in the capital-exporting country . . . capital-export neutrality results." (emphasis in original)).

45. Green, *supra* note 1, at 70-74.

46. *Id.* at 72. Green recognizes that "as a practical matter, the [pure residence] approach . . . would probably be feasible only if governments were to agree on a uniform definition of the corporate income tax base." *Id.* For discussions of the difficulties of implementing pass-through integration for publicly traded entities, see U.S. TREASURY DEP'T, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS: TAXING BUSINESS INCOME ONCE 30-35 (1992) [hereinafter TREASURY INTEGRATION REPORT] (rejecting pass-through integration because of its difficulties). See also FEDERAL INCOME TAX PROJECT, AMERICAN LAW INST., INTEGRATION OF THE INDIVIDUAL AND CORPORATE INCOME TAXES, REPORTER'S STUDY OF CORPORATE TAX INTEGRATION (1993) [hereinafter ALI INTEGRATION REPORT] (discussing the difficulties that pass-through integration raises, but proposing a framework for implementation and recommending integration); Anthony P. Polito, *A Proposal for an Integrated Income Tax*, 12 HARV. J.L. & PUB. POL'Y 1009, 1030-48 (1989) (discounting administrative objections to integration of the general income tax).

income from the United States and the Caymans. X develops products in the United States, manufactures them in India, and sells them in the United States, but its profits are, to a large extent, channeled to investments in the Caymans.⁴⁷

In this stylized world, if all taxation were based on residence, the United States would receive the taxes from the income of its residents (active and passive), as well as the entire taxes from X, either because X is headquartered there (if corporations are to have an artificial residence) or because all of X's shareholders are residents of the United States and none are residents of India. India, the developing country, would thus be left only with the taxation of the local income of its residents and the income of its elite from the United States and the Caymans, of which the latter is difficult for India to collect. This would likely be an insufficient amount of income for India, which would therefore refuse to cooperate in the residence-based system.

The other extreme alternative, taxing all income on a source basis, seems more appealing in this regard. In the simplified world, this system would result in United States taxation of active and passive income from the United States, including X's income from the United States, and Indian taxation of active and passive income from India, including X's income from India (assuming that X can be effectively taxed on a source basis).⁴⁸ In comparison with a regime under which each country has the right to tax the passive income of its residents and active income earned within its borders, India would not lose from this arrangement, except for the taxes it forgoes on passive income of Indian residents from the United States and the Caymans, which are difficult for India to collect in any event. Moreover, India would gain to the extent that portfolio income is derived by foreign investors in India. However, as was indicated earlier, pure source-based taxation is also unattractive.⁴⁹

None of the reasons that disfavor pure source-based taxation apply with the same forcefulness to active business income as they do to passive income; because much of the active income in the world is earned by MNEs, which do not vote and are not residents of a single society.⁵⁰ Moreover, CEN does not apply with the same forcefulness to MNEs as it does to portfolio investments. Consider three reasons for this. First, much

47. See Green, *supra* note 1, at 46-50 (explaining the ability of MNEs to avoid taxes by "financial maneuvering"). These methods will be discussed further *infra* Part III.

48. For a discussion of the problems of effective source-based taxation, see *infra* Part III.

49. See *supra* notes 39-46 and accompanying text.

50. Gerald Piel, *Globalopolies*, 254 NATION 652 (1992) (reporting that the 350 largest transnational corporations account for one-third of the gross national product of the industrialized world and that "[t]hese increasingly stateless entities recognize the sovereignty for reasons of their own choosing").

of the world's international investment is now portfolio investment, and the role of MNEs, although still growing in absolute terms, is diminishing relative to the growth of portfolio investment. For example, in 1970, foreign direct investment accounted for 75% of United States receipts of foreign income; in 1990, United States receipts from foreign portfolio investments exceeded receipts from direct investment, even though direct investment rose from 10.8% of corporate profits in 1970 to 17.9% in 1990.⁵¹ The same phenomenon exists for foreign portfolio investment into the United States, which in 1990 was almost three times as high as foreign direct investment into the United States.⁵²

Second, MNEs have the ability, through debt financing and transfer-pricing manipulation, to achieve effective CEN by lowering the rate of tax they pay in high tax jurisdictions. It has been found that as long as MNEs can deduct interest expense, they will expand to the point at which the return to capital in a given country equals the global rate of interest paid by the MNE (plus a risk premium specific to the particular country and project) and that the combined source and residence rates of tax are irrelevant to this decision.⁵³ This means that the MNE has achieved CEN because it can make its investment decision without regard to the combined rates of tax.

Finally, the United States debate about CEN is misguided as applied to MNEs because it applies CEN only to MNEs whose parents happen to be incorporated in the United States, which is increasingly a purely formal distinction.⁵⁴ As Joel Slemrod writes, it would be just as significant to tax corporations whose names begin with the letters *A* through *K* differently than corporations whose names begin with *L* through *Z* and to forbid name changes.⁵⁵ For true CEN to apply to MNEs, either the United States would have to tax all MNEs on their worldwide income or all MNEs

51. HUFBAUER, *supra* note 1, at 63.

52. *Id.* at 63-64.

53. *Id.* at 134.

54. *See, e.g.*, KENICHI OHMAE, *THE BORDERLESS WORLD: POWER AND STRATEGY IN THE INTERLINKED ECONOMY* 10 (1990) (noting that corporations that serve global markets are no longer identified by the "nationality" or place of incorporation due to their increasing employment of foreign workers); ROBERT B. REICH, *THE WORK OF NATIONS: PREPARING OURSELVES FOR 21ST CENTURY CAPITALISM* 110, 110-18 (1991) (suggesting that the global "organizational webs of high-value enterprise" are preventing products and goods from acquiring a national identity); Robert B. Reich, *Who is Us?*, *HARV. BUS. REV.*, Jan.-Feb. 1990, at 53, 54-56 (noting that many distinctions between United States and foreign-owned MNEs are moot because it is becoming more profitable for Americans to invest in both types of enterprises); Raymond Vernon, *How American is the American Corporation?*, 32 (Feb. 17, 1994) (unpublished manuscript, on file with the *Texas Law Review*) (noting the conflict "between the requirements of a nation-state system and the realities of the multi-national enterprise").

55. JOEL B. SLEMROD, *FREE TRADE TAXATION AND PROTECTIONIST TAXATION* 20 (National Bureau of Economic Research Working Paper No. 4902, 1994); *see* HUFBAUER, *supra* note 1, at 5-8 ("The nationality-neutral global firm is a vision for the mid-21st century, not a reality today.").

would have to be subject to worldwide taxation by their country of residence (assuming that one country is determined uniformly to be the country of residence); neither of these conditions is likely to be fulfilled.

The taxation of active business income by the source jurisdiction and of passive portfolio income by the residence jurisdiction would appear to address most of the issues identified above. The taxation of passive income on a residence basis is congruent with the need to preserve redistribution and representation for individuals, who earn most of this income (especially if one ignores passive income earned by affiliated corporations), and it is congruent with achieving CEN. As explained in Part III below, it appears unlikely that source countries would be harmed significantly by giving up source-based taxation of passive income earned by individuals and close corporations. The taxation of active income by the source country is congruent with the need to preserve some source of revenue for the source country, and if most such income is earned by MNEs, the arguments for taxing it on a residence basis do not apply. Thus, it appears that the current international consensus has significant advantages that should be borne in mind when considering ways to simplify and modernize it.⁵⁶

II. The Active or Passive Distinction and United States International Taxation

This Part of the Article describes how the structure of United States international taxation reflects the active or passive distinction and what changes can be made by the United States unilaterally to make its regime more congruent with the international consensus.⁵⁷ The modifications identified in this Part should be distinguished from more profound changes that can only be achieved by multilateral action.⁵⁸

56. The discussion below assumes that the income tax will continue to be the main direct tax, and will not be replaced by a consumption or other type of direct tax in the foreseeable future. For an analysis of the possibility of a shift to consumption-based taxation on an international basis, see McLure, *supra* note 42. The current United States proposals to shift to consumption-based taxation by allowing unlimited deductions for savings do not, however, significantly affect the analysis below, because the same international issues will surface under that type of tax (an unlimited deduction for savings and acquisition of business assets is similar to the difference in depreciation rates between the United States and other countries that already exists, see Rob Norton, *Our Screwed Up Tax Code*, FORTUNE, Sept. 6, 1993, at 34, 44 ("[M]ost [countries] also offer generous depreciation allowances (which permit corporations to drastically reduce taxable income)."), and the deduction affects mostly the effective rate of tax). The discussion also assumes that many countries will continue to have a classical (unintegrated) corporate tax system. For a discussion of how the analysis fits with an integrated tax system, see *infra* Part IV.

57. For survey discussions of the United States international tax regime, see ISENBERGH, *supra* note 1 and KUNTZ & PERONI, *supra* note 1. The best summary of the regime is Ault & Bradford, *supra* note 32. See also Janet G. Stotsky & Emil M. Sunley, *The Tax System of the United States*, 9 TAX NOTES INT'L 1755 (1994) (providing a broad survey of domestic taxation issues and their effects on domestic and international taxpayers).

58. For a discussion of these multilateral proposals, see *infra* Parts III & IV.

The fundamental distinction underlying the United States international tax regime is between domestic taxpayers (United States citizens, residents, domestic corporations, partnerships, and trusts), who are taxed on their worldwide income,⁵⁹ and foreign taxpayers (all others), who are taxed only on their United States source income.⁶⁰ Domestic taxpayers are taxed by the United States because of their personal connection to the United States, that is, on the basis of residence; the United States does, however, include nonresident United States citizens in this category.⁶¹ Foreign taxpayers are taxed by the United States on the basis of their territorial connection to the United States, that is, on the basis of source.⁶² One problem that is raised by this distinction is that the choice between being taxed on a residence or source basis is initially left to the taxpayer, because corporations are classified as domestic or foreign based on their formal place of incorporation. Therefore, it is possible for a domestic taxpayer to shift income from residence- to source-based taxation by routing it to a corporation incorporated abroad; if the income is foreign source (and not effectively connected with the conduct of a trade or business in the United States), the result is the avoidance of current United States taxation.⁶³ Much of the complexity of the current United States international tax regime stems from attempts to address this problem through antideferral regimes.⁶⁴

A. *Foreign Taxpayers*

The active or passive distinction is reflected in the two ways in which the United States taxes foreign taxpayers on income derived from sources

59. I.R.C. § 61 (1994).

60. *Id.* §§ 871, 881-882; *see also id.* § 7701(b)(1)(B) (defining who is a nonresident alien individual); *id.* § 7701(a)(5) (defining what is a foreign corporation and partnership). Foreign taxpayers may also be taxed on non-United States source income, if that income is effectively connected with the conduct of a trade or business in the United States. *See id.* § 864(c)(4).

61. *Id.* §§ 1, 11. For the exclusion of the foreign source income of foreign taxpayers, *see id.* §§ 2(d), 11(d).

62. *Id.* §§ 871, 881-882.

63. *See id.* §§ 11(d), 882(a).

64. *See supra* note 113 (detailing the antideferral sections in the Internal Revenue Code). All of these sections represent various regimes created to address the problem of the choice between being taxed on a residence or source basis being left to the taxpayer. Current simplification proposals in this area include the Tax Simplification Act of 1993, H.R. 13, 103d Cong., 1st Sess. §§ 401-404 (1993), which was later folded into the Tax Simplification and Technical Corrections Act of 1993, H.R. 3419. At least some of the simplification measures may be re-introduced in the 104th Congress as part of the 1995 budget reconciliation bill. Barbara Kirchheimer, *Reconciliation to Include Simplification, Some Extenders, Aide Says*, 10 TAX NOTES INT'L 1733 (1995). *See also* the recent attempt by the IRS to prevent domestic corporations from reincorporating abroad on a tax-free basis, I.R.S. Notice 94-46, 1994-1 C.B. 356, and the various proposals to impose a tax on United States citizens who expatriate, e.g., Sam Gibbons, *Gibbons Bill Would Tax Expatriates*, 67 TAX NOTES 1071 (1995).

within the United States. Income that is effectively connected with a United States trade or business, which includes primarily active business income, is taxed on a net basis in the same way as it would have been taxed if earned by a domestic business.⁶⁵ On the other hand, "[f]ixed, determinable, annual or periodic" income (FDAP), which includes passive income, is nominally taxed on a gross basis at a relatively high rate (30%),⁶⁶ but a combination of source rules, statutory exemptions, and tax treaties results in such income being generally taxed only when earned by foreign businesses as part of their active business operations⁶⁷—such income generally is not taxed when earned by portfolio investors.

1. Active Business and Effectively Connected Income.—The taxation of active business operations in the United States is relatively straightforward. Income that is effectively connected with a United States trade or business is taxed at the regular rates and on the same net basis as income earned by domestic taxpayers.⁶⁸ The crucial terms, "trade or business" and "effectively connected," are not defined in the Code (with certain exceptions),⁶⁹ but a series of rulings and court cases has sought to distinguish active business operations, which are subject to this regime, from mere investment activity, which is not subject to it.⁷⁰ In particular, since 1966, the United States generally has not treated passive earnings of foreign businesses in the United States as subject to tax on a net basis unless the assets or operations of the business participated in generating the income.⁷¹ In addition, a specific Code provision excludes investments made through a United States broker from being treated as a trade or business for this purpose.⁷²

In general, the definition of effectively connected income corresponds to the economic definition of active business income. However, effectively connected income is in some respects broader, and in others narrower, than

65. I.R.C. §§ 871(b), 882 (1994).

66. *Id.* §§ 871(a), 881.

67. Passive income earned as part of an active business operation in the United States would be taxed as effectively connected income rather than as FDAP. *Id.* § 864(c)(2).

68. *Id.* §§ 871(b), 882.

69. *See id.* § 864(b) (providing that certain limited personal services performed for a foreign employer and certain trading in securities and commodities will not be considered a "trade or business within the United States").

70. *See, e.g.,* De Amodio v. Commissioner, 34 T.C. 894, 903-09 (1960) (reviewing cases that define what constitutes engaging in a United States trade or business); Lewenhaupt v. Commissioner, 20 T.C. 151, 162-63 (1953) (discussing the definition of a United States trade or business); Harvey P. Dale, *Effectively Connected Income*, 42 TAX L. REV. 689 (1987) (discussing the development of the active business terminology).

71. I.R.C. § 864(c) (1994).

72. *Id.* § 864(b)(2).

active business income from United States sources.⁷³ First, the source rules operate to exclude from the United States taxing jurisdiction income that would not be subject to United States tax under the permanent establishment threshold of tax treaties. In particular, income from sales is generally sourced according to the residence of the seller,⁷⁴ and income from sales of purchased inventory is sourced according to passage of title (a formal attribute totally within the taxpayer's control) unless such income is attributable to a United States office or other fixed place of business.⁷⁵ Similarly, income from international communications and from activities in space—two of the newer additions to the source rules—is sourced according to the residence of the seller and, thus, is not subject to United States tax if the seller is foreign unless it is attributable to a United States office or fixed place of business.⁷⁶ These rules reflect the international consensus that source-based taxation of active business income should be limited to business operations that exceed a certain minimal standard of activity in the host country.⁷⁷

In certain cases, the United States treats passive income as effectively connected income. For example, capital gain from the sale of real property located in the United States is treated as effectively connected income even if the foreign investor plays an entirely passive role.⁷⁸ In other cases, income that is not clearly active or passive is treated as active. This is true, for example, if United States source income is not effectively connected but is also not FDAP (such as capital gains of an active United States business from its portfolio investments).⁷⁹

2. *Passive Income.*—It is more difficult to see how the United States follows the international consensus regarding the taxation of passive income because the statute provides for a heavy 30% withholding tax on gross

73. See Dale, *supra* note 70, at 692 (noting that although the definition “loosens . . . the force of attraction rule by permitting certain types of [United States source] income to escape” tax, it “tightens the web by including certain limited types of [foreign source] income”).

74. I.R.C. § 865(a) (1994). But see *id.* § 865(e)(2) (providing an exception to this general rule for inventory sold by a nonresident with an office or fixed place of business in the United States).

75. *Id.* §§ 861(a)(6), 865(e).

76. *Id.* § 863(d), (e).

77. In some cases, however, the line between active and passive foreign investors is not easy to draw. See, e.g., *De Amodio v. Commissioner*, 34 T.C. 894, 903-09 (1960); *Lewenhaupt v. Commissioner*, 20 T.C. 151, 162-63 (1953); see also Linda Z. Swartz, *Troubled Real Estate Partnerships: What Options Are Available to Foreign Lenders?*, 12 J. PARTNERSHIP TAXATION 196, 208 (1995) (illustrating how a passive investment may cause a foreign investor to be deemed engaged in a United States trade or business).

78. I.R.C. § 897 (1994). In addition, foreign taxpayers may treat rental and other income from real property located within the United States as effectively connected. *Id.* §§ 871(d), 881(d).

79. *Id.* § 864(c)(3).

passive income from United States sources.⁸⁰ In this case, however, it is necessary to look beyond the basic statutory rate and to determine how often the current regime actually imposes it. In effect, through a combination of source rules, treaties, and statutory exemptions, few items of income from the portfolio investments of foreign taxpayers end up being subject to the 30% tax. In 1990, foreigners earned approximately \$16 billion in passive income (including passive income of controlling shareholders), but the United States collected only about \$2 billion from all its withholding taxes together, an effective rate of only 12.5%. Approximately an additional \$42 billion of passive income was exempt from tax under the provisions described below.⁸¹

a. Capital Gains.—First, it should be noted that capital gains, which are a form of passive income, have never been subject to withholding, except in the case of real property. Thus, a nonresident's gain from the sale of stock in a United States corporation is untaxed by the United States, even though it represents the present value of the future stream of income from the stock.⁸²

b. Interest.—The most prevalent exemption from the nominal 30% withholding tax is interest, which, under an exemption enacted in 1984,⁸³ is not subject to tax if earned by foreign portfolio investors.⁸⁴ The exceptions to this exemption are instructive. One exception addresses foreign banks making loans into the United States in the ordinary course of their business, in which case the interest represents active business income.⁸⁵ Another exception to the portfolio interest exemption concerns interest paid to foreign shareholders who own more than 10% of the stock of the payer.⁸⁶ This rule reflects the distinction outlined above between active and portfolio income on the basis of control and it also provides some deterrent against controlling shareholders' attempts to disguise dividends as interest. Similarly, another rule restricts the application of the exemption to contingent interest, which is similar to dividends and thus subject to abuse in the hands of controlling shareholders.⁸⁷

In addition, yet another rule restricts the deductibility of interest paid to foreign related parties (generally, under a 50% common ownership

80. *Id.* §§ 871(a), 881.

81. *Revision for the Spring 1993 Issue*, IRS STATS. INCOME BULL., Fall 1994, at 7 (Table: Forms 1042s).

82. See I.R.C. § 865(a)(2) (1994).

83. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 127, 98 Stat. 494, 648.

84. I.R.C. §§ 871(h), 881(c) (1994).

85. *Id.* § 881(c)(3)(A).

86. *Id.* §§ 871(h)(3), 881(c)(3)(B).

87. *Id.* §§ 871(h)(4), 881(c)(4).

threshold) if the payer's debt-to-equity ratio is too high.⁸⁸ This "earnings stripping" rule is also designed to backstop the interest or dividends distinction and to prevent too high a percentage of United States business profits from being paid out as deductible interest to controlling shareholders. The combination of the 10% stock ownership limit on the portfolio interest exception and the limits on deductibility keeps a foreign enterprise engaged in an active business operation in the United States through a subsidiary from escaping United States tax by paying interest that is not subject to withholding and that reduces the profits of the subsidiary, although that result can still be achieved by financing the subsidiary from an unrelated foreign entity (as long as it is not a "bank").⁸⁹ The emphasis on related parties in both the earnings stripping rule and the 10% stock ownership exception reflects the sense that a related foreign party is really engaged in active business in the United States through its control of its subsidiary, and that the interest income it receives represents more than purely passive income. Thus, these rules run contrary to the formal distinction between the foreign parent and the subsidiary—the internationally accepted definition of a permanent establishment excludes a parent from being treated as engaged in an active business in a country merely because it controls a subsidiary⁹⁰—but the rules are congruent with a view that restricts passive income to portfolio income.

c. *Dividends*.—The situation in the case of dividends is more complicated. Unlike interest, which is not subject to withholding under the United States Model Treaty, dividends are subject to taxation at their source (at 5% or 15%, depending on whether or not they are paid to shareholders owning 10% of the payer or not) even if a treaty is in place.⁹¹ Second, dividends are subject to potential triple taxation: they are not deductible to the payer, they are subject to withholding, and they are potentially subject to tax in the hands of the recipient (with no foreign tax credit or exemption if, for example, they are treated as domestic source dividends under a foreign country's source rules, which frequently are less formalistic than the residence of the payer rule followed by the United

88. *Id.* § 163(j).

89. If the subsidiary is financed from an unrelated foreign entity, the earnings stripping rule will not apply because the entity is unrelated, and the portfolio interest exception will apply because the entity is unrelated and is not a bank. *See id.* §§ 163(j)(3), 871(l), 882(c). Therefore, interest payments will reduce the United States tax base and will not be subject to withholding.

90. *See, e.g.,* OECD MODEL TREATY, *supra* note 4, art. 5(7) ("The fact that a company [in one country] . . . controls or is controlled by a company [in another country] . . . shall not of itself constitute either company a permanent establishment of the other.").

91. U.S. MODEL TREATY, *supra* note 4, art. 10(2). The threshold is 25% under the OECD Model Treaty. OECD MODEL TREATY, *supra* note 4, art. 10(2).

States).⁹² Thus, dividends are a tax-inefficient way of repatriating the earnings of United States corporations.

Nevertheless, even in the case of dividends, certain rules operate to reduce the likelihood that portfolio dividends will be subject to effective source-based taxation. First, the 30% withholding tax on portfolio dividends is relatively easy to avoid because of an administrative rule, which provides that payers should withhold tax on dividends based on the address to which the dividend is sent, without any certification as to the actual residence of the recipient.⁹³ This rule means that portfolio investors (but not easily traceable direct investors) can avoid withholding at the 30% rate by directing their dividends to an address in a country with a favorable treaty rate with the United States.⁹⁴

Second, the source rule for dividends, like the rule for interest, is formalistic: dividends are sourced according to the residence of the payer.⁹⁵ In the absence of other rules, this would mean that a foreign corporation whose entire income is effectively connected with its United States trade or business could pay dividends to foreign shareholders without withholding tax being imposed. In fact, however, the source rule has been modified to make such dividends United States source income in certain cases;⁹⁶ but in practice, the Treasury Department has found it impossible to enforce withholding on dividends paid by a foreign corporation to foreign shareholders⁹⁷ and is forbidden from doing so by many United States treaties.⁹⁸ To counteract this result, Congress in 1986 enacted the branch profits tax, which seeks to impose an equivalent tax on the earnings of the foreign corporation that are withdrawn from its United States trade or business.⁹⁹ Although the branch profits tax operates as a replacement for withholding on dividends (and interest) paid by the foreign corporation from its United States business, it should be noted that unlike a withholding

92. See, e.g., Income and Corporation Tax Act, 1988, ch. 1, § 246I (U.K.) (incorporating a 1994 law that determines the source of dividends with reference to the source of the underlying profits, rather than residence of the payer).

93. Treasury Regulations specify the forms of income for which such certification is required; dividends are specifically excluded. Treas. Reg. § 1.1441-6(a) (1984). The Treasury Department has been unable to change this rule, despite repeated efforts. See John K. McNulty, *Corporate Income Tax Reform in the United States: Proposals for Integration of the Corporate and Individual Income Taxes, and International Aspects*, 12 INT'L TAX & BUS. LAW. 161, 241 (1994).

94. The Treasury Department intends to issue proposed regulations that will require the dividend recipient to certify that he is a resident of a treaty country in order to benefit from the reduced treaty rate of withholding. See John Turro, *Reforming Withholding Tax Rules for Foreign Investors*, 66 TAX NOTES 1604, 1604 (1995) (discussing concerns about the possible institution of global certification procedures).

95. I.R.C. § 861(a)(2) (1994).

96. *Id.* § 861(a)(2)(B).

97. Norman Sternlicht, *Inequality After the Branch Profits Tax*, 14 INT'L TAX J. 245, 245 (1988).

98. E.g., U.S. MODEL TREATY, *supra* note 4, art. 10(5).

99. I.R.C. § 884 (1994).

tax on dividends, the branch profits tax is an additional tax on the corporation engaged in an active United States business, which may or may not be passed on to the passive investors in that corporation. In addition, the United States has agreed with many of its treaty partners to refrain from imposing the branch profits tax on corporations resident in the other country, and in fact, the United States collects very little revenue from the tax.¹⁰⁰

Finally, in many cases, dividends can be disguised as interest, with respect to which small investors can take advantage of the portfolio interest exemption. Although the 1993 Tax Act reduced the size of this loophole, it still exists, for example, in the case of interest based on the value of publicly traded stock.¹⁰¹ The combination of opportunities for avoidance described above means that dividend withholding is infrequent for portfolio investors.

d. Rents and Royalties.—The withholding tax on royalties and rents is slightly harder to avoid than the tax on dividends or interest because the source rule is less formalistic and more reflective of economic reality. Royalties and rents are sourced according to the place where the asset that gives rise to them is used.¹⁰² However, the United States, like most industrialized countries, negotiates for a 0% withholding rate on rents and royalties in its tax treaties.¹⁰³ Moreover, even in the absence of a treaty, companies can frequently recharacterize royalties as sale proceeds or as income from services,¹⁰⁴ and in both cases, favorable source rules exist that allow taxpayers to avoid United States withholding taxes altogether.¹⁰⁵

To sum up, the taxation of foreign taxpayers generally follows the active or passive distinction. Active income—income effectively connected with a United States trade or business—is subject to United States tax at its source. Passive FDAP income is nominally subject to withholding taxes,

100. See I.R.S. Notice 87-56, 1987-2 C.B. 367 (listing treaty partners for which the United States will not apply the branch profits tax).

101. I.R.C. § 871(h)(4)(C)(v)(I) (1994).

102. *Id.* § 861(a)(4).

103. U.S. MODEL TREATY, *supra* note 4, art. 12; cf. OECD MODEL TREATY, *supra* note 4, art. 12 (1) ("Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other state if such resident is the beneficial owner of the royalties.").

104. See, e.g., Commissioner v. Wodehouse, 337 U.S. 369, 392 (1949) (discussing the statutory distinction between royalties, which were subject to withholding tax, and gains from the sale of property, which were not); Karrer v. United States, 152 F. Supp. 66, 71-72 (Ct. Cl. 1957) (allowing a taxpayer to successfully characterize payments that appeared to be royalties as income from services).

105. See Treas. Reg. § 1.871-11 (1984). In addition, income from interest rate swaps and other types of swaps is sourced in the country of the recipient. Treas. Reg. § 1.863-7(b)(1) (1984). Since swaps can provide adequate substitutes for interest or dividends, this adds another loophole to the withholding regime.

but because of the operation of statutory rules (*e.g.*, the portfolio interest exemption), source rules (*e.g.*, the formal rules for sourcing dividends, interest, and wages), regulatory rules (*e.g.*, the address rule for dividend withholding), and treaties (*e.g.*, the 0% rate on interest and royalties), the United States frequently does not tax such income in the hands of portfolio investors.

Commentators have suggested that the 30% United States withholding rate is too high because it reflects an attempt to tax income at net rates of between 70% and 90%.¹⁰⁶ In fact, the refusal to lower the rate when net United States tax rates were lowered in 1986 may reflect Congress's recognition that the withholding regime is filled with loopholes and that the 30% rate is rarely imposed upon portfolio investors but that it is a useful bargaining chip in treaty negotiations. However, if the proper United States policy is not to tax passive income at its source, this can be achieved in simpler ways than the hodgepodge of rules and exceptions outlined above.¹⁰⁷

B. Domestic Taxpayers

Domestic United States taxpayers are taxed on their worldwide income, but a foreign tax credit is given for foreign income taxes on foreign source income up to the United States tax rate.¹⁰⁸ This suggests that the United States policy is to give the source country primary tax jurisdiction over all types of income. Although this is true to some extent,¹⁰⁹ a combination of statutory rules results in passive foreign income being treated far less favorably than active foreign income, so that in practice, the United States is more likely to respect the primary right of the foreign jurisdiction to tax active income than passive income.

1. Deferral.—The first distinction between active and passive income involves deferral. The possibility of deferring current United States tax on foreign source income results from the fact that only domestic taxpayers are taxed on their worldwide income¹¹⁰ and that taxpayers can easily choose between classification as foreign or domestic according to the

106. See, *e.g.*, Zeev Holender & Alan I. Appel, *The U.S.-Israel Treaty, Bearing Two Protocols, Moves Toward Ratification*, 4 J. INT'L TAX'N 292 (1993) (describing the 30% withholding tax as "high"); Conversation with David Rosenbloom, former United States International Tax Counsel (Oct. 15, 1994).

107. For a suggestion on a simplification of the United States regime, see *infra* subpart II(C).

108. I.R.C. §§ 901, 904 (1994).

109. See Green, *supra* note 1, at 74 ("Under the current international tax norms . . . the United States must yield primary tax jurisdiction to source countries.").

110. I.R.C. §§ 11(d), 881-882 (1994).

formal jurisdiction of their incorporation.¹¹¹ If only these rules applied, a taxpayer could defer current United States tax on foreign source income simply by routing it to a subsidiary incorporated abroad. If the subsidiary were incorporated in a tax haven, the result would be no current taxation of the foreign source income of the subsidiary, which is equivalent to a tax exemption for the interest on these earnings for the period of deferral.¹¹² This would amount to virtually complete exemption in present value terms if the deferral lasts long enough.

Such favorable treatment of foreign source income would encourage United States taxpayers to route their income to foreign "incorporated pocketbooks." To counter this tendency, the United States has a complex set of overlapping antideferral regimes, all of which result either in current taxation of the foreign source income to controlling United States shareholders or in an interest charge on the income when it is repatriated to the United States.¹¹³ The earliest of these regimes, dating from 1937, applied only to foreign corporations controlled by five or fewer United States individuals.¹¹⁴ In 1962, the antideferral mechanism was applied to foreign corporations controlled by United States corporate as well as individual shareholders,¹¹⁵ and in 1986, it was extended to all United States shareholders of foreign corporations, even if they only hold a minuscule percentage of the shares.¹¹⁶

It should be noted, however, that the common feature of all of these regimes, as well as of a currently-proposed, simplified regime uniting most of them,¹¹⁷ is that they only apply to passive foreign income. In 1962, the original Kennedy administration proposal for eliminating deferral on all the foreign earnings of controlled foreign corporations was defeated,¹¹⁸ as were similar proposals in the 1970s. Most recently, in 1992, a similar proposal by former-Congressman Dan Rostenkowski was also met with little enthusiasm, and no movement in this direction seems to be likely.¹¹⁹

111. *Id.* § 7701(a)(4), (5).

112. WILLIAM D. ANDREWS, BASIC FEDERAL INCOME TAXATION 263 (4th ed. 1991).

113. *See* I.R.C. §§ 551-558 (1994) (composing what is referred to as the foreign personal holding corporation regime); *see id.* §§ 951-60 (composing what is referred to as the "subpart F" regime); *id.* §§ 1291-1297 (composing the passive foreign investment company regime); *see also id.* §§ 541-547 (composing what is called the personal holding corporation regime, which applies to foreign corporations under some circumstances); *id.* §§ 531-537 (creating the accumulated earnings tax, which also applies to foreign corporations).

114. *Id.* § 552(a)(2).

115. Revenue Act of 1962, Pub. L. No. 87-834, § 12(a), 76 Stat. 960, 1006.

116. *Id.* §§ 1291-1297 (composing the passive foreign investment company regime); *see also id.* §§ 1246-1247 (governing "foreign investment companies").

117. *See* H.R. 13, 103d Cong., 1st Sess. §§ 401-404 (1993) (proposing a unified "passive foreign corporation" regime to supplant all of the aforementioned regimes except subpart F).

118. *See* PICCIOTTO, *supra* note 1, at 111-12.

119. *Cf.* H.R. 5270, 102d Cong., 2d Sess. § 201 (1992) (proposing the repeal of tax deferral for controlled foreign corporations).

Instead, the 1993 Tax Act contained an expansion of subpart F, which applied it to passive income generating assets of controlled foreign corporations.¹²⁰ Despite the rhetoric surrounding this measure as intended to combat the migration of United States manufacturing jobs overseas, the predictable response was an increase in the investment of controlled foreign corporations in their active foreign businesses but no diminution in deferral.¹²¹

The result of this combination of regimes is that active foreign income enjoys a privileged position over passive foreign income. Although passive foreign income may be taxed currently even to noncontrolling United States shareholders, most active foreign income is not, even if the active income is not currently taxed overseas. Thus, the United States unilaterally grants the source jurisdiction the primary right to tax active income and does not assert residual jurisdiction even if the foreign country does not exercise that right, as long as the income stays abroad; but it asserts its residence jurisdiction to tax currently passive foreign income, albeit with a foreign tax credit (up to the United States tax rate) to avoid double taxation of that income.¹²²

2. *Foreign Tax Credit*.—A second significant distinction in favor of source-based taxation of active foreign income involves the operation of the foreign tax credit. As revised in 1986, the limitation on the credit (by which the credit is limited to the United States tax rate on foreign source income) is further limited by applying it separately by categories of income ("baskets").¹²³ In particular, several categories of passive income are segregated from each other, so that high foreign taxes on one type of passive income cannot be averaged with low foreign taxes on another type of passive foreign income.¹²⁴ For example, if Germany imposes a high withholding tax on interest and India does not, these two categories of income are segregated into separate baskets and cannot be combined to bring the average foreign tax below the limitation.¹²⁵ This means that if

120. I.R.C. § 956A (1994).

121. See John M. Peterson, Jr. et al., *A Passive-Aggressive Approach to Anti-Deferral in the 1990s: Critical Analysis and Planning Techniques Under Section 956A*, 72 TAXES 1084, 1108 (1994) ("Section 956A actually provides a stronger incentive to reinvest such profits outside the United States in active businesses . . ." (emphasis omitted)); Philip A. Stoffregen & Stewart R. Lipeles, *The Impact of Section 956A and Related Legislative Changes on U.S. Multinationals*, 63 TAX NOTES 751, 759 (1994) ("Section 956A . . . may cause U.S. multinationals in the aggregate to increase their foreign holdings instead of repatriating the accumulated earnings of existing CFCs.").

122. I.R.C. § 901(a) (1994) (allowing United States taxpayers a credit against taxes of foreign countries and of possessions of the United States).

123. *Id.* § 904(d).

124. *Id.* (creating separate basket limitations for certain categories of income, including high withholding tax interest and various types of dividends).

125. *Id.* § 904(d)(1)(B), (d)(2)(B) (creating and defining, respectively, a separate limitation category for "high withholding tax interest"). In the recent United States tax treaty with Mexico, the

the high withholding tax on the gross interest from Germany translates into a rate on the net interest income that is higher than the United States rate, the excess foreign taxes cannot be credited, resulting in a permanent bias against such investments. Similarly, dividends from each foreign corporation in which the taxpayer controls between 10% and 50% of the shares are segregated, so that high withholding taxes on such dividends from one country cannot be averaged with low withholding taxes on dividends from a different country, such as a treaty partner of the United States.¹²⁶

The exception to this "basket" system is active foreign source income, which is all lumped into one residual category.¹²⁷ This means that high foreign taxes on active income can usually be credited in full if the United States corporation can find a low-taxed source of active foreign income. For example, suppose that United States corporation X has \$100 in United States source income and \$100 in foreign source income from Germany, which is subject to a German tax rate of 50%. In that case, X will end up with a high effective tax rate and \$15 of excess foreign tax credits: X's foreign tax credit will be limited to \$35 (35% [the United States tax rate] x \$100 [X's foreign source income]); X's United States tax liability will be \$35 (35% x \$200 [worldwide income]) = \$70 [tentative United States tax] - \$35 [foreign tax credit allowed by the limitation]; X's total worldwide tax liability will be \$85 (\$50 [German tax liability] + \$35 [United States tax liability]), an effective tax rate of 42.5%; and X will have \$15 of excess foreign tax credits (\$50 [foreign tax liability] - \$35 [United States foreign tax credit]).¹²⁸ If X can in this situation find a foreign country which does not tax active income (e.g., Ireland, which grants tax holidays to foreign investors),¹²⁹ and from which it can earn an additional \$100 of foreign source income, its effective tax rate will be dramatically lower: X can credit the entire amount of foreign taxes paid (35% [the United States tax rate] x \$200 [X's foreign source income] = \$70 [United States foreign tax credit limit], which is greater than X's total foreign tax liability of \$50); X's United States tax liability will be \$55 (35% x \$300 [worldwide

rate of withholding on interest is set at 4.9%, in order to avoid this limitation. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Income Taxes, Sept. 18, 1992, U.S.-Mex., art. 11, S. TREATY DOC. NO. 103-07, 103d Cong., 1st Sess. (1993) [hereinafter Mexico Treaty].

126. I.R.C. § 904(d)(1)(E), (d)(2)(E) (1994) (creating a separate credit limitation category for certain dividends from controlled corporations). For an impressive defense of this complex system, see Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 AM. J. TAX POL'Y 1, 57 (1991) (concluding that despite minor technical flaws, the credit "embodies skill and principle in the face of significant pressure").

127. I.R.C. § 904(d)(1)(I) (1994).

128. See *id.* § 904(a) (setting forth the general formula for the foreign tax credit limitation).

129. See ARTHUR ANDERSEN & CO., TAX AND TRADE GUIDE: REPUBLIC OF IRELAND 161-62 (1972) (noting that financial inducements to attract foreign industrialists include "[e]xemptions from Irish income taxes").

income] = \$105 [tentative United States tax] - \$50 [United States foreign tax credit]; X's total worldwide tax liability will be \$105 (\$50 [German tax liability] + \$55 [United States tax liability]), an effective tax rate of 35% or 7.5% less than before.¹³⁰

This ability to average active foreign income from several sources for foreign tax credit limitation purposes gives a significant incentive to United States taxpayers who operate abroad to invest in foreign jurisdictions that levy low effective tax rates on the taxpayers' active business income because this will enable them to credit the often higher foreign taxes imposed on business operations in other countries.

To sum up, active foreign business income of domestic taxpayers is not taxed by the United States currently if earned through a foreign subsidiary until it is distributed to the United States taxpayer (as a dividend, interest, or even as a loan),¹³¹ even if there is no source-based taxation. Moreover, even when it is distributed, such active income retains a privileged position because the averaging rules generally allow a credit against all foreign taxes on such income, so that the United States will rarely levy even residual taxes on this income. Passive foreign income, on the other hand, is taxed currently (or is subjected to an interest charge),¹³² and taxpayers are discouraged from investing such income in countries imposing high taxes at the income's source by effectively denying a foreign tax credit for such taxes by segregating them into separate baskets. As a result, the United States most often will get to tax such passive income currently and in full. While the United States retains the residual right to tax active income as the residence country and recognizes the primary right of other countries to tax passive income at its source, these rules promote—as the international consensus would indicate—source taxation of active income and residence taxation of passive income, even in the absence of a tax treaty with the United States.

C. *Alternatives to Current United States Rules*

The current United States international tax system is congruent with the active or passive distinction in some respects but not in others. In particular, the nominally high rate of withholding tax imposed on foreign taxpayers deriving some types of passive income from United States sources is incongruent with the international consensus and with other tax

130. Because of this phenomenon, the refusal of the United States to grant "tax sparing" credits (*i.e.*, to credit taxes nominally payable to a foreign country, but forgiven under a tax holiday) is much less injurious to United States based MNEs than might otherwise appear to be the case.

131. See I.R.C. §§ 951(a)(1)(B), 956(b)(1)(B) (1994) (providing that a United States shareholder must include in income a pro rata share of the increase in obligations owed by United States shareholders to a controlled foreign corporation).

132. See *id.* § 1291 (imposing an interest charge on certain passive income on which taxes have been deferred).

rules, and it causes much of the complexity within the system. In addition, the foreign tax credit rules are immensely complicated because the United States grants credits for foreign taxes on passive income, despite the primacy of residence taxation on such income under the international consensus described above.

Before describing some simplification measures that can be adopted unilaterally in the context of the passive or active distinction, it is useful to consider whether the United States should continue to observe this distinction or whether it should move unilaterally in the direction of maximizing revenues by: (a) ending deferral for foreign source active business income of United States taxpayers (and their controlled foreign subsidiaries); and (b) imposing source-based taxation on all income that is sourced in the United States under economically based (rather than formalistic) source rules.¹³³ Both of these suggestions have been made by academic commentators and have found some support in Congress in the current deficit conscious era.

1. *Ending Deferral.*—Ending deferral for active foreign income has been proposed many times, both as a way of preserving CEN and as a revenue raising measure.¹³⁴ True CEN would, as explained above, require taxing all foreign corporations on their worldwide income, and it is doubtful whether even that extreme step would enhance efficiency. Moreover, ending deferral would not raise significant revenue. First, since 1986, a high proportion of active business income has been taxed abroad at rates as high or higher than the United States rate,¹³⁵ and many United States corporations thus find themselves in an excess credit situation; ending deferral while granting foreign tax credits would not lead to greater United States revenues in those cases. Second, ending deferral would require the United States to end deferral for foreign source losses as well.¹³⁶ For these reasons, the most recent proposal to end all deferral was scored to raise only \$200 million by the revenue estimators.¹³⁷

133. See, e.g., Edrey, *supra* note 24.

134. E.g., H.R. 5270, *supra* note 119; see also Asim Bhansali, Note, *Globalizing Consolidated Taxation of United States Multinationals*, 74 TEX. L. REV. 1401, 1407-15 (1996) (proposing an end to deferral that would be achieved through consolidated taxation of United States parent corporations and their foreign subsidiaries).

135. Virginia M. Turris, *Foreign Tax Credit: Limitation After Tax Reform Act: The Separate Limitation Categories and the Application of the Look-Through Rule*, 42 TAX LAW. 275, 277 (1989).

136. Paul W. Oosterhuis & Roseann M. Cutrone, *The Cost of Deferral's Repeal: If Done Properly, It Loses Billions*, 58 TAX NOTES 765, 768 (1993) (concluding that in order to follow the economic policy underpinnings for eliminating deferral, United States companies must be given a realistic opportunity to elect to include their foreign subsidiaries in their consolidated group for United States income tax purposes).

137. See Lee Sheppard, *Deferral, Runaway Plants, and Capital Allocation*, 59 TAX NOTES 999, 1002 (1993) (referring to the estimated \$200 million revenue gain from a Clinton administration proposal to repeal deferral).

In addition, the current proposals to end deferral apply only to controlled foreign corporations. However, to seriously combat deferral from a purely United States perspective—even assuming that only corporations controlled by United States persons should be affected—current United States taxation should apply to all income earned through foreign corporations, controlled or uncontrolled, passive or active. Because a United States shareholder has no way of making a noncontrolled foreign corporation distribute its income to her, the regime would have to include an option to pay the tax with an interest charge when the earnings are distributed, similar to the current PFIC regime.¹³⁸ However, even that option imposes a heavy burden on the taxpayer, who may have difficulty making a foreign corporation in which she owns only a minuscule percentage of shares disclose the information necessary for a tax return. It is doubtful whether ending deferral is worth that burden.

2. *Taxing All Income Economically Derived from the United States.*—Levying United States tax on all income that derives economically from the United States faces far more significant obstacles than ending deferral. First, it would require unilaterally levying withholding taxes on portfolio interest (including bank deposits), which would either deter foreign investors from placing their mobile capital in the United States or require raising interest rates to preserve foreign investors' after-tax return.¹³⁹ Second, it would require drastic changes to the source rules, so that dividends or interest would be sourced not according to the formal residence of the payer, but according to the level of the payer's economic activity in the United States. These changes in the source rules are complicated and very difficult to administer because the proper withholding would be on payments from foreign entities to foreign recipients. The branch profits tax, which currently substitutes for such withholding for dividends, is an inadequate proxy because it falls on the wrong taxpayer and because it is extremely complicated to administer.¹⁴⁰

138. I.R.C. §§ 1291-1297 (1994). For critiques of the complexity of the PFIC regime, see, e.g., David R. Tillinghast, *International Tax Simplification*, 8 AM. J. TAX POL'Y 187, 204-05 (1990) and Stephen E. Shay, *The Post-TAMRA Treatment of U.S. Shareholders of PFICs* (pts. 1 & 2), 70 J. TAX'N 296, 374 (1989).

139. See HUFBAUER, *supra* note 1, at 66 (explaining that "a tax on interest paid to foreigners will prompt these tax-sensitive investors to withdraw funds until market forces push the domestic interest rate up by enough to offset the tax").

140. Commentators have been critical of the branch profits tax for other reasons as well. See, e.g., Fred B. Brown, *Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?*, 49 TAX L. REV. 133, 195-96 (1993) (criticizing the branch profits tax as an example of the unwarranted disparity in tax treatment of United States subsidiaries of foreign corporations and United States branches of foreign corporations); Richard L. Doernberg, *Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Arrogation of Authority*, 42 TAX LAW. 173, 181, 201 (1989) (arguing that the enactment of the branch profits tax overrides

In the absence of such changes, however, the current rules place an immense premium on whether payments are characterized as dividends (and subject to withholding tax) or portfolio interest (and exempt) and on whether they are royalties (generally taxable) or income from sales or services (generally not taxable because of the source rules). These distinctions require constant policing, and much of the complexity of the inbound rules of the Code stems from this problem.¹⁴¹ In particular, the various limitations on the portfolio interest exemption derive primarily from the need to distinguish dividends from interest, and significant litigation and uncertainty surrounds the distinction between royalties and sales or services.¹⁴²

It would appear, therefore, that instead of attempting to enforce the unenforceable, considerable simplification and greater consistency could be achieved if the United States were unilaterally to adopt two complementary and symmetrical changes in its international tax regime: abandoning the taxation of United States source portfolio income (including dividends) and ending the foreign tax credit for foreign source portfolio income.¹⁴³

3. *Ending Source-Based Taxation of Portfolio Income.*—Ending source-based taxation of portfolio income of foreign taxpayers would have numerous benefits. This proposal would enable the United States to simplify considerably its tax rules relating to inbound investment: the contingent debt limitation on the portfolio interest exception could be lifted because it is designed to prevent the avoidance of the withholding tax on dividends.¹⁴⁴ Similarly, the branch profits tax, which is designed as a substitute for withholding on dividends, could be abandoned.¹⁴⁵ The source rules relating to inbound investment would be maintained because

existing treaty nondiscrimination provisions and that this override constitutes a violation of international law by the United States); Alan S. Lederman & Bobbe Hirsh, *Final Branch Regulations Fail to Clear the Thicket of Complexity*, 78 J. TAX'N 110, 117 (1993) ("[F]or the typical foreign corporation [the rules] leave the computation of branch taxes entwined in a thicket of complexity."). The original revenue estimate for the branch profits tax totalled a modest \$110 million over five years. GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1047 (1986).

141. See Brown, *supra* note 140, at 185-86 (proposing that the "nebulous standard" for determining the status of investment income, which has "engendered a considerable number of disputes between taxpayers and the Service," be replaced by an elective system for administrative simplification purposes).

142. See, e.g., *Commissioner v. Wodehouse*, 337 U.S. 369 (1949) (holding that income to a non-resident alien for royalties for copyrights used in the United States is subject to United States tax); *Karrer v. United States*, 152 F. Supp. 66, 73 (Ct. Cl. 1957) (holding that payments to a non-resident alien for services performed outside the United States are not subject to United States tax).

143. See HUFBAUER, *supra* note 1, at 66-67 ("[Countries should] fully tax income received by their own residents from international portfolio investments. At the same time, they should not tax interest income paid to foreign investors.").

144. I.R.C. § 871(h)(4) (1994).

145. *Id.* § 884.

they are needed to enforce taxation on direct investment, but the pressure of determining the source of portfolio income would be significantly lowered by a rule stating that the income of foreign taxpayers is not from United States sources unless it is either effectively connected with a United States trade or business or derived from a 10% or more controlled United States subsidiary. This rule would make it less important to distinguish among categories of passive income and exclude from taxation those taxpayers not engaged (directly or indirectly) in a United States trade or business. The sourcing of active business income of those taxpayers engaged in a United States trade or business would have to be addressed by other means.¹⁴⁶

The limitation of this proposal to portfolio income may seem incongruent with the international consensus to the extent that the consensus requires that all passive income (and not just portfolio income) be taxed on a residence basis. However, in the absence of such a limitation, it is doubtful whether the United States can under the current rules effectively enforce source-based taxation of active income because of the difficulties in enforcing transfer pricing.¹⁴⁷ In the absence of an international consensus on transfer pricing, it would seem necessary to maintain withholding taxes on passive income distributed to foreign direct investors and on passive income effectively connected with a United States trade or business in order to ensure that some tax is levied on United States source active business income. For the same reason, the earnings stripping rule needs to be retained.¹⁴⁸ However, more than half of all foreign investment in the United States would be freed from withholding taxes under the proposed rule.¹⁴⁹

There are two main objections to unilaterally abolishing the withholding tax on portfolio FDAP income. The first is the loss of revenue, but this will be relatively small (about \$2 billion per year under the current system) and will be offset by the savings produced (both for the IRS and for taxpayers) by the simplification entailed in abolishing withholding and by the revenue raised by the abolition of the foreign tax credit for foreign withholding taxes on portfolio income.¹⁵⁰ The second objection, which is potentially more serious, is that there would be no incentive for other nations to enter into tax treaties with the United States and reduce their

146. See discussion *infra* Part III.

147. See discussion *infra* Part III.

148. I.R.C. § 163(j) (1994).

149. HUFBAUER, *supra* note 1, at 63-64.

150. *Id.* at 71-76. Hufbauer estimates the combined effect of abolishing withholding on inbound portfolio investment and granting only a deduction, but no credit, on taxes on outbound portfolio investment as a revenue *gain* of \$12 billion, without even taking into consideration the administrative savings. *Id.*

withholding taxes unless the United States had withholding taxes, that it could reciprocally reduce.¹⁵¹ However, this objection ignores the reality that few countries are today in need of reducing United States source taxation on the passive income of their residents. Developed countries, whose residents invest heavily in the United States, already benefit from low or no United States source-based taxation of passive income under existing treaties and generally renegotiate those treaties not to achieve further reductions in source-based taxation but to redefine the scope of the treaty in other ways, such as the definition of a permanent establishment or the exchange of information article. The abolition of residual United States withholding taxes would not significantly affect the incentives of those countries to renegotiate their treaties. Developing countries, which generally have no treaty with the United States,¹⁵² generally also do not have significant investments by their residents in the United States.¹⁵³ To the extent they do, these investments represent capital flight, which is encouraged by the portfolio interest exemption and is not viewed favorably by the developing countries.¹⁵⁴ Such countries would be interested in treaties with the United States to benefit from the exchange of information and to encourage United States investment by ensuring the creditability of their taxes and by defining what constitutes a permanent establishment. Thus, it would seem that few countries today would negotiate treaties with the United States primarily to obtain a reduction of United States withholding taxes.

4. Eliminating the Foreign Tax Credit for Foreign-Source Portfolio Income.—The second proposal involves simplification of the foreign tax credit mechanism by granting the credit only for taxes on active income, plus withholding taxes on passive income representing distributions by foreign corporations to significant United States direct investors (e.g., to shareholders who own 10% or more of a corporation's stock), but denying credit for foreign withholding taxes on portfolio income and allowing only a deduction for those taxes.

The result of these changes would be the abandonment of the basket system. All active income, as well as all passive income from 10% or more controlled foreign corporations, would be given a foreign tax credit

151. Hufbauer does not discuss this issue, suggesting only that the denial of the credit be phased in gradually to allow for renegotiating treaties. *Id.* at 67.

152. Julie A. Roin, *Adding Insult to Injury: The "Enhancement" of S 163(J) and the Tax Treatment of Foreign Investors in the United States*, 49 TAX L. REV. 269, 304 n.68 (1994).

153. *Id.*

154. *Cf. id.* at 67 n.9 (noting that the rule adopted by some developing countries that exempts from tax the income of residents from foreign investments has played a "troublesome" role with regard to capital flight).

with an overall limitation. All other income would not receive a foreign tax credit; instead, the foreign taxes would be deductible as a business or investment expense. This proposal would only be implemented in the absence of a treaty requirement to credit low foreign withholding taxes, but United States treaty policy should seek to persuade foreign countries to abandon their residual withholding taxes on portfolio income in the treaty context.¹⁵⁵

The rationales for this proposal—other than its simplification potential—are that the United States should not credit foreign taxes on income on which it has the first right to levy tax under the international consensus and that source countries will not be harmed if the United States does so. In today's mobile capital markets, there is already considerable pressure to reduce withholding taxes on passive portfolio income; a refusal to credit such taxes would further contribute to their reduction.¹⁵⁶ Economists have long argued that the burden of taxing mobile capital from abroad by source countries falls on the source country, because foreign investors would refuse to lend unless their yield was raised to cover the withholding tax; thus, investments with a lower yield would not be made, even though they would be profitable on a pretax basis.¹⁵⁷ For example, if a 20% withholding tax is imposed and foreign investors can obtain a 10% after-tax yield elsewhere, the source country yield would have to be 12.5% to give the foreign investors a net yield of 10%. The foreign investors will not be harmed, but domestic investments (of equivalent risk and maturity) with a yield of less than 12.5% will not be made, even if they would have been made if no tax were imposed. Because the need to pay higher yields to foreign investors leads to artificially high returns for domestic investors, a loss of welfare for the source country results.¹⁵⁸

This result does not necessarily occur in the presence of a foreign tax credit because foreign investors will not be harmed by the 20% tax if they

155. See *id.* at 67 (suggesting that the United States terminate existing treaties in a gradual fashion).

156. Cf. HUFBAUER, *supra* note 1, at 68 (stating that denial of a United States foreign tax credit for portfolio income would begin a chain of events that would lead to repeal of foreign withholding taxes on such income).

157. See Mark Gersovitz, *The Effects of Domestic Taxes on Foreign Private Investment*, in *THE THEORY OF TAXATION FOR DEVELOPING COUNTRIES* 615, 616-18 (David Newberry & Nicholas Stern eds., 1987) (explaining that under a set of certain assumptions, any tax on foreign capital will be borne entirely by the source country because any increase in tax will result in a corresponding decrease in capital investment); Chang H. Lee, *Toward a Small Country Theory of Designing an In-bound Income Tax System and Interpreting Tax Treaties*, ch. 7, at 1-3 (1992) (unpublished S.J.D. dissertation, Harvard Law School) (concluding that a developing country should exempt foreign capital from tax, except to the extent host country taxes would be creditable against taxes of the investor's home country).

158. HUFBAUER, *supra* note 1, at 66 (explaining that when interest rates are pushed up to offset taxes "the end result will be a loss for the capital-importing country, because some profitable investment opportunities will be forgone").

can obtain a credit for the tax against their domestic tax liability. However, significant numbers of investors either are tax exempt or have excess credits on passive income and therefore cannot use the credits under the current rules.¹⁵⁹ In those circumstances, abolishing the credit would not harm the source country more than the current situation does. Moreover, the unavailability of a credit would discourage investment in countries with withholding taxes and, in turn, encourage those countries to eliminate harmful withholding taxes.

Although abolishing the credit for portfolio income may create a certain amount of international double taxation, the amount is unlikely to be high, given the mobility of capital investment. In addition, the burden would be mitigated by the deductibility of the foreign tax, and it would seem likely that the simplification potential and transaction costs saved by abolishing the basket system outweigh the disadvantage to foreign portfolio investment.¹⁶⁰ It should be noted that this proposal does not extend to foreign withholding taxes on direct investment because these taxes represent the only efficient way for many developing countries to tax foreign direct investment. Thus, the treatment under the two proposals for inbound and outbound investment would be parallel: there will be no United States withholding tax on inbound portfolio investment, and there will be no United States credit for foreign withholding taxes on outbound portfolio investment, while both withholding taxes and credits will be maintained for direct investment.

A more radical proposal would entail abolishing the foreign tax credit altogether, granting an exemption to foreign active income, and taxing foreign passive income on a worldwide basis with no credit. This result may already be achieved under the current system to a large extent. Because corporations have the ability to average high and low tax rates on active foreign income, it is relatively rare for residual United States tax to be levied on such income. The exemption for foreign source active income would benefit developing countries and act as a substitute for the tax sparing credit the United States has been unwilling to grant.¹⁶¹ However,

159. Some have suggested that small countries should impose inbound withholding taxes only when a credit is actually available to the foreign investor. Lee, *supra* note 157. But this may adversely affect the creditability of the tax. See, e.g., Treas. Reg. § 1.901-2(c) (as amended 1991) (denying credit for such "soak-up" taxes).

160. See HUFBAUER, *supra* note 1, at 68 (predicting that the effect of such unilateral United States steps would be the gradual disappearance of withholding taxes on portfolio investments).

161. See generally H. David Rosenbloom & Stanley I. Langbein, *United States Tax Treaty Policy: An Overview*, 19 COLUM. J. TRANSNAT'L L. 359 (1981) (discussing the United States position on tax sparing). A tax sparing credit is a foreign tax credit for taxes that a foreign country would have levied, if not for a tax holiday designed to attract foreign investment. Chang H. Lee, *Taxation of U.S.-Korea Technology Transfer: A Developing Country's Point of View*, 10 INT'L TAX & BUS. LAW. 1, 40-42 (1992). Other countries have granted such credits in their tax treaties, but the United States has refused

such a system would put great pressure on the definition of the source of active income, which is the great weakness of the current regime.¹⁶² Thus, unless the issue of sourcing active income is effectively resolved, granting a complete exemption from United States tax for such income would go too far.

III. The Major Problems in the Current Regime: Enforcing Residence-Based Taxation of Individuals and Allocating Active Income Among Taxing Jurisdictions

The international consensus described above—to tax passive income primarily on a residence basis, while active income is taxed primarily on a source basis—currently suffers from two major flaws that threaten to undermine the entire structure: the increasing difficulty in enforcing residence-based taxation of individuals and the increasing difficulty in determining what is the source of active business income. Although the simplification measures suggested in Part II can be adopted unilaterally by the United States, both of these underlying problems can only be addressed through a consensual approach.

A. *Enforcing Residence-Based Taxation of Individuals*

The first problem is practical, not theoretical, but it is very real: even developed countries find it hard to effectively enforce residence-based taxation on the global income of individuals, especially from tax havens, and developing countries find this task impossible. As portfolio investment grows and becomes increasingly more mobile, this problem becomes more and more acute.¹⁶³

Source-based taxation of passive income is much more effective than residence-based taxation because the source country has the information needed to enforce the tax if it wishes to do so. Source-based taxation is, however, hindered by the existence of tax havens and by the failure of developed countries to levy source-based taxation on some portfolio income for fear of driving it towards tax havens. Regardless, as explained earlier, residence-based taxation of individuals is to be preferred on the grounds of equity (redistribution), efficiency (CEN), and political accountability.

to do so because the result would be to lower the United States tax levied on United States source income. *Id.* at 41.

162. See discussion *infra* Part III.

163. See Alberto Giovannini & James R. Hines, Jr., *Capital Flight and Tax Competition: Are There Viable Solutions to Both Problems?*, in *EUROPEAN FINANCIAL INTEGRATION* 172, 172 (Alberto Giovannini & Colin Mayer eds., 1991) (recognizing the problems associated with revenue collection and “internationally mobile capital”); Richard M. Bird, *Income Tax Reform in Developing Countries: The Administrative Dimension*, 37 *BULL. FOR INT’L FISCAL DOCUMENTATION* 7 (1983) (suggesting a system of withholding taxes on income from “movable capital” because “such income is all too likely to escape tax entirely in the circumstances of most developing countries”).

There are two complementary ways to develop a solution to this dilemma. The first is to enhance the information exchange programs under tax treaties, so that developed countries can share with developing countries the data necessary for effective enforcement of residence-based taxation, especially data on tax haven investments.¹⁶⁴ The development of information technology and its spread throughout the world promise significant progress in this direction in the next century. Another promising development is the increasing number of treaties, with their attendant information exchange benefits, between developed and developing countries.¹⁶⁵ The combination of these two developments may mean that in the twenty-first century, even the least advanced tax administration in a developing country will be able to benefit from the computerized databases of the most advanced administration—currently the IRS¹⁶⁶—in a developed country.

The second way is for developed countries to establish a concerted program of withholding taxes at the source of income for the benefit of the residence country.¹⁶⁷ All developed countries lose from the competitive abolition of withholding taxes, which impedes their efforts to collect taxes from their residents on investments in other developed countries.¹⁶⁸ Instead, developed countries could agree to levy a uniform backup withholding tax on all portfolio investments that would be retained by the country imposing the tax unless the investor furnishes documentation showing that the income has been declared in his or her residence country; in that case, the source country would transmit the withholding tax to the

164. See, e.g., U.S. MODEL TREATY, *supra* note 4, art. 26 (encouraging exchange of information and administrative assistance between treaty partners in order to enforce effective tax collection).

165. The United States has recently entered into tax treaties with India, Mexico, Kazakhstan, Russia, and Ukraine. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Mar. 4, 1994, U.S.-Ukraine, S. TREATY DOC. NO. 103-30, 103d Cong., 2d Sess. (1994); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Oct. 24, 1993, U.S.-Kazakhstan, S. TREATY DOC. NO. 103-33, 103d Cong., 2d Sess. (1994); Agreement on Taxation: Shipping and Aircraft, Apr. 12, 1989, U.S.-India, T.I.A.S. No. 11,711; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, June 17, 1992, U.S.-Russia, *reprinted in* 3 TAX TREATIES (CCH) ¶ 8003; Mexico Treaty, *supra* note 125.

166. Cf. *Hearing of the House Ways and Means Comm. Oversight Subcomm. Re: Internal Revenue Service Budget Request*, 104th Cong., 1st Sess. (1995), available in WESTLAW, CONGHRT Database, File No. 1995 WL 10383255 at *8 (statement of Margaret Richardson, Commissioner, Internal Revenue Service) ("I believe that the United States currently has the best administration in the world, but we at the Internal Revenue Service do recognize that we can no longer do business as usual.").

167. HUFBAUER, *supra* note 1, at 68-71 (urging the United States to adopt legislation designed to set the stage for an international arrangement on this issue).

168. See Green, *supra* note 1, at 55-59 (asserting that the competitive reduction of corporate tax rates inhibits government's ability to effectively tax mobile capital); see also David Buchan, *Belgium 5; Tax Plea to IMF*, FINANCIAL TIMES (London), June 18, 1990, Survey, at 31 (describing the damaging effect of tax competition on the Belgian government's revenues).

residence country through a clearinghouse mechanism similar to the one used by some European Community countries for imputation credit purposes.¹⁶⁹

One can envisage the development of this system in two stages. In the first stage, developed countries, which could generally be defined as the members of the OECD, would agree to levy the backup withholding tax at a uniform rate, perhaps 10%, which would not be creditable. This tax would drive some investments to tax havens, but the rate would be low enough to limit the extent of this movement. The essential feature of the tax is its uniform application by all the major capital importing countries, which prevents tax competition. In the second stage, investors would encourage residence countries to enter into agreements with the capital importing countries to set up the clearinghouse mechanism through which withholding taxes can be credited against the income tax liability of the investor in the residence country.¹⁷⁰

How likely is this scenario to occur? The level of agreement needed for the first stage is much lower than what was needed to reach the current international tax consensus. If a major capital importing country, such as the United States, abolished all portfolio withholding, it would put considerable pressure on the other members of the OECD to cooperate toward instituting some kind of uniform withholding system to prevent capital from migrating to the United States. Once a uniform withholding system were in place, it would constitute a major inducement for developing countries to enter into treaty negotiations to obtain the benefit of the taxes withheld. Although tax havens will not cooperate, it is possible to limit their attractiveness through the information exchange programs outlined above. In addition, the attractiveness of tax havens currently is, to a large measure, as a conduit for investments into developed countries, which do not have effective withholding taxes on payments to tax haven "residents." This attractiveness will be reduced if backup withholding is implemented by the developed countries.

In addition to preventing tax competition, it may also be possible to give the developed countries a concrete incentive to participate in the backup withholding regime by allowing them to retain a portion of the tax as a fee for their services in collecting and transmitting the tax to the residence country, especially when the investment balance in the developed country is tilted heavily in the direction of inbound investment.¹⁷¹

169. See generally Hugh J. Ault, *International Issues in Corporate Tax Integration*, 10 LAW & POL'Y INT'L BUS. 461, 484-85, 493 (1978) (discussing the imputation credit for corporate dividends and its association with the clearinghouse mechanism).

170. For conditions that should be imposed before the tax is remitted to the residence country, see HUFBAUER, *supra* note 1, at 69-70.

171. This method is currently implemented between Israel and the Palestinian National Authority: the taxes withheld from the income of Palestinians working in Israel are remitted to the Palestinian

B. *Allocating Active Income by Source*

Under the current consensus, the determination of the source of passive income is somewhat unimportant because passive income is primarily taxed on a residence basis, with no distinction as to its source; source is significant only to the extent that withholding taxes are imposed. The determination of the source of active income, however, is crucial because it determines the jurisdiction to which taxes on such income are primarily due. If there is no consensus on the allocation of active income, the result is either overtaxation or undertaxation. The income will be overtaxed if two taxing jurisdictions lay claim to taxing the same income on a source basis, in which case neither would grant a credit for the other's taxes; the income will be undertaxed if divergent sourcing rules in two or more jurisdictions cause each jurisdiction to grant the primary right to tax to the other.¹⁷²

The most significant issue concerning source-based taxation of active income involves the proper method of allocating the taxable income of MNEs among taxing jurisdictions.¹⁷³ In general, there are two approaches to this problem, which has been the subject of heated debate in the past thirty years. One approach is the arm's-length method, which respects each corporation included in a MNE as a separate legal entity for tax purposes, and the other is the unitary or formulary apportionment method, which treats the entire MNE as one unit and then seeks to apportion its income among taxing jurisdictions based on a formula.¹⁷⁴

1. *Traditional Arm's-Length Allocations.*—The arm's-length method was first promulgated in regulations issued by the United States Treasury Department (under the guidance of the Assistant Secretary for Tax Policy, Professor Stanley Surrey) in 1968 and has since become the basis for the approach of most industrialized countries to the allocation of active income. The arm's-length method is embodied in most tax treaties, including the model treaties issued by the United Nations and the OECD.¹⁷⁵ It

National Authority, less a "commission" of 25%. See Ephraim Kleiman, *The Economic Provisions of the Agreement between Israel and the PLO* (unpublished manuscript, on file with author).

172. See, e.g., *Phillips Petroleum Co. v. Commissioner*, 101 T.C. 78, 104 (1993) (allocating a portion of Phillips's income to Japan, even though Japan treated the income as taxable only in the United States).

173. See generally Green, *supra* note 1, at 32-46 (discussing the use of the transfer manipulation price as a means for multinationals to minimize their global income tax liability); Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 90 (1995) (demonstrating the possibilities for transfer-pricing abuses by MNEs).

174. Avi-Yonah, *supra* note 173, at 92.

175. OECD MODEL TREATY, *supra* note 4, art. 9; U.N. MODEL TREATY, *supra* note 4, art. 9; see also I.R.S. Notice 88-123, 1988-2 C.B. 458, 475 (demonstrating how the arm's-length standard is an international norm); Organization for Economic Co-operation & Dev., Committee on Fiscal

involves treating each constituent unit of a MNE, which can be a subsidiary or a branch, as a separate taxable entity and reconstructing its income—by assigning certain amounts of income to a source in the taxing jurisdiction—based on hypothetical transactions that would have taken place had the unit been dealing with other portions of the MNE at arm's length.¹⁷⁶

The paradigmatic case of applying the arm's-length method involves finding a precisely comparable transaction for each transaction between portions of an MNE and deriving the income of each portion based on the comparable transaction.¹⁷⁷ For example, suppose the only transaction between a parent corporation and a subsidiary in a different jurisdiction involves the parent's manufacture of widgets at a cost of \$60 each, the sale of the widgets to the subsidiary, and the subsidiary's resale of the widgets to unrelated customers in its jurisdiction for \$100 each, at a marketing and distribution cost to the subsidiary of \$20 per widget. On an *a priori* basis, the price charged by the parent to the subsidiary, which determines the allocation of income between the taxing jurisdictions (the "transfer price"), can be anything between \$60, the minimum amount that would permit the parent to recover its manufacturing costs, and \$80, the maximum amount that would permit the subsidiary to avoid losing money.¹⁷⁸ Because the allocation of the residual of \$20 between the parent and the subsidiary makes little economic difference when they are parts of the same MNE, it is to the taxpayer's advantage to determine the transfer price on the basis of the effective tax rates in both jurisdictions and shift the residual to the jurisdiction with the lower rate.¹⁷⁹ There is some evidence that this type of tax planning actually takes place—it has even been suggested that the opportunity to engage in transfer pricing is a major reason for the existence

Affairs, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators*, 9 TAX NOTES INT'L 155, 161-63 (1994) [hereinafter *OECD Guidelines*] (stating the arm's-length principle and discussing its justifications). But see Louis M. Kauder, *The Unspecific Federal Tax Policy of Arm's Length: A Comment on the Continuing Vitality of Formulary Apportionment at the Federal Level*, 60 TAX NOTES 1147, 1155 (1993) (arguing that the OECD and U.N. Model Treaties do not require the application of the arm's-length standard).

176. See Treas. Reg. § 1.482-1(b)(1) (1994) (requiring the taxation of transactions involving controlled taxpayers to be determined by the arm's-length standard).

177. For a description of this "comparable uncontrolled transaction" (CUP) method, see *id.* § 1.482-2(e) (1968) and *id.* § 1.482-3(b) (1994).

178. See generally Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 627 (1986) (explaining the economics behind transfer pricing manipulation); Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 TAX NOTES 339, 345-47 (1992) (discussing the practical and conceptual difficulties presented by the arm's-length pricing requirement).

179. ROGER GORDON & JEFFREY MACKIE-MASON, *WHY IS THERE CORPORATE TAXATION IN A SMALL OPEN ECONOMY? THE RULE OF TRANSFER PRICING AND INCOME SHIFTING* 11 (National Bureau of Economic Research Working Paper No. 4690, 1994).

of MNEs—and that transfer pricing provides a potential method of reducing the inefficiencies resulting from discrepancies in tax rates among jurisdictions.¹⁸⁰

If, however, the parent corporation in the example above also sells widgets to an unrelated party in the same market as the subsidiary for \$75, the tax authorities have a basis for arguing that the proper allocation of the residual between the related parties should be \$15 to the parent and \$5 to the subsidiary. The same result would obtain if an unrelated seller would sell the same products to an unrelated distributor in the same market for \$75. This is the classic case for applying the arm's-length method to determine the allocation of income between related parties. In this situation, the arm's-length method is attractive because it neutralizes the tax advantage resulting from the MNE's structure, and therefore business will not be driven to the MNE form for tax reasons.

2. *Modification of the Arm's-Length Standard.*

a. Cost-Plus and Resale Price Methods.—As early as 1968, the United States Treasury recognized that such “comparable uncontrolled prices” (CUPs) may not be found.¹⁸¹ Consequently, the 1968 regulations, as well as other countries and the OECD, adopted two additional methods for determining the proper transfer price: the cost plus and resale price methods.¹⁸² Under these methods, the profit margin of either the manufacturing party or the distributing party is determined by comparing it to the profit margins of unrelated manufacturers or distributors of similar products in the same market. The advantage of these methods is that they do not require a specific transaction involving the same product; thus, they represent a move away from pure comparability, but still require a finding of rough comparability between the taxpayer and the unrelated manufacturers or distributors.

Over the last fifteen years, however, it has become increasingly clear that in a large number of cases involving MNEs, it is not possible to find even the roughly comparable transactions required to apply the resale price and cost plus methods and that the attempt to do so involves immense

180. See *Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 101st Cong., 2d Sess. 3-29 (1990) (statement of Rep. J.J. Pickle, Chairman) (summarizing economic evidence regarding the undertaxation of multinationals); cf. Harry Grubert et al., *Explaining the Low Taxable Income of Foreign-Controlled Companies in the United States*, in ALBERTO GIOVANNINI ET AL., *STUDIES IN INTERNATIONAL TAXATION* 237 (1993) (rejecting several alternative explanations for underpayment of United States tax by foreign companies and concluding that transfer pricing accounts for at least half of the underpayments).

181. Treas. Reg. § 1.482-2(e)(2) (1968).

182. *Id.* § 1.482-2(e)(2)-(4).

administrative costs.¹⁸³ In those situations, there is no clear answer to the crucial question: how to divide the profit continuum (between the minimum price acceptable to the seller, and the maximum acceptable to the buyer, *i.e.*, the range between \$60 and \$80 in the example given earlier) between the related parties. Because there is a range of prices that would have been an acceptable result in arm's-length negotiations, there is no single arm's-length price; the tax result depends on which of many acceptable prices is actually chosen by the related parties.¹⁸⁴

The pure arm's-length method is unworkable in many situations because there is no reason why comparable transactions should exist. An examination of the extensive economic literature concerning MNEs may explain why comparable transactions sometimes cannot be found. This economic literature seeks to answer the question of why enterprises choose to operate abroad through related parties rather than through unrelated distributors or licensees.¹⁸⁵ If one applies Coase's theory of the firm, the use of MNEs can be seen as an alternative to market-based transactions that results because of the various costs associated with operating through the market: governmental costs (taxes, trade barriers, and the like), natural costs (transaction costs), and structural costs (such as the ability to exert monopoly power through the related-party structure).¹⁸⁶ The MNE internalizes those costs and is therefore more efficient than market-based transactions.¹⁸⁷

There are numerous kinds of market imperfections that lead to the development of MNEs. For example, a potential licensor may have valuable unpatentable trade secrets that it does not wish to share with a potential licensee before a licensing agreement is signed, but it may be able to persuade the licensee that the product is valuable without revealing the secret (information asymmetry). Thus, it has been shown that MNEs will

183. *E.g.*, *E.I. DuPont de Nemours & Co. v. United States*, 608 F.2d 445, 450-52 (Ct. Cl. 1979) (demonstrating the difficulties in obtaining data on comparable transactions for use in evaluating cost-plus profit margins).

184. Langbein, *supra* note 178, at 637 ("[T]he 'arm's-length' criterion coherently generates two different prices as 'arm's-length' prices—two numbers which mark the limits of a continuum along which any price is an arm's-length price.").

185. *E.g.*, John H. Dunning, *Trade, Location of Economic Activity and the Multinational Enterprise: A Search for an Eclectic Approach*, in *READINGS IN INTERNATIONAL ENTERPRISE* 250, 258-61 (John Drew ed., 1995) (discussing how the benefits of internalization can encourage MNEs to forego market transactions with unrelated parties).

186. See RONALD H. COASE, *The Nature of the Firm*, in *THE FIRM, THE MARKET, AND THE LAW* 33-35 (1988) (discussing the economic advantages of operating as a single firm rather than through the free market).

187. See, *e.g.*, Jean-Francois Hennart, *The Transaction Cost Theory of the Multinational Enterprise*, in *THE NATURE OF THE TRANSNATIONAL FIRM* 81, 81 (Christos N. Pitelis & Roger Sugden eds., 1991) (describing "the transaction cost or internalization approach [which] argues that the transaction cost theory constitutes a general theory of economic organization which can explain the choice between hierarchical co-ordination and other forms of organization").

arise in industries in which patents, the existence of which can solve the information asymmetry problem, are less common or not enforceable.¹⁸⁸ Another example is the protection of goodwill inherent in a trademark. If it is difficult to monitor quality, a trademark licensee can “free ride” by debasing the quality, while continuing to enjoy the benefit of goodwill associated with the trademark and potentially damaging the reputation associated with the trademark.¹⁸⁹ Thus, international banking, insurance, and accounting operations, in which quality is hard to monitor, tend to rely less on franchising and more on control.¹⁹⁰ MNEs are also common in those situations in which long-term futures contracts for a product are difficult to obtain because they require major initial investments (leading to backward integration into production) and in those situations in which the difficulty in monitoring the behavior of unrelated distributors (as opposed to employees) leads to forward integration into sales.¹⁹¹

If MNEs exist because of imperfections in the arm's-length market, the implication is that comparable transactions will not be found when a MNE is successful because the MNE will have driven the arm's-length competitors out of business. Presumably a MNE that could have operated at arm's length through a local entity would have done so because of the normal difficulties of operating in a foreign country with a different culture and legal system. If a MNE chooses to integrate and still remains profitable, this suggests that there are disadvantages to operating through the market—disadvantages that would make finding arm's-length comparables a difficult task.¹⁹²

In terms of the example given above, this analysis suggests that the profit margin of the MNE as a whole would be higher than the sum of that of its constituent parts would be, if they dealt with each other at arm's length. One method of dividing the profit between the related parties in the absence of comparable transactions is to analyze the functions performed by each party and to allocate to each party a return appropriate to its function that is based on the return of entities performing comparable functions.¹⁹³ However, if the MNE is more profitable than the sum of

188. *Id.* at 85-88.

189. *Id.* at 88-89.

190. William D. Turner & Stephen K. Green, *Corporate Challenge to Corporate Treasures*, in *THE MULTINATIONAL ENTERPRISE IN TRANSITION* 125 (Phillip D. Grub et al. eds., 1986) (noticing that when multinational corporations centralized their treasuries, generally the quality of financial decision making improved).

191. *Id.* at 89-93.

192. See Avi-Yonah, *supra* note 173, at 148 (“[T]he very existence of integrated multinationals is evidence that the [arm's-length standard] does not reflect economic reality. . . . [M]ultinationals exist because of market and non-market advantages that are derived from their structure.”).

193. This “profit split” method was first suggested by the Treasury in 1988, I.R.S. Notice 88-123, 1988-2 C.B. 458, 490, and has been incorporated into the recent final regulations. See *Treas. Reg.*

its parts would be, even this method would leave a residual that cannot be allocated to any portion of the MNE because it represents the additional profit resulting simply from the existence of the MNE as a whole.¹⁹⁴ This residual cannot be allocated in its entirety to either party on theoretical grounds.¹⁹⁵

b. IRS Challenges and Court Decisions.—In a long series of cases since 1980, this problem has bedeviled the federal courts in their attempts to deal with transfer pricing issues under Section 482 of the Internal Revenue Code in the absence of comparable transactions. The result has been a series of cases in which the IRS has attempted to persuade the courts to look only at one side of the equation and to allocate the entire residual to the United States side.¹⁹⁶ Typically, the IRS has taken the position that the foreign manufacturer should not be allocated more than a return on the pure manufacturing function and that any profit above that should be allocated to the United States distributor. The IRS has argued that the manufacturer is assured of a market because of the relationship between the parties and therefore should not be allocated any return for risk. The courts have unanimously rejected this position, not necessarily because the IRS argument was wrong per se—it could hardly be denied that the relationship between the parties changed the riskiness of the subsidiary's operations—but because it did not follow from the argument that the entire residual should be allocated to the United States merely because its tax rates were higher. In the absence of meaningful guidance in the regulations on what to do in the absence of comparable transactions, the courts instead have split the residual profit between the related parties based on some vague intuitive understanding of their respective functions.¹⁹⁷

§ 1.482-6 (1994) (explaining the profit split method which “evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm’s length by reference to the relative value of each controlled taxpayer’s contribution to that combined operating profit or loss”).

194. Suppose that a comparison with unrelated manufacturers suggests that the manufacturing portion of the MNE should have a profit margin of 20% of its costs, or \$12, and a comparison with unrelated distributors suggests that the distributing portion of the MNE should have a profit margin of 10% of its costs, or \$2. If one looks only at the manufacturer, this would lead to a transfer price of $\$60 + \$12 = \$72$; if one looks only at the distributor, this would lead to a transfer price of $\$80 - \$2 = \$78$. A residual of \$6 is left because of the relationship between the parties; had they been unrelated, the analysis above suggests that the costs of each would have been higher and that the total profit from the transaction would have been \$14 rather than \$20.

195. Avi-Yonah, *supra* note 173, at 148-49.

196. For an extended discussion of these cases, see Avi-Yonah, *supra* note 173.

197. See, e.g., *Sundstrand Corp. v. Commissioner*, 96 T.C. 226, 375 (1991) (using the court’s “best estimate” of an appropriate transfer price); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252, 376 (1987) (making a “best judgment” allocation of profit); *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996, 1147-69 (1985) (basing the determination of “profit split” generally on functions performed by

Alternatively, to avoid such "rough justice" approximations, the federal courts have strained to find comparable transactions when none could economically be found. Thus, in *United States Steel Corp. v. Commissioner*,¹⁹⁸ the court of appeals found that a comparable transaction existed despite widely different volume and risks and even though the court realized that the result did not reflect "economic reality."¹⁹⁹ A similar outcome was reached in *Bausch & Lomb, Inc. v. Commissioner*.²⁰⁰ the Tax Court held that a comparable transaction was validly chosen despite the extremely different economic conditions existing between the related parties,²⁰¹ and the court of appeals affirmed because such differences "will always be the case when transactions between commonly controlled entities are compared to transactions between independent entities."²⁰²

This series of cases, which still continues and threatens to overwhelm the IRS and the Tax Court, has led to increasing criticism from the General Accounting Office and Congress of the arm's-length method, as applied at the federal level.²⁰³ The Conference Report on the 1986 Tax Reform Act instructed the Treasury Department to conduct a study of the problem and to consider carefully "whether the existing regulations [implementing the arm's-length method] could be modified in any respect."²⁰⁴ The result has been a lengthy study by the Treasury recommending significant changes to the arm's-length method,²⁰⁵ followed by proposed and tempo-

the parties, in a 196-page opinion), *aff'd*, 856 F.2d 855 (7th Cir. 1988); *Hospital Corp. of Am. v. Commissioner*, 81 T.C. 520, 596-601 (1983) (attributing 75% of the subsidiary's taxable income to the parent and using its "best judgment on the lengthy and inconclusive record before" it despite there being "little quantitative evidence in this record upon which [the court] can determine what a reasonable allocation of profits would be").

198. 617 F.2d 942 (2d Cir. 1980).

199. *Id.* at 951.

200. 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991).

201. *Id.* at 591.

202. *Bausch & Lomb*, 933 F.2d at 1091.

203. See H.R. REP. NO. 426, 99th Cong., 1st Sess. 423-24 (1985) (criticizing the arm's-length method for its refusal to recognize that the economic relationship among related parties is fundamentally different from that among unrelated parties); see also Daniel J. Frisch, *The BALRM Approach to Transfer Pricing*, 42 NAT'L TAX J. 261, 262 (1989) (recognizing that MNEs are integration economies whose sizeable incomes cannot be identified with any single member of the group); Langbein, *supra* note 178, at 627 (questioning the "viability [of the arm's-length standard] as a long term solution to the problem of allocating the income of multinational enterprises"); Stanley I. Langbein, *Transaction Cost, Production Cost, and Tax Transfer Pricing*, 44 TAX NOTES 1391, 1392 (1989) (noting that the debate over the benefits of using an arm's-length standard was opened once again under government-ordered studies); Wickham & Kerester, *supra* note 178, at 340 (recounting congressional testimony blaming the arm's-length standard for the IRS's poor record in transfer-pricing cases); Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202, 1214-23 (1976) (analyzing the cost savings that commonly controlled entities realize through economies of scale and reduced transaction costs but that are ignored by the arm's-length method).

204. H.R. REP. NO. 841, 99th Cong., 2nd Sess. II-688 (1986).

205. I.R.S. Notice 88-123, 1988-2 C.B. 458.

rary regulations with additional changes²⁰⁶ and, finally, new final regulations adopted in July 1994 that significantly modify the arm's-length method as applied by the United States.²⁰⁷

3. *New Section 482 Regulations.*—Although they retain the traditional CUP, cost plus, and resale price methods, the new regulations under Section 482 introduce two significant innovations. First, a new “comparable profits method” (CPM) is introduced, under which the functions performed by the “tested party” (the party whose functions are most easily defined) are analyzed and the tested party's profit levels are then compared to the profits of parties performing comparable functions (under a relatively lax standard of comparison). The profits of the tested party are then adjusted to fall within a range of profits earned by the comparable parties.²⁰⁸ However, this method does not indicate what to do with the residual that remains after each party is allocated the return appropriate for its functions. For that, a profit split method similar to that used by courts may be applied. Rather than using the intuitive analysis performed by the courts, the regulations allocate the profit split according to each party's contributions to developing intangibles, which are presumed to account for the residual.²⁰⁹

The striking fact about the profit split method is that it is essentially a unitary or formulary apportionment method: the entire residual profit of both parties *together* is split according to a formula based on the comparison of certain attributes of the parties. Indeed, as I have argued elsewhere,²¹⁰ the shift from CUP to resale price or cost plus to CPM to profit split can be seen as a continuum, with pure transaction-based allocations on one extreme and pure formulary allocation on the other. With each step away from CUP, the level of comparability required diminishes, but one gets closer to the underlying issue of how to divide the overall combined profit between the related parties.²¹¹

These developments, along with the adoption of similar profit split methods elsewhere in the world,²¹² have recently led a group of experts, including senior officials of the United Kingdom Inland Revenue, the Fiscal

206. Prop. Treas. Reg. § 1.482, 57 Fed. Reg. 3571 (1992); Temp. Treas. Reg. § 1.482 (1993).

207. Treas. Reg. § 1.482 (1994).

208. *Id.* § 1.482-5(c).

209. *Id.* § 1.482-6.

210. See Avi-Yonah, *supra* note 173.

211. *Id.* at 93-94 (arguing that the arm's-length and formulary methods of income allocation form “the two extreme ends of a continuum”). I owe the idea that the level of comparability diminishes as one moves closer to determination of profits to Philip R. West, Esq., of Steptoe & Johnson in Washington, D.C.

212. Japan, for example, has adopted a similar method. Marc M. Levey et al., *Japan's Transfer Pricing System is Evolving Along U.S. Lines*, 4 J. INT'L TAX'N 407, 411 (1993).

Affairs Division of the OECD, the Japanese National Tax Administration, and the United States Treasury, to conclude that "the arm's length principle and formulary apportionment should not be seen as polar extremes It is not clear where the arm's length principle ceases and formulary apportionment begins."²¹³ This is a highly significant statement in view of the frequent assertion that no compromise between the arm's-length and the formulary allocation methods is possible.²¹⁴ It suggests that we may be witnessing the birth of a new consensus, in which the labels put on the methods are less important than the ability to use a range of methods along the entire continuum.

4. *A Transfer-Pricing Consensus?*—If a consensual approach to transfer pricing is adopted, what may such a consensus look like?²¹⁵ The discussion above suggests that it should be based (as in the new United States regulations) on a series of methods, with pure arm's-length being used if comparable transactions can be found, and some type of profit split—reflecting the unitary treatment of the affiliated group—being used if there are no comparable transactions available. In fact, the adoption of profit split methods by the United States mirrors developments in other OECD countries, which have moved away from regarding each corporation in an affiliated group as a separate taxable entity for all purposes.²¹⁶

On the basis of these developments, it may be suggested that a compromise consensus can be adopted internationally along the following lines. First, if there are arm's-length comparable transactions (using the standard of comparability for CUP in the new United States regulations), they are the best indication of the appropriate profit split between related parties, and the income should be allocated on that basis. Second, in the absence of comparable transactions, a functional analysis of the portions of

213. Brian J. Arnold & Thomas E. McDonnell, *Report on the Invitational Conference on Transfer Pricing: The Allocation of Income and Expenses Among Countries*, 61 TAX NOTES 1377, 1381 (1993).

214. Cf. I.R.S. Notice 88-123, 1988-2 C.B. 458, 475 (responding to taxpayer and foreign-government fears that the "commensurate with income" standard included in the Tax Reform Act of 1986 was inconsistent with the arm's-length method). For examples of more recent statements along the same lines, see John Iekel, *Samuels Defends Revenue Estimating, Arm's Length Standard*, 65 TAX NOTES 1587, 1588 (1994) and John Turro, *Treasury Continues to Champion Worldwide Arm's Length Standard*, 66 TAX NOTES 316 (1995).

215. For a more extended discussion of this proposal, see Avi-Yonah, *supra* note 173, at 147-59.

216. On the use of formulary methods by other countries, see Avi-Yonah, *supra* note 173, at 157 & n.344. See also OECD MODEL TREATY, *supra* note 4, art. 7(4) (granting permission to use formulary methods in the case of branches). Other examples of the trend away from treating each corporation in an affiliated group as a separate entity for all purposes include the United States subpart F regime, which combats deferral by imputing the passive earnings of foreign subsidiaries to their domestic parents, I.R.C. §§ 951-960 (1994); see also BRIAN J. ARNOLD, *THE TAXATION OF FOREIGN CONTROLLED CORPORATIONS: AN INTERNATIONAL COMPARISON* (1986) (surveying similar methods used by other countries), and the United States indirect foreign tax credit, which treats taxes paid by foreign subsidiaries as if they were paid by the United States parent, I.R.C. § 902 (1994).

the MNE in each jurisdiction should be made, and returns should be allocated to each function (and not just to the tested party, as under the CPM) on the basis of the profits earned by parties performing the same functions in arm's-length transactions. The functional analysis should include the allocation of rents to the jurisdiction furnishing the basis for such rents (e.g., natural resources or a cheap labor pool).

Finally, the residual profit should be split on an agreed-upon basis. Because the residual results from the relationship between the affiliated corporations, any allocation rule would be arbitrary. Thus, the precise profit split agreed upon is immaterial, as long as the same rule is used by everyone. Because the most important point is to obtain a consensus, the most likely solution in the case of manufacturing MNEs would appear to be a division of the residual among all of the jurisdictions in which the MNE operates (at least if its operations constitute a permanent establishment), based equally on the MNE's tangible assets and sales, which are factors that are harder for the MNE to manipulate even through the use of tax havens. This type of allocation would appear to be closest to the goal of international equity and less loaded in favor of developed countries than the new United States profit split formula, which emphasizes the costs of developing intangibles, costs that are most commonly incurred in developed countries. If most manufacturing operations of MNEs are in developing countries, and if most sales are in developed countries, then using these two factors would result in an approximately even division of the residual between the two types of jurisdictions.²¹⁷ However, different methods of splitting the residual need to be applied in industries that are not based on manufacturing, such as the natural resources and financial services industries.²¹⁸ The new OECD draft report on transfer pricing supports the possible use of various types of profit splits in these cases.²¹⁹

Two aspects of the proposed system of allocating profits of a MNE are more important than the precise method adopted to split the residual. First, any allocation method must begin by treating all affiliated corporations that are controlled by the same interests as a single unit for tax purposes. The definition of control can be broad and flexible, similar to the definition proposed by the American Law Institute and to the one

217. See, e.g., Treas. Reg. § 1.863-3(b)(2) (as amended in 1988), examples 1 & 2 (using assets and sales to allocate the income from sales of inventory produced in one country and sold in another). This method is permitted under the arm's-length standard. OECD MODEL TREATY, *supra* note 4, art. 7(4).

218. Indeed, because the top 300 multinationals, which control about a quarter of the world's productive assets, see *supra* note 30, account for a very large part of the transfer-pricing problem, a specific formula can be developed in advance for each one. For a discussion of such "advance pricing agreements," see Avi-Yonah, *supra* note 173, at 154-56. For an example of such an industry formula, see I.R.S. Notice 94-40, 1994-1 C.B. 351.

219. OECD Guidelines, *supra* note 175, at 155.

used under Section 482,²²⁰ the operation of the method outlined earlier would permit results that are equivalent to pure arm's-length separate accounting when a controlled group is not operating as a unit. As noted above, tax law (as well as other areas of law) has for a long time been moving toward disregarding the separate existence of subsidiaries, and this move would merely be the logical culmination of the trend.²²¹

Second, the allocation method adopted must not distinguish among MNEs on the artificial ground of where the parent corporation is incorporated, managed, or controlled. In the current world economy, such distinctions are becoming increasingly meaningless and merely encourage the reincorporation of the parent in the most favorable jurisdiction (a tactic that has recently been the focus of IRS attention in the United States).²²²

C. *Reaching a Consensual Solution*

Can a consensus on the lines outlined above be reached? It is fashionable to despair of change in international taxation that depends on consensus and cooperation rather than on unilateral actions by taxing authorities. However, this view is curiously ahistorical. In 1923, it must have seemed equally hopeless, if not more so, to try to develop a consensus on the allocation of income between source and residence jurisdictions. After all, even though economists could argue that taxation of portfolio investment income at its source hurt the source country, giving up such taxes entailed a real revenue sacrifice by those countries in the broader interests of their economies. Source countries also gave up revenue when they agreed not to tax active business income from activities that did not rise to the level of a permanent establishment. Even more striking was the sacrifice required from residence countries when they agreed to refrain from taxing the active foreign business income of their residents in the interest of avoiding international double taxation. Yet today, we have an internationally accepted consensus on these issues, and on many smaller details of the system, and a multitude of bilateral tax treaties follows the OECD and UN models embodying this consensus.²²³

220. See I.R.C. § 482 (1994) (recognizing direct or indirect ownership or control as grounds for apportionment of tax liability); Treas. Reg. § 1.482-1 (1994) (setting forth the general principles and guidelines to be followed in determining a taxpayer's true taxable income under § 482); Avi-Yonah, *supra* note 173, at 153 (stating that the need to define a unitary business has proven to be a source of controversy and requires complicated rules).

221. For a discussion of this trend in other areas of law, see PHILLIP I. BLUMBERG, *THE MULTINATIONAL CHALLENGE TO CORPORATION LAW* 89-120 (1993).

222. I.R.S. Notice 94-46, 1994-1 C.B. 356.

223. See Richard E. Andersen, *Trade, Regional Interests Drive 1992 Global Tax Treaty Developments*, 2 J. INT'L TAX'N 379, 380 (1992) ("Mexico signed a comprehensive income tax treaty with Canada, based on the U.N. and OECD models."); Ulrik Fleischer-Michaelsen, *Denmark's Transfer Pricing System Is Attractive to Foreign Corporations*, 4 J. INT'L TAX'N 226, 227 (1993).

The case for reaching consensus on the enforcement of residence-based taxation and determination of the source for active income is at least as strong today as the case for consensus on the general structure was in 1923. Compared with 1923, the world's economy is much more integrated, international capital flows much larger, and MNEs make up a much higher proportion of world GDP.²²⁴ Moreover, consensus is necessary to avoid serious undertaxation of individuals (in the case of backup withholding on portfolio income)²²⁵ and MNEs (in the case of allocating active income to its source).²²⁶ Both developed and developing countries have much to gain and little to lose from reaching agreement, and significant revenue is lost by all concerned from failing to do so.

To understand how both developing and developed countries can gain from reaching a consensus on the two issues identified as the main flaws of the current regime, consider first the tax results under the current regime in the stylized world set forth earlier.²²⁷ As described, the stylized world is made up of the United States, India, and the Caymans, and in which MNE X is headquartered in the United States. The residents of the United States (the developed country) invest in the United States, in the Caymans (the tax haven), and in X; the residents of India (the developing country) invest in India, in the United States, and in the Caymans; and X is engaged in active business in the United States and India and siphons its profits to the Caymans. X achieves this result by using a holding company in the Caymans to buy products from its manufacturing subsidiary in India and to resell them at a higher price to its marketing subsidiary in the United States and then by using a finance subsidiary in the Caymans to siphon profits from its operations in the United States and India (by utilizing loopholes in their withholding regimes).²²⁸

("Articles 7 and 9 of the OECD Model have been incorporated in almost all income tax treaties into which Denmark has entered."); Denis Streiff & Clotilde Fournier, *France-Mexico Tax Treaty Follows OECD Model, with Variations*, 5 J. INT'L TAX'N 39, 41-42 (1994) (describing procedures taken to avoid double taxation, in conformance with treaties signed by France with Germany and Sweden); Sabine Stricker, *China Forges a Uniform Tax System for Foreign Investors*, 4 J. INT'L TAX'N 26, 26 (1993) (noting that the People's Republic of China has "entered into treaties for the avoidance of double taxation with the majority of Western countries").

224. See JOHN H. DUNNING, *MULTINATIONAL ENTERPRISES AND THE GLOBAL ECONOMY* 599-603 (1992) (tracing the evolution of the global economy from the embryonic MNEs that existed before World War I to today's prominent and complex MNEs).

225. For an analysis of how individuals are often undertaxed on portfolio income, see *supra* subpart II(A). For the suggestion that a new consensus should be reached, see *supra* Part III.

226. For a discussion of how the current consensus undertaxes MNEs, see *supra* subpart II(A).

227. See *supra* Part I.

228. For an extended discussion of MNEs' ability to avoid taxation, see Green, *supra* note 1, at 32-63. See also GORDON & MACKIE-MASON, *supra* note 179, at 9-12 (suggesting that MNEs exist to take advantage of such loopholes).

Under the current international tax structure, the tax results of this series of transactions would be as follows. The United States taxes its residents on their active income from the United States and their passive income from the United States and the Caymans, including income from X.²²⁹ It does not generally tax residents of India on their investment income from the United States because such taxation might induce Indian residents to shift their investments to the Caymans. The United States employs labor-intensive methods in an attempt to tax X on its profits derived from sources within the United States; it intensively audits the transfer prices between X's affiliates in the United States, India, and the Caymans, but it is not very successful. It also seeks to prevent X from deducting its intercompany interest payments and imposes withholding taxes on such payments. India taxes its residents on their active income from India, but it does not tax them on their passive income from the United States and the Caymans (either because it employs the exemption method or because it cannot effectively enforce residence-based worldwide taxation). Like the United States, India is also not very successful in taxing X because it has no resources to enforce transfer-pricing rules or thin capitalization rules. Although India has high withholding tax rates, it derives little income from them in practice because there is little individual investment in India except for the interest payments paid by X to its financing subsidiary.

How does this model measure up against the ideal of taxing active business income at its source and passive income on a residence basis? Active income under this model is only taxed on a residence basis to individuals, but it is not taxed at all when earned by a MNE. Passive income is taxed only when earned by the residents of the United States; India is unable to enforce either residence-based or source-based taxation of passive income. The gainers are the wealthy elite of India and X, who avoid taxes that should be paid under internationally accepted norms.

This analysis suggests that both the United States and India would benefit from a mutual change in which they abandon source-based taxation of passive income, but adopt a unitary approach to taxing X on a source basis. The United States would benefit from being able to tax X on the profits attributable to the United States under the formula without expending immense resources on transfer-pricing audits and litigation. India would benefit from taxing X on part of its profits and would not lose

229. The United States also purports to tax foreign source active business income that is taxed at a lower rate in the source jurisdiction (to the extent of the difference between foreign and United States tax rates). However, the ability to average rates from high- and low-tax jurisdictions for purposes of the foreign tax credit will often reduce, if not eliminate, the United States tax on foreign-source active business income. See *supra* notes 127-29 and accompanying text.

from abandoning source-based taxation on passive income because its source-based taxation effectively falls only on X (in its transactions with affiliates). India would also benefit if, as suggested above, the United States imposed backup withholding taxes on investments in the United States as a collection device for India. The major remaining loophole would then be India's inability to tax passive income earned by its residents from the Caymans, but the United States can aid in that effort as well by providing India with information and assistance in developing methods for effective residence-based taxation of foreign passive income. The United States will have an incentive to do so because investments will otherwise flow from it to the Caymans if it imposes withholding taxes on behalf of India.

Assuming that reaching consensus is in the interest of all parties, how can it be reached? As Richard Vann has suggested, the progress made recently in reaching agreement in international trade talks, which also involve divergent interests and real costs in reaching agreement, can serve as a model.²³⁰ It would be appropriate to establish a negotiating framework similar to GATT in order to resolve the two issues identified above, perhaps in the context of a new multilateral agreement on international investment, as suggested by Bergsten and Graham.²³¹ The United States, as the traditional leader in international tax matters, should take the lead in proposing such a framework initially for negotiations among the OECD members and then expanding to include developing nations as well.

IV. Simplifying the International Tax Regime Once a Consensus is Reached

Let us assume that a uniform withholding tax has been put in place by the developed nations and that a consensual method has been adopted to allocate the income of MNEs among taxing jurisdictions that treats each MNE as a single unit. What are the possible consequences for the international tax regime described above?

The simplified system of international income taxation that this Article proposes is as follows. All individual taxpayers should be taxed by their country of residence on their active and passive income, from whatever source derived. This would entail, as under the current United States system, provisions that require look-through treatment in the case of corporations controlled by relatively few individual taxpayers.²³² The

230. Richard J. Vann, *A Model Tax Treaty for the Asian-Pacific Region?* (pt. 2), 45 BULL. FOR INT'L FISCAL DOCUMENTATION 151 (1991).

231. C. Fred Bergsten & Edward M. Graham, *Needed: New Rules for Foreign Direct Investment?*, 7 INT'L TRADE J. 15 (1992).

232. I.R.C. §§ 551-558 (1994).

taxation of individuals should be enforceable through backup withholding by source countries, with the revenue transmitted under treaties to the residence country, and by information exchange aimed against source countries that refuse to implement backup withholding.²³³

All publicly held corporations (MNEs) should be taxed exclusively on a source basis, with the source of income determined on a unitary basis by applying a consensus formula. All intercorporate transactions within a MNE should be ignored for this purpose;²³⁴ passive income earned by a MNE from outside sources should be allocated on the same basis as the MNE's active business income. In addition, it should not matter where the MNE is headquartered (or where each subsidiary is incorporated); the residence of the MNE should have no meaning.²³⁵

This regime has two problem areas because it relies on a distinction between individuals, who are presumed to earn mostly passive income and are thus taxable on the basis of residence, and corporations, which are presumed to earn mostly active income and are thus taxable on the basis of source. The first problem is how to tax active income earned by individuals from foreign sources, such as through a sole proprietorship, a partnership, or a closely held corporation. The second problem is how to tax passive income earned through publicly held corporations, such as PFICs.

The issue in both cases is whether to prefer taxation based on the character of the income, which would suggest source-based taxation in the first case and residence-based taxation in the second, or taxation based on the identity of the ultimate taxpayer, which would suggest residence-based taxation in the first case and source-based taxation in the second. On the whole, I believe administrative simplicity favors taxing active income earned by individuals on a residence basis and passive income earned by PFICs on a source basis. Taxing active foreign income of individuals on a source basis would require the maintenance of a foreign tax credit system if that income is to be included in the worldwide tax basis for individuals. It would also require a branch profit tax mechanism if subsidiaries and branches (including partnerships) are to be taxed in the same way. On the whole, the trend in the United States and elsewhere is to avoid entity-level taxation for closely held investment vehicles (by using entities such as Subchapter S corporations and Limited Liability Companies), and that trend suggests that source countries should refrain from taxing active income earned through such investment vehicles and that residence countries should

233. See *supra* subpart III(A). For a similar proposal, see HUFBAUER, *supra* note 1, ch. 4.

234. Income from intercorporate transactions would, of course, be allocated based on a CUP, if one were available; however, such CUPs are rarely determinable. See *supra* text accompanying note 181.

235. See *supra* subpart III(B).

tax them all currently on a look-through basis.²³⁶ The revenue loss should not be too great, given that most foreign direct investment is made through MNEs.²³⁷

Taxing income earned through PFICs on a residence basis is complicated immensely by the problems of how a shareholder can know about the income of an entity she does not control, by liquidity problems, and by allocation problems that arise when shares of a PFIC are sold.²³⁸ In addition, PFICs are widely used to invest in developing countries, which would be reluctant to give up source-based taxation in this case. I would therefore tend to except PFICs from the rule and to tax them as an active business similar to banks and other financial institutions, that is, on a source basis. Actual distributions from PFICs should, however, be included in the income of the investors, like any other income.

A. *Proposals for Simplification*

Truly dramatic simplification can be achieved in the current United States international tax rules (and in the tax rules of other countries as well) if the following changes are adopted in the United States regime:

1. The source rules can be abolished in their entirety. Currently, the source rules serve two functions: to limit the taxation of foreign taxpayers to United States source income and to limit creditable foreign taxes to those imposed on foreign source income.²³⁹ The first function will be superfluous because there will be no taxation at the source of income on foreign individuals (except as a collection mechanism, which is linked to practical enforceability, not theoretical source) and because the taxation of foreign corporations will be determined by the unitary formula. The second function will be superfluous because there will be no foreign tax credit. The source rules for expenses can also be abolished because MNEs will be treated as single units and their global profits after global expenses allocated under the formula.
2. The foreign tax credit rules can be abolished in their entirety. Credit should not be given to source-based taxation

236. This suggestion is similar to the proposal by Green, *supra* note 1, at 72, to tax all MNEs on a look-through basis, which I consider impractical for the reasons given *supra* Part I.

237. For a discussion substantiating the importance of international direct investment through MNEs, see *supra* note 30 and accompanying text.

238. See Shay, *supra* note 138, at 374-83 (analyzing the complex rules for taxing a United States shareholder of a PFIC); Tillinghast, *supra* note 138, at 197-206 (discussing and offering solutions to the complexities of taxing shareholders of non-controlled foreign corporations).

239. Green, *supra* note 1, at 23-24.

of passive income of individuals.²⁴⁰ Nor should credit be given to foreign taxation of active income because it will be taxed on an exemption system: only that portion of MNE income allocable to the United States by formula should be taxed. Double taxation issues can be dealt with through the treaty process, as they currently are by countries with an exemption system.

3. Of the antideferral rules, subpart F can be abolished because passive income within a MNE will be ignored, and passive income from outside a MNE will be allocated through the formula in the same proportions as the active income is allocated. The antideferral rules relating to close corporations should be retained and consolidated and should relate to both active and passive income. The PFIC rules can be abolished.²⁴¹
4. The branch profits tax can be abolished because it is a proxy for source-based taxation of passive income.²⁴²
5. Section 482 of the Code will generally not be required for international transactions because of the allocation formula for MNEs.²⁴³
6. The earnings stripping rule can be abolished because it only applies to interest paid to related parties, which will be disregarded if MNEs are treated as single units.

Thus, the international aspects of the United States income tax system will be limited to rules designed to ensure current taxation of income earned abroad by individuals through closely held corporations and the single sourcing rule for MNEs. This level of simplification can be achieved through extension of the principles of taxing active income at its source and passive income by residence, and through extension of the trend to disregard both the artificial distinctions among related corporations that form part of MNEs and the distinctions between close corporations and their shareholders.

B. Effects of Corporate Integration

Finally, the issue of the integration of the corporate and individual income taxes needs to be addressed. There is a consensus among

240. See *supra* subpart II(C).

241. Cf. H.R. 13, *supra* note 117, §§ 401-404 (proposing to consolidate these provisions).

242. Arguably, the branch profits tax needs to be retained as part of the backup withholding regime, but the need for simplification makes withholding on actual distributions preferable.

243. This will eliminate the vast majority of litigation under § 482. For a discussion of the vast amount of litigation under § 482, almost all of which is international, see Avi-Yonah, *supra* note 173, at 112-29.

economists and tax scholars that taxing corporate income twice, first when it is earned by a corporation and again when it is distributed to shareholders (as is the case in "classical" systems like the United States),²⁴⁴ leads to significant welfare losses (because of the tax incentive to invest through unincorporated entities) as well as increased complexity (because of the need to distinguish between deductible dividends and nondeductible interest).²⁴⁵ However, as Hugh Ault has pointed out, integration poses a problem for the international consensus described above because it implies that either the active income earned through corporations or the passive income derived by shareholders from the corporation in the form of dividends should not be taxed.²⁴⁶ If integration is achieved in a form that reduces taxes at the corporate level, it undermines the taxation of active income at its source. If integration is achieved in a form that reduces taxes at the shareholder level, it undermines the taxation of passive income on a residence basis. Therefore, most countries that have adopted integration do not extend its benefits to foreign shareholders except by treaty, and even then usually only in treaties with countries that have integrated tax systems and can reciprocate.²⁴⁷ However, this result violates the nondiscrimination principle that also underlies the international treaty network.²⁴⁸

How can integration be reconciled with the proposal set out above, which seeks to preserve the taxation of active income at its source and passive income on a residence basis? To answer this question, it is first

244. See TREASURY INTEGRATION REPORT, *supra* note 46, at 1 (describing the current United States system as a "classical system of corporate income taxation").

245. For discussions of the rationale for integration, see, e.g., *id.* and ALI INTEGRATION REPORT, *supra* note 46. See generally Alvin Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 717 (1981).

246. Ault, *supra* note 14, at 566; see also Warren, *supra* note 14, at 599 (proposing an alternative method for dealing with this problem).

247. Cf. Ault, *supra* note 14, at 582-608 (surveying international tax treaties and suggesting approaches to future international tax treaties affecting integrated systems of corporate taxation). The United States treaties with the United Kingdom and France are exceptions to this rule. See Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., art. 10, 31 U.S.T. 5668, 5677-79; Convention with Respect to Taxes on Income and Property, July 28, 1967, U.S.-Fr., art. 10, 19 U.S.T. 5280, 5294-96.

248. See Warren, *supra* note 14, at 603-04 (pointing out that it is impossible to have nondiscrimination, economic neutrality, and reciprocity at the same time). Professor Warren also suggests that the United States abandon reciprocity to preserve nondiscrimination; thus, a country such as Canada, which grants an imputation credit to domestic shareholders would have to grant a similar benefit to foreign shareholders, even if those shareholders reside in a country with a classical tax system such as the United States, which would not be required to grant any benefits to Canadian shareholders in return. *Id.* at 612-13. I would abandon nondiscrimination to preserve reciprocity because I do not believe countries will agree to enter into tax treaties unless reciprocity is preserved; in the Canada and United States case, if nondiscrimination were the overriding principle, Canada would have an incentive to shift to a classical system to avoid the unilateral granting of benefits illustrated above.

necessary to consider the three methods of achieving integration of corporate and shareholder level taxes.²⁴⁹ The first method emphasizes the role of the corporation as a mere withholding device for taxes imposed on shareholders. Integration could in theory be achieved by abolishing the corporate tax altogether and by treating all corporations as pass-through vehicles, but because this is administratively complex and because of the collection advantages afforded by the corporate form, integration is instead achieved by levying a withholding tax at the corporate level and then crediting that tax against the shareholder's individual liability. (This method is sometimes called an "imputation" method because corporate taxes are imputed to shareholders, and the credits given to shareholders are sometimes called imputation credits.)

The second method of achieving integration emphasizes the distinctions among the various ways of dividing the active profits of the firm among different types of investments: dividends, interest, royalties, and wages. From this perspective, there is no justification for the disparate treatment afforded interest, royalties, and wages, all of which are deductible from the corporate tax base when paid, and dividends, which are not deductible. Thus, integration may be achieved by making dividends deductible. This method of integration achieves the same mathematical results as the first one but in a different form.

A third method of achieving integration emphasizes the desire to avoid taxing the same income twice. From this perspective, integration can be achieved by retaining the corporate tax with no changes, but excluding dividends from income. This is the proposal that was advanced by the United States Treasury Department in its 1992 report on integration.²⁵⁰ Its major difference from the other two proposals is that it does not permit progressive taxation of dividend income because such income is only taxed at the corporate level, typically at a flat rate, regardless of the ability to pay of the shareholder who ultimately bears the burden of the tax.

Of these three methods, deducting dividends at the corporate level and excluding dividends at the shareholder level do not pose a significant problem for the international consensus identified above. In both cases, one of the two countries with a legitimate claim to tax income earned through a corporation gives up that claim unilaterally. In the case of the dividend deduction, the source country gives up its right to tax active income at its source. In the case of the dividend exclusion, the residence country gives up its right to tax passive income on a residence basis.

249. For discussions of the various methods of achieving integration, see TREASURY INTEGRATION REPORT, *supra* note 46; ALI INTEGRATION REPORT, *supra* note 46, at 50-54; Warren, *supra* note 245.

250. TREASURY INTEGRATION REPORT, *supra* note 46, at 11-25 (proposing a "dividend exclusion prototype" that would exclude dividends from gross income).

Although there may be good policy arguments against either of these changes,²⁵¹ the changes do not disturb the consensual allocation of income among other countries, which are free to maintain a classical or integrated system of taxation as they see fit.

Most countries that have integrated tax systems, however, treat the corporate income tax as a withholding device and grant domestic (but not foreign) shareholders an imputation credit for the corporate tax that is applied against the shareholders' individual tax liability.²⁵² Refusing to grant the credit to foreign shareholders violates the principle of nondiscrimination,²⁵³ but granting such a credit would, if it were respected by the residence country, shift the revenue loss from integration from the source country to the residence country, which may not have an integrated tax system. The result would be a violation of the principle of reciprocity because the residence country, if it has a classical system, would not grant a similar benefit to shareholders from the source country. Moreover, granting the imputation credit to foreign shareholders would also violate the principle of neutrality because shareholders from the residence country would have an incentive to invest in and receive dividends from source-country corporations. This incentive would exist because dividends from source-country corporations would entitle shareholders to a credit, but dividends from domestic corporations would not.

Because of these considerations, it seems unlikely that in a world in which some countries maintain classical tax systems, integration credits could generally be extended to foreign shareholders. This conclusion was reached by the Ruding Committee, which was asked to study the integration issue in the context of achieving harmonization of direct taxation in the European Union.²⁵⁴ The Ruding Committee recommended the adoption of a system of harmonized direct taxation in the European Union that is quite similar to the worldwide proposal set out in this Article. In general, the Committee recommended that passive income be taxed in the Union entirely on a residence basis and that withholding taxes be abolished on dividends, interest, and royalties, with backup withholding imposed on dividends for the benefit of residence countries.²⁵⁵ The Committee also recommended that active income be taxed on a source basis, with

251. See the discussion *supra* subpart I(B), concerning why countries should not abandon either source-based taxation of active income or residence-based taxation of passive income.

252. For comparative views of integration systems, see TREASURY INTEGRATION REPORT, *supra* note 46, at 158-84; Reuven S. Avi-Yonah, *The Treatment of Corporate Preference Items Under an Integrated Tax System: A Comparative Analysis*, 44 TAX LAW. 195, 196-98 (1990).

253. See Warren, *supra* note 14, at 601.

254. COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION (1992) [hereinafter RUDING COMMITTEE REPORT]. For a discussion of the RUDING COMMITTEE REPORT, see Ault, *supra* note 14, at 590-93.

255. RUDING COMMITTEE REPORT, *supra* note 254, at 203-04.

arbitration procedures established to mitigate, if not to eliminate, transfer-pricing disputes.²⁵⁶

Because the European Union contains countries that maintain classical systems, such as the Netherlands, and countries that have adopted integrated systems with imputation credits, the Ruding Committee recognized both the need to prevent discrimination and preserve neutrality in the taxation of capital flows. Therefore, the Committee recommended that member states with integrated tax systems be required: (a) to grant domestic shareholders credit for foreign corporate taxes paid at the source to other member states, to the extent that dividends received by the shareholders from domestic corporations represent income taxed in those other states, and (b) to grant domestic shareholders credit for dividends received directly from foreign corporations that have paid corporate level taxes at the income's source.²⁵⁷ However, the Committee explicitly refrained from recommending that member countries be required to grant imputation credits to foreign shareholders in order to preserve the taxation of active business income by the source country.²⁵⁸

The system recommended by the Ruding Committee preserves neutrality and reciprocity at the expense of nondiscrimination. A shareholder from a country with an integrated tax system would receive integration credits whether she invests in a domestic corporation (without regard to the source of that corporation's income) or in a foreign corporation. These credits would come at the expense of the residence country's fisc, with the source country retaining its full entitlement to the corporate level tax. From the perspective of a shareholder from a country with a classical system, no credits would be obtainable from either a domestic or foreign investment.

Although the resulting compromise is not perfect—it permits the source country to discriminate between domestic shareholders (entitled to a credit) and foreign shareholders (not entitled to a credit)—the recommendations of the Ruding Committee appear to offer the greatest likelihood of achieving consensus in a world in which some countries continue to maintain a classical system. If, however, the United States, which is the most important advocate of classical corporate taxation, ever adopts an integrated tax regime, most of the world is likely to follow. In that case, a reciprocal granting of integration credits would be easy to achieve without undoing the international consensus described in this Article.

256. *Id.* at 205.

257. *Id.* at 207-08.

258. *Id.* at 208.