Reconsidering the Taxation of Foreign Income

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Reconsidering the Taxation of Foreign Income

JAMES R. HINES JR.*

I. INTRODUCTION

A policy of taxing worldwide income on a residence basis holds enormous intuitive appeal, since if income is to be taxed, it would seem to follow that the income tax should be broadly and uniformly applied regardless of the source of income. Whether or not worldwide income taxation is in fact a desirable policy requires analysis extending well beyond the first pass of intuition, however, since the consequences of worldwide taxation reflect international economic considerations that incorporate the actions of foreign governments and taxpayers. Once these actions are properly accounted for, worldwide taxation starts to look considerably less attractive. Viewed through a modern lens, worldwide income taxation by a country such as the United States has the effect of reducing the incomes of Americans and the economic welfare of the world as a whole, prompting the question of why the United States, or any other country, would ever want to maintain such a tax regime.

The purpose of this Article is to analyze the consequences of taxing active foreign business income,¹ and in particular, to compare a re-

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¹ Worldwide income taxation typically includes the taxation of individual incomes, but, in the interest of tackling one issue at a time, this Article puts the specific considerations that apply to individual income tax implications of worldwide taxation and territoriality aside for a more propitious moment. As a practical matter, worldwide taxation of business income by the United States is much more consequential in the sense of revenue collected and burdens imposed than is U.S. worldwide taxation of individual income. As one indication of the relative magnitudes involved, the aggregate foreign earned income reported by U.S. individuals filing Form 2555 in 2001, plus trust income earned in 2002, was $27.9 billion. By contrast, the largest controlled foreign corporations of U.S. corporations reported $160.1 billion of after-tax foreign earnings and profits in 2002. Jeff Curry & Maureen Kee-nan Kahr, Individual Foreign-Earned Income and Foreign Tax Credit, 2001, IRS, Stat. Income Bull., Spring 2004, at 98; Daniel S. Holik, Foreign Trusts, 2002, IRS, Stat. Income Bull., Summer 2005, at 134; Mike Masters & Catterson Oh, Controlled Foreign Corpora-
regime in which a home country taxes foreign income to a regime in which it does not. In practice, countries typically do not adopt such extreme policy positions. For example, a country such as France, which largely exempts foreign business income from taxation, nevertheless taxes small pieces of foreign income;² and a country such as the United States, which attempts to tax the foreign incomes of U.S. corporations, permits taxpayers to defer home country taxation in some circumstances, claim foreign tax credits in most situations,³ and in other ways avoid the consequences of full home country taxation. It is nevertheless useful to consider stylized and somewhat extreme versions of territoriality and residence taxation, in part because the older theory that forms the basis of much U.S. policy advocates in favor of an extreme position of taxing worldwide income, and in part because insights drawn from considering extreme examples prove useful in understanding the murky middle to which tax policies naturally tend in practice.

The older wisdom in the international tax policy area holds that worldwide taxation of business income with provision of foreign tax credits promotes world welfare, whereas worldwide taxation of business income without foreign tax credits (instead permitting taxpayers to deduct foreign tax payments in calculating taxable income) promotes domestic welfare. These claims about the underlying welfare economics, introduced by Peggy Musgrave⁴ and subsequently quite influential, have come under considerable academic fire in recent years.⁵ Modern economic thinking parts company with Musgrave's analysis in two important respects. The first is that modern scholarship incorporates the impact of economic distortions introduced by taxes other than those imposed on foreign income, which Musgrave's

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² Code Général des Impôts art. 209 (stating that, subject to tax treaties and certain exceptions, only profits from operations in France are subject to corporate income tax); id. art. 209B (providing an exception for controlled corporations located in a country with a preferential tax regime); id. art. 238 bis. 01 (creating an anti-abuse provision for French corporations that move assets out of France); id. art. 209 quinquies (allowing a French corporation to be taxed on either consolidated profits or worldwide profits, with consent from the Ministry of Economy and Finance).

³ IRC §§ 901, 902.


analysis does not. The second is that modern scholarship incorporates reactions by foreigners to home country tax changes. Capital ownership by foreign and domestic investors is directly affected by home country tax policies, and these ownership effects, properly understood, have the potential to reverse entirely the welfare prescriptions that flow from Musgrave's analysis.

The second and third Sections of this Article review the older theory of home country taxation of foreign income, the more modern ownership neutrality concepts, and their implications. These ownership neutrality concepts, which are developed in Desai and Hines, offer normative criteria by which to evaluate the desirability of tax systems in practice. The ownership neutrality concepts stress the importance of productivity effects of capital ownership in evaluating the incentives created by tax systems.

Section IV considers the implications of capital ownership for the design of tax systems that exempt foreign income from taxation. In particular, this Section notes that in order to create efficient ownership incentives it is necessary to avoid using simple formulas to allocate general domestic expense deductions between domestic and foreign income.

In an effort to make the ownership issues perhaps more vivid, Section V evaluates rather whimsical systems of residence-based excise and value-added taxation. The same arguments that typically are advanced in favor of worldwide taxation of corporate income apply with equal force to residence-based excise and value-added taxation, and the evident drawbacks of the latter apply equally to residence-based corporate income taxation.

Section VI considers the implications of residence taxation for taxpayer equity and the distribution of tax burdens, noting that equitable taxpayer treatment requires a special regime for the taxation of foreign income, and that the burdens (including the efficiency costs) of taxing foreign income typically are borne by domestic labor in the form of lower real wages. Section VII considers the implications of practical complications, including the reactions of foreign governments and the ability of taxpayers to avoid taxes on domestic income. Section VIII is the conclusion.

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Capital export neutrality (CEN) as defined by Musgrave is the criterion that an investor's capital income is taxed at the same total rate wherever the income is earned. The idea behind CEN is that equal taxation of income earned in different locations effectively removes location-based tax incentives, thereby encouraging firms to locate their investments wherever they generate the greatest pretax returns. Since in a world without taxation firms likewise face incentives to maximize pretax returns and market outcomes are generally thought to be efficient in the absence of taxation, it seems natural to associate CEN with efficient production incentives.

Implementation of CEN requires governments to adjust their taxation of investment returns based on the tax policies of other countries. Since investors always have the option of earning income in their home countries, CEN is satisfied if foreign income is subject to the same rate of taxation as is income earned at home. This is far from guaranteed, since tax rates differ substantially among countries, and the international convention is that countries in which investments are located are entitled to tax investment returns at their own tax rates. Consequently, it falls upon home governments to implement CEN if they choose to do so, by adjusting their own taxation of foreign income earned by their residents. A home government can support CEN by subjecting foreign income to taxation at a rate equal to the difference between the home country tax rate and the foreign tax rate, thereby producing a total (foreign plus home) tax burden equal to the home country tax rate. A home country that taxes worldwide income at the same rate that it taxes domestic income, and permits taxpayers to claim credits for any income taxes paid to foreign governments, effectively implements a system that is consistent with CEN. It is noteworthy that such a system would not permit taxpayers to defer home country taxation of unrepatriated foreign income, and imposes no limits on foreign tax credits, so investors subject to foreign tax rates that exceed the domestic tax rate would receive tax rebates from their home country.

The United States currently taxes worldwide income and permits investors to claim foreign tax credits, but U.S. taxation of certain foreign income is deferred until the income is repatriated, and foreign tax credits are limited to prevent high rates of foreign taxation from producing U.S. tax rebates. As a result, the current U.S. tax system does not correspond to a system that implements CEN. Despite this difference, CEN is often used as a basis with which to analyze potential

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7 This Section and the Section that follows draw on Desai & Hines, Old Rules, note 6, and Desai & Hines, Tax Reform, note 6.
reforms to the U.S. tax system, since CEN is thought to maximize the economic welfare of the world as a whole.

Policies that encourage efficient allocation of investment need not maximize the welfare of home countries, since home countries may not receive all of the benefits of improved resource allocation. The Musgrave concept of National Neutrality (NN) is that home countries promote domestic welfare by taxing worldwide income while treating foreign income taxes simply as costs of doing business. Consequently, a home country tax system that satisfies NN is one in which investors are required to pay home country taxes on their foreign incomes and are permitted to deduct foreign tax payments from taxable income. This system does not permit taxpayers to claim foreign tax credits, since it does not distinguish foreign tax costs from other foreign costs, such as the costs of labor and materials. The fact that foreign taxes represent transfers to foreign governments rather than real resource costs is, by this analysis, irrelevant to the home country.

The analysis of national neutrality suggests that almost all countries treat foreign income far too generously, since permitting taxpayers to claim foreign tax credits—or worse, exempting foreign income from home taxes entirely—encourages excessive investment from the standpoint of the home country. Since CEN calls for foreign tax credit systems, it follows from the Musgrave analysis that there is a tension between policies that maximize national welfare—NN—and policies that maximize global welfare—CEN—and that some kind of cooperative agreement might be needed to align national and global interests. There remains, however, the empirical puzzle of why virtually every country fails to pursue its own interest by subjecting after-tax foreign income to full domestic taxation, and in particular why so many countries exempt foreign income from taxation.

Capital Import Neutrality (CIN) is the concept that an investment should be taxed at the same total rate regardless of the location of the investor. Taxation by host countries at rates that differ between locations can be consistent with CIN, since different investors are taxed (at the corporate level) at identical rates on the same income. In order for such a system to satisfy CIN, however, it is also necessary that individual income tax rates be harmonized, since CIN requires that the combined tax burden on saving and investment in each location

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not differ between investors. While CEN is commonly thought to characterize tax systems that promote efficient production, CIN is thought to characterize tax systems that promote efficient saving. Another difference is that CIN is a feature of all tax systems analyzed jointly, whereas individual country policies can embody CEN or NN. As a practical matter, since many national policies influence the return to savers, CIN is often dismissed as a policy objective compared to CEN and NN.

Several important assumptions are buried inside the analytic frameworks that imply that CEN maximizes global welfare. The first assumption is that home country governments have incentives to maximize the profits of home country firms plus the value of the taxes that they pay to the home government. The second assumption is that foreign tax policies do not respond to home country tax policies. The third assumption is that host governments value inbound foreign direct investment in a manner that is unrelated to their tax rates. And the fourth assumption is that home country taxation of foreign income does not directly or indirectly affect foreign firms.

Policies that promote the efficient operation of domestic firms also promote domestic welfare when domestic residents have stakes in the success of home country firms, which they can as shareholders, employees, customers, those who sell these firms inputs, or who interact with them in other capacities. The first assumption takes the (tax) residence of home country firms as fixed, and does not incorporate the efficiency cost associated with raising government revenue from virtually any source. The second assumption implies that governments ignore their impact on each other's policies, and the third assumption requires that governments not adjust tax rates in a way that reflects the value to their economies of attracting additional investment. These assumptions have been subjected to critical analysis, though there are adherents of CEN who insist that its implications survive these criticisms.

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11 See, e.g., Rousslang, note 9.
The fourth assumption, that home country taxation does not directly or indirectly affect foreign firms, is the least consistent with theory and the most important from the standpoint of its policy implications. In fact, there is every reason to expect the actions of domestic firms to affect their foreign competitors; and since domestic firms are influenced by home country taxation, it follows that foreign firms are indirectly influenced. In a competitive market, greater foreign investment by domestic firms is typically associated with greater domestic investment by foreign firms. The NN implication that home countries maximize their own welfare by subjecting foreign income to taxation with only deductions for foreign income tax payments then no longer follows, since from the standpoint of the home country, greater foreign investment by domestic firms does not come at the cost of reduced domestic investment to the degree that foreign investment in the home country rises as a result. Hence there is not a welfare loss from reducing domestic investment, because total domestic investment need not fall when domestic firms undertake greater foreign investment. From a CEN standpoint, this logic also implies that worldwide taxation with foreign tax credits need not promote efficient global production, since the effect of domestic investment abroad on foreign investment at home means that efficiency is advanced by encouraging economically appropriate ownership of assets.

III. IMPLICATIONS OF CAPITAL OWNERSHIP

This section describes the application of ownership criteria to the taxation of foreign income, and offers an assessment of the importance of capital ownership to economic welfare.

A. Capital Ownership Neutrality

Capital Ownership Neutrality (CON) is a property of tax systems that maintain incentives for efficient ownership of capital assets. Capital ownership neutrality is important to efficiency only insofar as ownership is important to efficiency, a notion that is ruled out by assumption in the Musgraves framework that serves as the basis of CEN and NN. If the productivity of a business asset depends in part on

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how it is owned and controlled, then an efficient tax system provides incentives for ownership that maximizes the value of output.

Consider the case in which all countries exempt foreign income from taxation. Then the tax treatment of foreign investment income is the same for all investors, and competition between potential buyers allocates assets to their most productive owners. Allocation on the basis of productivity typically does not imply that all assets would be held by a small number of highly efficient owners, since there are limits to the abilities of owners and managers to maintain the productivity of widespread business operations, and therefore benefits to specialized ownership. Efficient ownership entails combining assets in a way that is more productive than alternative ownership arrangements, taking into account the costs of trying to maintain too large or too diverse a set of assets under single ownership and management.

If the rest of the world exempted foreign income from taxation while the United States taxed foreign worldwide and granted Americans the opportunity to claim foreign tax credits for foreign income tax payments, then the difference between these tax treatments of foreign income would influence ownership patterns. Foreign investors would have stronger relative incentives to hold assets in low-tax countries, since they benefit from reduced tax rates whereas Americans, who also benefit from lower foreign tax rates, simultaneously receive fewer foreign tax credits for their investments in low-tax locations. Consequently American investments can be expected to be more strongly concentrated in high-tax countries than is true of the rest of the world. As a result, the tax treatment of foreign income distorts asset ownership, moving it away from the pattern that is associated with maximum productivity.

In this example, if the United States were to join the rest of the world in exempting foreign income from taxation then tax systems would no longer distort asset ownership, thereby satisfying the requirement for CON. Capital ownership neutrality, however, does not require that every country exempt foreign income from taxation: Instead what is required is that foreign income be taxed in a similar manner by all countries. For example, countries with differing home tax rates might all tax foreign income while granting taxpayers the opportunity to claim foreign tax credits, and despite the underlying differences in tax rates, such a configuration would satisfy CON. The reason is that investors all face incentives to choose investments that

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13 Mitchell Kane considers the tax implications of a different notion of efficient ownership, which accounts for the differences between the implications he draws for efficient taxation and those of capital ownership neutrality and national ownership neutrality. See Mitchell A. Kane, Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks, 26 Va. Tax Rev. 53 (2006).
maximize pretax income, and since this is common across countries, there are no tax-based incentives to reallocate assets among investors from countries with differing tax systems.

Efficient allocation of capital ownership means that it is impossible to increase productivity by reallocating assets between owners. This does not require that assets be equally productive with any owner, since what matters is the potential productivity gain to be had by swapping assets among owners. Thus, investors from Country A might have stronger tax incentives to invest in low tax countries than is true for investors from Country B. It follows from the difference between their tax systems that there are potential productivity gains to be had by trading some high-tax investments held by Country B owners for low-tax investments held by Country A owners—and this potential productivity gain is available despite any underlying differences in productivity rates associated with ownership. Hence it is differences in the relative tax treatment of investments in differing locations, rather than absolute differences in the productivity of differing owners, that give rise to asset ownership inefficiencies. Systems that tax foreign income similarly therefore maintain efficient ownership patterns even if their tax rates differ.

The welfare properties of CON emphasize the allocation of ownership of a given volume of business activity between locations whose tax attributes differ. The taxation of foreign income also has the potential to influence rates of national saving and the sizes of domestic firms, though this effect is not explicitly incorporated in the analysis. National saving is affected by a large range of public policies including monetary policy, intergenerational redistribution programs such as social security, the taxation of personal income, estate taxation, and other policies that influence the discount rates used by savers. Business activity is likewise influenced by a host of fiscal, monetary, and regulatory policies. Given these various factors that influence national saving and corporate investment, it is appropriate to analyze the optimal taxation of foreign and domestic income separately from the question of how much governments should encourage capital accumulation and total investment of home-based firms.

B. National Ownership Neutrality

The importance of ownership to productivity carries the implication that countries acting on behalf of their own economic interests have incentives to exempt foreign income from taxation. This perhaps sur-

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14 Id. at 27 (arguing that only when capital is equally productive in the hands of each investor would there be an efficient allocation of capital ownership).
prising conclusion reflects that, viewed exclusively from an ownership standpoint, additional foreign investment does not come at the cost of reduced domestic investment, since additional foreign investment reflects a reallocation of ownership rights in which domestic owners obtain foreign assets by swapping domestic assets to foreign owners. As a result, there is no associated reduction in real domestic investment levels, and the effect of foreign investment on domestic tax revenue depends entirely on the productivity of the resulting ownership pattern. To a first approximation there is little effect of additional foreign investment on domestic tax revenue, which is very different from the premise of the Musgrave analysis in which foreign investment comes dollar for dollar at the expense of domestic investment. Countries therefore maximize their welfare by maximizing the productivity of their domestic and foreign assets, which they do by exempting foreign profits from home country taxation. It does not follow that such a policy encourages excessive foreign investment, since the cost of foreign investment is the cost of trading domestic assets for foreign assets, and domestic taxes are built into this cost, since any new owners of domestic assets will have to pay those taxes. Given this implicit cost, a policy of exempting foreign income from taxation effectively subjects all investments to the same tax rate, and thereby promotes efficiency.

Tax systems that promote domestic welfare by exempting foreign income from taxation can be said to satisfy National Ownership Neutrality (NON). It is noteworthy that countries have incentives based on ownership considerations to exempt foreign income from taxation no matter what policies other countries pursue. It is therefore perhaps understandable why so many countries have persisted in exempting foreign income from taxation, since such policies advance their interests—and if every country exempted foreign income from taxation, the uniformity of tax treatment would promote an efficient allocation of capital ownership that maximizes world productivity. To be sure, there are important considerations omitted from this analysis, including the requirement that taxpayers adhere to rules concerning the allocation of income for tax purposes. One concern often expressed about exempting foreign income from taxation is that doing so might encourage taxpayers to report that income actually earned at home was instead earned in low-tax foreign locations. While taxpayers may face such incentives under a system of worldwide taxation with foreign tax credits, presumably the incentives would be stronger if foreign income were entirely exempt from domestic taxation.15 This

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15 See, e.g., Michael J. McIntyre, Guidelines for Taxing International Capital Flows: The Legal Perspective, 46 Nat'l Tax J. 315 (1993). There is ample evidence, reported in
problem, to the extent that it is one, is best addressed directly with enforcement of existing and potentially new rules rather than by modifying the taxation of foreign income to accommodate income shifting behavior on the part of taxpayers.

C. Implications of Ownership

The principles of CON and NON are based on the welfare impact of the importance of ownership to productivity in the design of international tax systems. This emphasis on ownership effects is consistent with the modern theory of foreign direct investment, which is based on a transaction-cost approach under which the market advantages of multinational firms arise from the benefits of joint ownership of assets across locations. It is also consistent with the scale of operation of the large and very active worldwide market in mergers, acquisitions, and asset divestitures. Participating firms presumably are willing to assume the costs of ownership realignments because of their advantages.16

Desai and Hines review the extensive available evidence of the impact of home country tax regimes on patterns of asset ownership by multinational firms,17 including the effects of foreign tax systems on the location of investment within the United States,18 the effects of home country taxes on the distribution of American and Japanese investment around the world,19 and the impact of foreign tax credit and deferral rules on asset ownership.20 The ownership structure of outbound foreign investment likewise appears to be sensitive to its tax consequences.21 And Desai and Hines analyze dramatic ownership

James R. Hines, Jr., Lessons from Behavioral Responses to International Taxation, 52 Nat'l Tax J. 305 (1999), that tax rates influence the location of reported pretax income.


17 Desai & Hines, Tax Reform, note 6.


21 Rosanne Altshuler & Harry Grubert, Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy, 87 J. Pub. Econ. 73 (2003); Mihir A. Desai, C. Fritz Foley &
reversals in which U.S. multinational firms expatriate by inverting their corporate structure, reconfiguring their ownership as foreign corporations in order to reduce the burden imposed by U.S. tax rules.\(^\text{22}\) These and other cases indicate that ownership patterns of foreign affiliates and their parent companies are significantly affected by tax incentives in their home countries.

**D. Foreign Investment and Domestic Investment**

One of the significant ways in which the modern analysis of taxing foreign income parts company with earlier approaches lies in its consideration of the impact of outbound investment on domestic investment. As noted above, once one acknowledges that greater foreign investment need not entail reduced domestic investment, then the opportunity cost of greater foreign investment changes significantly, and with it, the desirability of taxing foreign income.

International capital market equilibrium implies that the capital account must be balanced over time: Net outbound foreign investment equals net inbound foreign investment in present value. It does not follow, however, from this implication of market equilibrium that greater outbound foreign direct investment triggers greater inbound foreign direct investment, since the capital account can be balanced either through foreign direct investment flows or through portfolio capital flows.\(^\text{23}\) Hence the degree to which greater outbound foreign direct investment is associated with greater or lesser domestic investment is ultimately an empirical question.

There is a flurry of recent evidence suggesting that greater outbound foreign direct investment may not reduce the size of the domestic capital stock, but instead more likely increases it. This evidence includes aggregate time series evidence of the behavior of U.S. multinational firms,\(^\text{24}\) aggregate evidence for Australia, industry-level studies of Germany\(^\text{25}\) and Canada,\(^\text{26}\) and firm-level evidence for

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\(^{\text{23}}\) Official transfers also enter the capital account, although these are typically of very small net magnitude.


the United States,\textsuperscript{27} the United Kingdom,\textsuperscript{28} and Germany.\textsuperscript{29} The difficulty confronting all of these studies is that foreign investment is itself a purposive choice, reflecting economic conditions that very likely also directly influence the desirability of domestic investment, making it difficult to disentangle the pure effect of greater foreign investment on domestic economic activity. These studies approach this problem in different ways, drawing conclusions that are accordingly persuasive to differing degrees, although the accumulation of this evidence strongly points to the possibility that greater outbound investment need not be associated with reduced domestic investment.

The study by Desai, Foley, and Hines is instructive in this regard, as it exploits firm-level information and differences in foreign economic growth rates to identify the effects of greater outbound foreign investment.\textsuperscript{30} U.S. firms investing in foreign countries whose economies grow rapidly tend to exhibit much faster growth rates of foreign direct investment than do otherwise similar U.S. firms investing in foreign countries that experience slow economic growth.\textsuperscript{31} Hence it is possible to use (firm-specific) average foreign economic growth rates to predict changes in foreign investment, which in turn can be compared to subsequent changes in domestic economic activity. The evidence indicates that, for U.S. firms, 10\% greater foreign capital investment is associated with 2.6\% greater domestic investment, and 10\% greater foreign employment is associated with 3.7\% greater domestic employment.\textsuperscript{32} Foreign investment also has positive estimated effects on domestic exports and research and development spending, suggesting that growth-driven foreign expansions stimulate demand for tangible and intangible domestic output.

\textbf{E. Is Ownership Decisive?}

The analysis of ownership incentives carries implications for tax policy that differ sharply from those of allocating a fixed supply of investment increases domestic capital stock when directed toward some countries and decreases it when directed toward others).


\textsuperscript{30} See Desai et al., note 27, at 182.

\textsuperscript{31} Id. at 192.

\textsuperscript{32} Id. at 182.
capital between competing locations. In the standard Musgrave setting, the problem is that tax rates differ between countries. This then leads to excessive investment in low-tax countries, and by comparison inadequate investment in high-tax countries. The solution offered by the CEN paradigm is to undo international tax rate differences with offsetting differences in home country taxation.

The ownership approach identifies a different set of problems and a different tax policy to address these problems. Distortions to international ownership create their own inefficiencies and thereby threaten productivity in a manner no less real, and certainly no less important, than the inefficiencies that may arise from too many factories appearing in tax havens. A tax system that seeks to implement CEN to correct the problem of investment incentives thereby creates its own set of problems with distorted ownership, and the evidence, both casual and statistical, is that ownership is highly sensitive to its tax treatment.

These issues would be moot if all countries were to discontinue taxing business income at source, but whatever may be the potential efficiency gains of such a reform, governments are unlikely to undertake it in the near future. Hence the more restricted efficiency question concerns the appropriate taxation of foreign business income in a world with many tax rate differences, with activities within a country taxed at many different rates, and therefore many sources of potential inefficiency. In emphasizing ownership rather than other dimensions of business activity, the analysis takes these ownership and control considerations to be of first order importance.

IV. IMPLICATIONS FOR EXPENSE ALLOCATION

Businesses engaging in worldwide production typically incur significant costs that are difficult to attribute directly to income produced in certain locations. Important examples of such expenses include those for interest payments and general administrative overhead. There is a very important question of how these expenses should be treated for tax purposes. Practices differ in countries around the world, and indeed, U.S. practice has varied over time, but the current U.S. tax treatment is squarely on the side of allocating domestic expenses between foreign and domestic income based on simple indicators of economic activity. Thus, for example, a U.S. multinational firm with

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33 As Hines and others note, the welfare cost of excessive investment in low-tax countries takes country tax rates to be unrelated to the social value of FDI. See Hines, note 5, at 398.
34 Id.
35 Reg. §§ 1.861-8, 1.861-8T, 1.861-9, 1.861-9T, 1.861-10, 1.861-10T (apportioning income, interest expense, and other expenses through a formulary approach).
$100 of domestic interest expense is not permitted to claim as many foreign tax credits as is an otherwise equivalent U.S. firm without the interest expense, reflecting the theory that a portion of the borrowing on which interest is due went to finance foreign investment.

Expense allocation of the variety embodied in current U.S. tax law has a decided intuitive appeal. It carries the general implication that domestic expenses that are incurred in the production of foreign income that is exempt from U.S. taxation (as is the case, for example, of income earned in countries with very high tax rates, for which foreign tax credits are available) are effectively not permitted domestic tax deductions (via an equivalent reduction in foreign tax credit limits). While one can, and undoubtedly should, criticize the details of the current U.S. rules governing expense allocation, it must be conceded that the general structure of expense allocation is largely consistent with the rest of the U.S. system of attempting to tax foreign income in a manner that vaguely embodies CEN.36

Taking as a premise that CEN is an unsatisfactory basis for taxing foreign income, and that a country prefers to exempt foreign income from taxation based on capital ownership considerations, then what kind of expense allocation regime properly accompanies the exemption of foreign source dividends from domestic taxation? The answer is that domestic expenses must not be allocated at all, but instead traced to their uses, as most countries other than the United States currently do with respect to interest expense. To put the same matter differently, tax systems should permit taxpayers to allocate general expenses that cannot be directly attributed to identifiable uses in such a way that they are fully deductible in the country in which they are incurred.

In order to understand the logic behind permitting the full deductibility of domestic expenses, it is helpful to start by noting that any other system of expense allocation will have the effect of distorting ownership by changing the cost of foreign investment. Consider the case of a firm with both foreign and domestic income, and $150 of expenses incurred domestically in the course of activities that help the firm generally, and thereby arguably contribute both to domestic and foreign income production. One sensible-looking rule would be to allocate the $150 of expenses according to income production, so that if the firm earns half of its income abroad and half at home, with the foreign half exempt from domestic taxation, then the firm would be

entitled to deduct only $75 of its expenses against its domestic taxable income. For a firm with a given level of borrowing, greater foreign investment would then be associated with reduced domestic interest deductions, and therefore greater domestic taxes. Hence the home country in fact would impose a tax on foreign income, in the sense of discouraging foreign investment and triggering additional domestic tax collections for every additional dollar of foreign investment. The only sense in which this tax differs from a more conventional tax on foreign income is that it does not vary with the rate of foreign profitability.

The fact that a simple-minded expense allocation rule acts just like a tax on foreign investment might at first suggest that those who design policy should seek alternative expense allocation systems that do not create these incentives. Unfortunately, there is no clever solution available for this problem: Any system that allocates expenses based on a taxpayer's behavior will have the effect of influencing that behavior, in the same way that a more conventional tax would. An alternative system of tracing expenses, in which taxpayers determine and report the uses to which deductible expenses are put, does not have this feature but creates ample opportunities for tax avoidance. Hence policies designed to avoid taxing foreign income necessarily must forgo allocating expenses incurred domestically.

This implication of foreign income exemption seems to run afoul of obvious objections from the standpoint of tax arbitrage. Why should the United States permit taxpayers to borrow in the United States, using the proceeds to invest abroad, and thereby earn income that is exempt from U.S. tax while claiming deductions against other U.S. taxable income for the cost of their borrowing? Even the observation that this is exactly what many other countries do has the feel of not fully addressing this issue. The answer lies in the fact that greater foreign investment triggers added domestic investment, so from the

37 We could envision a world in which foreign governments might permit the firm to deduct the other $75 of its expenses against income earned in their country, though this is of course not the world we inhabit. The discussion that follows assumes that governments do not permit deductions for general expenses incurred in other countries, as is indeed the universal practice.

38 See Shaviro, note 36, at 354.

39 See notes 24-30 and accompanying text. It is worth emphasizing that a system of CON and NON would subject truly passive foreign income to domestic taxation. See Desai & Hines, Old Rules, note 6, at 950 & n.22. One can think of a parent company using the proceeds from issuing a bond to invest in a foreign affiliate that uses its invested capital to buy the bond. In such a case, either the home country should subject the foreign income to taxation and permit a deduction for domestic interest expenses, or else exempt the foreign interest income from taxation and deny the domestic interest expense deduction. The argument in this Section presumes that the passive foreign interest income would be taxed by the home government.
standpoint of the U.S. tax system, the borrowing does not simply generate uncompensated interest deductions, but instead a domestic tax base that is equivalent to (quite possibly greater than) the tax base that would be forthcoming if the borrowing proceeds were invested domestically by the same entity that does the borrowing.

The same point can be considered from the standpoint of the taxpayer. A U.S. multinational firm with domestic and foreign operations should be indifferent, at the margin, between investing an additional dollar at home or abroad; if not, the firm is not maximizing profits. Hence when the firm borrows an additional dollar to invest abroad, it might as well invest at home, since the two produce equivalent after-tax returns—and it is clear that if a purely domestic firm borrows to undertake a domestic investment, it is entitled to deductions for its interest expenses.

Part of the confusion that surrounds the treatment of interest expenses (and other general expenses that firms incur and that are difficult to assign to particular lines of business) is that, from a tax standpoint, the marginal source of investment finance matters greatly. That said, the marginal source of investment finance is extremely difficult to pinpoint. Debt finance is generally preferred to equity finance on the basis of tax considerations, since in a classical corporate income tax system such as that practiced by the United States, interest expenses are deductible whereas dividend payments to shareholders are not. Hence debt finance might be thought of as a worst case scenario from the standpoint of raising corporate tax revenue; with appropriate income measurement, marginal debt-financed domestic investments generate no tax revenue, and with inappropriate income measurement, these investments might generate positive or negative tax revenue.

If the goal of a tax system is properly to raise revenue while offering appropriate economic incentives, and these are understood to include efficient incentives for capital ownership, then the simple exemption of foreign income from taxation is insufficient without accompanying expense allocation rules. Exempting foreign income from taxation gives taxpayers incentives to allocate their resources to maximize after-local-tax profits only if there is no unwinding of these incentives through expense allocation that depends on where income is earned or where other expenses are incurred. Using a system of expense tracking that in practice often entails full deductibility of domestic expenses need not be viewed as a daring step. The same logic that underlies the efficiency rationale behind exempting foreign income in the first place also implies that expenses should be deductible where incurred.
V. RESIDENCE-BASED EXCISE AND VALUE-ADDED TAXATION

The current U.S. system of taxing foreign income includes the proviso that taxpayers are entitled to claim foreign tax credits only for foreign income taxes, and related taxes, paid (or deemed paid) to foreign governments.\(^\text{40}\) Consequently, the payment of other taxes, such as foreign excise taxes, value-added taxes, property taxes, and many others, does not create an entitlement to claim foreign tax credits.\(^\text{41}\) In practice, this restriction creates numerous difficulties both for taxpayers, who may be denied U.S. foreign tax credits for payments to foreign governments that bear many similarities to income taxes, and for foreign governments, who are often eager to adopt innovative tax systems but are deterred by the potential noncreditability of the resulting taxes. The rule limiting foreign tax credits to income taxes is quantitatively quite important, as the annual foreign income tax payments of U.S. companies greatly exceed their payment of foreign taxes that do not qualify as income taxes.\(^\text{42}\)

Why are foreign tax credits permitted only for foreign income tax payments? Various justifications have been offered for this restriction, including, prominently, the argument that the burdens of corporate income taxes fall on owners of capital in the form of lower returns, whereas the burdens of other taxes tend to fall on foreign consumers.\(^\text{43}\) It is difficult to understand the relevance of tax incidence in this context. In part, this is due to the fact that little was known until relatively recently about the incidence of corporate income taxes, so any legislative restriction based on knowledge of the underlying economics of corporate tax incidence prior to the modern era would have represented a pure stab in the intellectual dark. But more importantly, it is difficult to discern what possible difference even secure knowledge of the incidence of corporate taxation would make to the desirability of permitting taxpayers to claim credits for alternative taxes paid to foreign governments. The justification for taxing foreign income after foreign tax credits presumably lies in some combination of the efficiency and distributional effects of such taxation from the standpoint of home country taxpayers, to which the ultimate incidence of foreign corporate taxation makes little if any contribution.

\(^{40}\) IRC §§ 901, 902.

\(^{41}\) IRC §§ 901(b), 902(c)(4)(A); see also Reg. § 1.901-2.


A simpler and more direct explanation for the practice of limiting foreign tax credits to foreign income tax payments is the similarity of the taxes involved, since foreign tax credits are used to offset home country taxes that otherwise would be due on foreign income. This logic implies that governments might permit taxpayers to claim credits for foreign excise tax payments that can be used to offset domestic excise tax liabilities due on foreign sales, an entitlement that makes sense only if countries impose worldwide excise taxes on a residence basis. Such a worldwide excise tax regime offers few attractions from the standpoint of national economic policy, but analyzing the properties of such a system offers the prospect of casting useful light on the taxation of worldwide income on a residence basis.

A. Residence-Based Excise Taxation

To take a concrete example of excise taxation imposed on a residence basis, suppose that the U.S. federal government were to levy a $2 tax on each gallon of gasoline sold in the United States and sold abroad by persons resident in the United States. U.S. taxpayers would be entitled to claim foreign tax credits for excise taxes paid to foreign governments, so that a firm selling gasoline in a country whose excise tax rate exceeds $2 per gallon would owe no additional tax to the United States, whereas a firm selling gasoline in a country with a $0.75 per gallon tax would owe $1.25 per gallon to the United States. One could imagine permitting worldwide averaging, thereby permitting taxpayers to use excess excise tax credits from sales in jurisdictions with excise taxes exceeding $2 per gallon to claim credits to offset taxes due on sales in jurisdictions with excise taxes less than $2 per gallon.

What would be the impact of such a home country tax regime? Firms selling in countries with excise taxes exceeding the U.S. rate would have excess foreign tax credits and therefore no U.S. tax obligations, so the tax regime would not affect them. Firms without excess foreign tax credits would face U.S. excise taxes on foreign sales that vary with local excise tax rates. Odd though such a system would be, it does not necessarily follow that it would spell the end of foreign gasoline sales by U.S. companies in all low-tax jurisdictions, though that is certainly one possibility. U.S. companies would persist in selling gasoline in those foreign markets in which two conditions hold: (1) that U.S. firms are profitable, and (2) that the same U.S. firms could not be even more profitable (in a present value sense) by selling their operations to foreign petroleum companies who are not subject
to the U.S. tax regime.\textsuperscript{44} Since U.S. firms may have significant cost or marketing advantages over their competition in certain foreign locations, it is possible that they would be able to remain in business despite the significant tax penalty associated with U.S. residence. In cases without such advantages, and where low foreign excise tax rates imply significant U.S. tax costs, U.S. firms are likely to disappear.

The economic costs of a residence-based excise tax regime are simple to identify. U.S. firms lose the opportunity to earn profits in foreign markets from which they are driven by U.S. excise taxes, and this, in turn, reduces the rate of return to domestic activities that make foreign operations otherwise profitable. Since there is every reason to believe that a worldwide excise tax regime would have very significant effects on the participation of U.S. firms in foreign markets, the associated economic costs are potentially enormous. The tax crediting mechanism creates an odd pattern of U.S. excise taxes on foreign operations, with zero and even (in some cases) negative excise taxes on foreign sales in some countries, whereas in other countries the U.S. system imposes positive tax rates that vary with local excises. Even in circumstances in which U.S. firms sell in foreign markets despite the imposition of significant U.S. excise taxes on such sales, the volume of foreign activity will be reduced, and distorted among countries, as a result of such taxes.\textsuperscript{45}

What possible justification could be offered for a home country excise tax regime such as that just described? Many, if not all, of the same arguments commonly advanced in favor of worldwide income taxation would apply with equal force to worldwide excise taxation. From the standpoint of the world as a whole, the benefits of selling an additional gallon of gasoline in country A equals the benefit to consumers in country A, which in turn is measured by the (tax-inclusive) price that consumers pay for the gasoline.\textsuperscript{46} Since sellers receive only the tax-exclusive price of gasoline, their incentives do not correspond

\textsuperscript{44} One method of selling foreign operations to foreign companies not subject to the U.S. tax regime is for a U.S. company to expatriate by inverting the corporate structure to establish non-U.S. ownership of its foreign operations. The adoption of residence-based excise taxation would certainly increase incentives to expatriate, and there is ample evidence that expatriation behavior is sensitive to incentives. See, e.g., Desai & Hines, note 22. The discussion that follows limits its analysis to situations in which domestic firms face sufficient economic or political costs of expatriating that they do not avail themselves of this option.

\textsuperscript{45} Desai et al., note 42, offers evidence of the impact of taxes other than income taxes on the volume of foreign activity by U.S. businesses.

\textsuperscript{46} This discussion of the example of gasoline excise taxes puts aside one of the primary considerations in taxing gasoline, namely the externalities associated with the environmental, health, congestion, and other consequences of consuming gasoline. To the degree that countries differ in their gasoline excise taxes based on differences in levels of local externalities, then global efficiency requires preserving these differences, and not offsetting
to global efficiency except in the unlikely event that excise taxes are the same everywhere. In the absence of residence-based worldwide excise taxation, too few gallons of gasoline will be consumed in countries with high excise tax rates, and (relatively) too many in countries with low excise tax rates. Domestic excise taxation might be said to encourage U.S. firms to move their sales offshore. A system of residence-based taxation in effect harmonizes excise taxes around the world from the standpoint of domestic producers.

An analogous argument would apply to domestic welfare, which, by the standard logic, is maximized by a worldwide excise tax regime even less generous than that under consideration. Domestic welfare, the thinking would go, is maximized by subjecting foreign sales to domestic excise taxation without provision of foreign tax credits. The reason is that, from the standpoint of the United States, the value of selling a marginal gallon of gasoline in a foreign market equals the profit that it generates, whereas the value of selling a marginal gallon of gasoline in the United States equals the profit it generates plus the associated excise tax revenue. Equating these two requires that the United States impose equal excise taxes on foreign and domestic sales.

One simple and entirely reasonable objection to subjecting foreign sales to home country excise taxation is that excise taxes tend to be incorporated in sales prices, so that, for example, increasing a (commonly used today, destination-based) excise tax on gasoline by $0.10 per gallon tends to be associated with roughly $0.10 per gallon higher gasoline prices. Of course, this incidence is unlikely to be exact, and indeed, both theoretical and empirical studies of sales tax incidence find that prices can move by less than, or in some cases more than, changes in excise tax rates. But the efficiency argument—which is identical to the argument used by Musgrave and many subsequent authors to support worldwide taxation—is valid on its own terms regardless of the incidence of the tax. That is, the argument is unchanged whether or not gasoline taxes are incorporated fully in consumer prices. Furthermore, and this is the underlying point, the same argument that consumer prices incorporate excise taxes applies to corporate income taxes, and for the same reason: Both excise taxes and corporate income taxes increase the cost of doing business, and market forces translate higher costs into higher consumer prices.

B. Residence-Based Value-Added Taxation

The analysis of the efficiency properties of worldwide taxation, and the resulting apparent desirability of residence-based excise taxes, applies with equal force to other taxes, such as value-added taxes. Suppose, for example, that the United Kingdom were to tax value added on a residence basis, so the 17.5% British value-added tax (VAT) rate would apply not only to goods and services sold in the United Kingdom (as it does currently), but also to goods and services produced by U.K. resident firms sold for consumption abroad. Again, one can entertain the possibility of a crediting scheme, in which taxpayers would be entitled to credit VATs paid to foreign governments against their domestic tax liabilities. As of 2008 VATs were used by more than 140 countries in the world, though not one of them attempts to levy a VAT in this way. It is instructive to consider the implications of such a VAT, which offers a clue to why such a design is so unpopular.

The application of such a VAT scheme by the United Kingdom would obviously stimulate an enormous restructuring of British foreign investment. By far the largest destination country for British foreign direct investment is the United States, and the absence of a U.S. VAT implies that the value added produced by the U.S. investment of British firms would be subject to a 17.5% VAT rate for any firms that do not have excess VAT credits from other foreign operations. The British VAT scheme would have less purchase in Europe, given the generally high VAT rates in the European Union, and indeed, the availability of excess VAT credits from European operations might offset a significant portion of U.K. VAT liabilities on U.S. source income for some British taxpayers. But in the circumstances in which worldwide taxation matters—when taxpayers would not have excess foreign tax credits in the absence of active management—the residence-based VAT system would impose significant burdens, and burdens that vary with local VAT rates.

How are taxpayers likely to respond to the introduction of residence-based value-added taxation? The obvious reaction is to shed, or avoid in the first place, ownership of value-added producing activities in jurisdictions where British ownership triggers significant tax liabilities. Again, it does not follow that British firms would maintain no U.S. operations; it is almost certain that they would continue at least some operations, despite the tax cost. But the distortion to ownership, investment, and productivity would be enormous.

The older efficiency norms that underlie CEN and related concepts would evaluate residence-based value-added taxation favorably. Poli-

cies that allocate value added around the world based on pretax returns maximize world welfare, so the CEN logic implies that total (host country plus home country) value-added tax rates should be the same everywhere. In the absence of worldwide tax harmonization, this can be achieved only by home country tax regimes that offset any differences between domestic and foreign taxation, as in the hypothetical British example. Home country welfare would be maximized by a different regime, in which after-foreign-tax returns are subject to home country value-added taxation at the normal rate. In the British example, a firm producing $100 of value added in a country with a 20% VAT would pay a VAT of $20 to the foreign government and then $14 (17.5% * $80) to the U.K. government. This tax system, says the theory, maximizes home country welfare.

C. Application to Income Taxes

No country attempts to tax sales or value-added on a residence basis, doubtless deterred by some of the considerations that are apparent from the preceding analysis. A very similar analysis can be offered for application of the residence principle to worldwide property and other taxation. The reason to analyze these taxes is not because they might realistically be adopted by the United States or some other government in the near future, or because they contain desirable features, but instead for the light that they shed on residence-based systems of taxing corporate income earned in other countries. To put the matter directly: Why is it that residence-based excise, value-added, and property taxation are clearly undesirable policies, while residence-based income taxation has not enjoyed the same unpopularity?

Residence-based taxation of foreign income has the same ownership effects as would residence-based excise or value-added taxation, with the same (negative) impact on economic welfare. The economic consequences of income taxation seem subtler than those of, say, excise taxation, but this is merely an illusion, since a $10 million tax liability associated with U.S. ownership will discourage U.S. ownership of foreign business assets to the same extent whether the $10 million is called an income tax or an excise tax.

VI. Fairness and Distribution

This Part considers some of the fairness and income distribution considerations raised by the question of whether or not to tax foreign income.
Simple fairness principles can have considerable purchase in tax design, and one of the powerful arguments occasionally advanced in favor of taxing worldwide income is that the failure to do so would produce a system that unfairly burdens taxpayers with domestic income relative to taxpayers with foreign income. Even in the absence of widely agreed-upon norms of fairness, this argument has considerable intuitive appeal, and therefore warrants careful consideration.

It is helpful to work through a simple, and somewhat extreme, example in order to identify the salient fairness issues at stake in taxing (or exempting) foreign income. Compare two taxpayers, both earning $100 of pretax income; one earns $100 domestically, where the income is subject to a 35% tax, whereas the other earns $100 in a jurisdiction that does not tax corporate income at all. For simplicity, there are no other taxes in these countries.

In the absence of worldwide residence-based taxation, it appears that the taxpayer with foreign income somehow obtains an unfair advantage over the taxpayer earning domestic income. Both have (by assumption) equivalent if not identical business operations; both benefit from the services that the home government provides; but only the taxpayer whose income has a domestic source contributes resources to the provision of home country government services. In such a setting, and with such reasoning, even the acknowledged equal opportunity of any taxpayer to earn foreign income if desired hardly seems to allay fairness concerns.

On closer examination, however, the pretax situations of those earning foreign and domestic income betray marked dissimilarities. In the example, the taxpayer with foreign business income operates in an environment in which it is necessary to compete with other business interests that are not subject to the same home country tax regime. Consider the case in which competing business interests are not subject to taxes beyond the local source-basis tax, either because their business homes are countries that exempt foreign income from taxation, or because they are domestic firms in the foreign country. The profits of these competing firms are therefore not taxed at all, and competition among these firms therefore drives returns down to a level at which the pretax rate of return just equals the after-tax returns.

available elsewhere. Put simply, the zero tax rate in the foreign jurisdiction unleashes foreign competition that reduces the returns that investors can earn locally.

To the extent that investors are affected by local foreign competition, they incur costs that are associated with the competition triggered by low foreign tax rates. For example, foreign investment attracted by low foreign tax rates will tend to bid up real local wages, increasing the cost of business for all investors. As a consequence, it is more difficult than it would be otherwise for a firm to turn a profit in such a country; to put the same matter differently, an investor in a zero-tax country pays an implicit tax in the form of lower returns produced by market competition.

The tax treatment of interest earned on state and local debt offers an instructive comparison. For most taxpayers, the exemption of state and local bond interest from taxable income offers a marked benefit, since, minor complications aside, the after-tax rate of interest equals the pretax rate of interest. Does it follow that anyone who invests in state and local bonds receives a significant windfall as a result? Certainly not, since the availability of the tax exemption greatly increases demand for these bonds, increasing bond prices and thereby depressing market yields. With a sufficient number of top-bracket investors, market equilibrium requires that the risk-adjusted after-tax return available from investing in state and local bonds equals the risk-adjusted after-tax return available from other securities held by top-bracket investors. Thus the tax exemption for state and local bond interest fails to ignite a groundswell of objection on the basis of fairness.

Fleming, Peroni, and Shay, among others, would distinguish on fairness grounds those implicit taxes paid on tax-exempt debt from explicit taxes that are required to be remitted explicitly to governments. Certainly given the intrinsic vagueness of almost any notion of fairness it is impossible to identify a specific characteristic that a tax system must satisfy in order to be fair, and to declare any alternatives to be unfair. From the standpoint of the ultimate distribution of income, the question remains whether an investor who has already paid an implicit tax needs to be subject to an explicit home country tax in the name of fairness. There is the additional considera-

50 As it happens, there appears to be insufficient demand for state and local debt among top-bracket investors, as the implied tax rate from tax exempt bond yields is below the 35% top federal rate. See Michael J. Graetz & Deborah H. Schenk, Federal Income Taxation: Principles and Policies 224 (6th ed. 2009) (ratio of yields generally about 75%). As a consequence, a taxable investor facing a 35% tax rate in most years receives a small windfall from buying state and local debt.

tion that many intuitive notions of fairness grapple rather little, if at all, with the extraterritorial nature of worldwide income production. On what fairness basis does foreign income production require domestic taxation? And is it fair for the United States to subject income earned in other countries to U.S. taxation, thereby quite possibly affecting the distribution of income in foreign countries?

The same fairness argument that favors subjecting foreign income to domestic income taxation would also favor subjecting foreign value-added to domestic value-added taxation, foreign sales to domestic sales taxation, and similarly extending other domestic taxes to foreign activities. Why is there not a groundswell of fairness-motivated objection to the territoriality of value-added taxes, particularly in countries such as Denmark and Hungary that boast very high domestic VAT rates? In the case of the VAT, it is obvious that taxes are largely capitalized into the prices of goods sold, so multinational firms do not obtain extraordinary tax benefits from selling in countries with low VAT rates, since competition pushes down final output prices in such places. Expressed differently, one pays an implicit tax on sales in jurisdictions with low tax rates. Exactly the same process applies to income taxes, the only difference being that the implicit taxes are slightly less transparent.

B. Who Pays and Who Benefits?

The analysis of CON and other welfare benchmarks is premised in part on the notion that home countries benefit from policies that improve the productivity and therefore profitability of home country companies. While this is not a logical necessity, there are at least two reasons why it is appropriate for the analysis to proceed on this basis. The first is that home country residents typically have strong stakes in the profitability of home country companies through their interactions as owners, workers, suppliers, and consumers. Ownership is the most obvious of these channels: The widely documented “home bias” in asset ownership implies that domestic residents are considerably more likely than others to own local companies and thereby benefit from their profitability. Greater profitability is likewise associated with higher wages and other benefits for members of the community. The second reason comes from the analysis of Gordon, who notes that the burden of taxation and its associated efficiency cost

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52 See Desai & Hines, Tax Reform, note 6, at 493.
is borne by local factors, such as labor and land. If a small open economy attempts to tax foreign income at a nonzero rate, then it discourages foreign multinational firms from investing and the cost of this taxation is ultimately borne by local workers and landowners. Hence, it is not necessary for local residents to own multinational firms in order to be appropriately concerned about the efficiency with which they are taxed.

It is possible to add some precision to the analysis of who bears the burden of taxing foreign income by considering the incidence of the corporate income tax writ large. In an open economy such as the United States, capital taxes, of which corporate income taxes are only one species, are largely borne by factors that are fixed in the United States. In practice, this means that taxes paid by U.S. corporations, including taxes on their foreign incomes, reduce real wages in the United States, doing so both through direct tax burdens and also through indirect burdens in the form of reduced aggregate economic productivity. William Randolph estimates that 70% of the U.S. corporate income tax burden is borne by labor, but this is a lower bound estimate. Randolph's model takes world capital supplies to be fixed, which is unrealistic. Using a more appropriate specification in which capital supply is an increasing function of real returns, the burden of capital income taxation is borne to an even greater degree by local labor.

VII. Complications

Actual tax systems are considerably more distortionary than the stylized versions considered in this Article. Equity-financed corporate income is taxed twice by classical corporate tax systems while debt-financed corporate income is taxed only once, investments in certain industries and assets receive favorable tax treatment not available to

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54 Roger H. Gordon, Taxation of Investment and Savings in a World Economy, 76 Am. Econ. Rev. 1086, 1095 (1986).
55 Id. at 1096.
58 Id. at 8.
59 See Don Fullerton & Gilbert E. Metcalf, Tax Incidence, in 4 Handbook of Public Economics, note 10, at 1787, 1833.
60 Compare IRC § 11 (imposing a tax on corporate income), and IRC §§ 301, 316 (imposing a shareholder-level tax on dividend distributions), with IRC § 163(a) (allowing a corporate-level deduction for interest paid or accrued).
other investments, capital gains are taxed only upon realization, and then at rates that may differ from the rates at which other income is taxed, and there are many other income distinctions drawn by the tax system with little economic basis. In addition, activities that generate positive externalities, such as those that produce new technologies with economic spillovers, those that improve the natural environment, or others, may fail to receive appropriate encouragement from the tax system in the form of subsidies or reduced tax rates. The appropriate taxation of foreign income in an environment in which the tax system is already imperfectly tailored to tax domestic income may differ from the system that the government would want to adopt if its other tax policies were optimally designed. The analysis nonetheless serves as a useful starting point for the design of optimal tax systems, but it is worth bearing in mind that it is only a starting point.

Tax systems that exempt foreign income have the potential to put more pressure on aspects of the tax system, such as the transfer pricing rules, that allocate income between domestic and foreign source. In some settings with worldwide taxation, the source of income will not matter for domestic tax purposes, hence (domestic, anyway) enforcement of these matters becomes an issue of little consequence. In tax systems that exempt foreign income, the source of income and expense becomes a matter of great importance.

The difficulty of articulating and enforcing a coherent regime that distinguishes domestic from foreign source income is certainly a challenge for those who would base taxation on this distinction. This Article follows almost all of the preceding literature in taking enforcement matters to be outside the scope of the present inquiry, in large part because the traditional case for worldwide taxation is not presented in those terms. And indeed, even incorporating the enforcement difficulties that tax systems face, the notion of adopting worldwide taxation for no reason other than the difficulty of enforcing a transfer pricing regime has a strong element of the transfer pricing tail wagging the tax system dog. Certainly transfer pricing is a difficulty, and

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61 See, e.g., IRC § 38(b) (detailing various favored investments that generate business tax credits).
62 See IRC § 1001(a) (requiring a “sale or other disposition”).
63 Compare IRC § 1(h) (providing capital gains rates), with IRC § 1(a) (providing rates for ordinary income).
64 For an extended analysis of this point, see generally Hines, note 5.
should be addressed on its own terms, not by changing every other element of international taxation.

A final issue that is difficult to evaluate, but potentially important, is the reaction of other governments to changes in U.S. tax policies. It is standard to assume that changes in U.S. policies do not affect the policies of other governments, but this will not be the case in some competitive situations and if governments react strategically with each other. Naturally, this consideration has the potential to change the optimal tax policy from the standpoint of a government seeking to maximize the welfare of its own residents, since it enhances the attractiveness of home country tax policies that encourage foreign governments to reduce their own taxation of inward foreign direct investment. Incorporating such spillovers in the choice of optimal tax policies requires governments to determine the direction and magnitude of any effects of home country tax policies on foreign tax policies. While the United States is a capital exporter of sufficient size potentially to influence the tax policies of other countries, most capital exporting countries are unlikely to have such effects and therefore may not be influenced by this consideration. And even for the United States it is very difficult to estimate the effect of the home country tax regime on foreign tax policies.

VIII. Conclusion

A reconsideration of the taxation of foreign income is long overdue. It is surprisingly easy to grow comfortable with systems that tax foreign business income while providing foreign tax credits, doing so in the vague sense that these systems promote national or world welfare. If instead the opposite were the case, if as a result of taxing foreign

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67 See Feldstein & Hartman, note 66, at 622.

68 Id. at 621.

69 See, e.g., Charles E. McLure, Jr. & George R. Zodrow, A Hybrid Consumption-Based Direct Tax Proposed for Bolivia, 3 Int'l Tax & Pub. Fin. 97, 97 (1996) (documenting the reluctance of the government of Bolivia to introduce a cash-flow style corporate income tax due to its potential noncredibility by U.S. investors in Bolivia). Case-specific tax provisions, such as individually-negotiated tax holidays, are more likely to be influenced by home country tax rules. See, e.g., Hines, note 19 (reporting evidence concerning the effect of “tax sparing” on local tax rates in developing countries).
income the welfare of domestic residents is gradually eroded as domestic business operations become less productive and less dynamic, it might not be immediately apparent in what is otherwise a strong and affluent economy. This is a potential danger for large economies that persist in taxing foreign income without regard to the resulting distortions to ownership and productivity. Whereas some forms of international taxation, such as subjecting U.S. firms to U.S. excise taxes on their foreign sales, are transparently inefficient and self-defeating, others, such as the current U.S. regime of taxing foreign income, are no less inefficient, only somewhat subtler in their appearance.

As long as governments persist in taxing business income at source there also will be a need to determine the appropriate residence-based taxation of business income. No single system produces efficient incentives at all margins of behavior, since there are so many business activities that are taxed in so many different ways. It is clear, however, that ownership is very important, and that international ownership is strongly influenced by taxation. In a context of shifting ownership, there are significant costs associated with subjecting active foreign business income to home country taxation, and these costs are not somehow recouped by preventing the outflow of what otherwise would be domestic economic activity, since foreign business operations if anything increase demand for domestic operations. Hence the feared loss of domestic tax base that might accompany exemption of foreign income is illusory. Viewing foreign taxation through the lens of ownership, itself just a small change in perspective on international taxation, has the potential to clarify the issues facing governments that tax business income.