ENDING THE TAXATION OF FOREIGN BUSINESS INCOME

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From the inception of the income tax, there has been a debate[2] about the best way to tax foreign-source income.[3] While there are innumerable variations, one can divide the participants into two major camps: Those who favor taxation by the country of residence of the taxpayer[4] (sometimes referred to as a "worldwide" system), and others who believe income should only be taxed in the source country[5] (sometimes referred to as a "territorial" or an "exemption" system). The member nations of the Organization for Economic Co-operation and Development are evenly divided between the two systems.[6] Because the United States taxes the worldwide income of US persons,[7]

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[2] For a history of this debate see Peter Harris, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES (1996) at 72-88. See also Klaus Vogel, *World-wide vs. Source Taxation of Income- A Review and Reevaluation of Arguments* in INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS. (Charles McLure, Hans Werner Sinn, Richard Musgrave eds. 1990) at 117-166, and Joel Slemrod, *The Taxation of Foreign Direct Investment: Operational and Policy Perspectives* in BORDERLINE CASE: INTERNATIONAL TAX POLICY, CORPORATE RESEARCH AND DEVELOPMENT AND INVESTMENT (James Poterba ed., 1999)

[3] Foreign-source income is income that is generated from activities conducted outside of the United States. Terrence Chorvat, *Taxing International Corporate Income Efficiently* 52 Tax L. Rev. 225, 227 (2000).

[4] The "residence country" of a corporation is the country in which the corporation is managed or incorporated. For an individual it is where he or she resides. See Chorvat note 3 *supra*, at 226.

[5] The "source" country is the country in which the activities that generated the income occurred. Chorvat, note 2 *supra* at 227

[6] National Foreign Trade Council, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY, PART ONE : A RECONSIDERATION OF SUBPART F. (1999) ("NFTC") p.57, Table 6-1. Some countries exempt active foreign source income by statute (such as the Netherlands and France), others by treaty (such as Canada and Germany). See Hugh Ault, COMPARATIVE INCOME TAXATION (1997) at 402- 406

[7] A US person is any person (corporation or individual) who is subject to income tax in the United States on a residence basis. This includes all corporations incorporated in one of the 50 states or the District of Columbia. For individuals, it includes all citizens and permanent residents, as well as those who reside here for most of the taxable year. Internal Revenue Code ("IRC") section 7701(a)(1), (4), (30).

the US system is in form a worldwide system.[8] However, most of the important trading partners of the United States have adopted territorial systems.[9]

This article will demonstrate that when compared with an exemption system the current US system discriminates against immature businesses and creates economic distortions for all US multinationals. In addition, an exemption system would be simpler and cheaper.[10] Therefore, this article proposes that the United States adopt an exemption system. However, some of the elements of the current system should be retained: The United States should continue to tax passive foreign source income and certain anti-abuse rules should be remian in place.[11]

While the debate over whether a worldwide or an exemption system is superior is an old one,[12] it is very much of current interest as well. On March 25, 1999, the National Foreign Trade Council issued a widely read and controversial report, which sets forth a case for reducing the US taxation of foreign source income.[13] This report was jointly released with Congressman William Archer, the Chairman of the House Ways and Means Committee.[14] It also received positive comments from William Roth, the Chairman of the Senate Finance Committee.[15] Both the Senate Finance Committee and the House Ways and Means Committee have held hearings and introduced legislation to further the report's conclusions.[16] The proposed Legislation includes the Houghton Bill H.R.

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[8]For a discussion of the US system see discussion Part I.C, *infra*.

[9] This includes, for example, Canada, The Netherlands, France, Germany, Ault, note 6 *supra*, at 402-406.

[10] Harry Grubert and John Mutti "*Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?* 2 International Tax and Public Finance 439 (1995) , Reuven Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification* 74 Tex. L. Rev. 1301 (1996).

[11] These rules are discussed in section IV.B, *infra*

[12] Vogel, note 2 *supra*, at 118 , Harris, note 2 *supra* at 75

[13] NFTC, Note 6 *supra*, at 53

[14] *Archer Joins NFTC in Releasing Council's Subpart F Report. March 25, 1999* 1999 TNT 58-5

[15] *US Congressman Roth Applauds NFTC's Subpart F Report* March 25, 1999 1999 TNT 58-39.

[16] On June 24 and 30, 1999 , the House Ways and Means Committee held hearing discussing the NFTC report and the US international tax system. 1999 TNT 118-108, 1999 TNT 126-52. More hearings are planned for 2000. Chairman Archer has stated that the US international tax rules are antiquated, "unbelievably complex" and put US businesses at a competitive disadvantage. Ryan Donmeyer, *Will Congress Have Time, Stomach to Reform International Provisions*. 85 Tax Notes 1487 (Dec. 20 , 1999).

On March 11, 1999, the Senate Finance Committee held hearings on the US international tax system. In March 11, 1999 hearings Senator Roth stated "to stay at the cutting edge of this dynamic and promising international

2018 to simplify international taxation (TNT 1999-2132, proposed June 21, 1999) and the Breaux-Mack Bill S.2503-S.2506. Furthermore, there have been a variety widely-read recent studies in the area. For example, one highly cited study by Gary Hufbauer [17] argued for an exemption system for foreign source income of businesses.

Those arguing in favor of adopting an exemption system have done so almost entirely on grounds of increasing the "competitiveness" of US firms. They argue that because our major trading partners have adopted exemption systems and their firms are not subject to tax on a worldwide basis, US firms are at a competitive disadvantage.

This article adds to the debate in three ways. First, it makes the case for the exemption system purely on grounds of enhancing worldwide economic efficiency. This standard looks to whether the policies at issue increase worldwide income as opposed to "competitiveness" which only looks to increasing the profits of US firms.[18] The key to the analysis of efficiency is resource allocation.[19] In general, the taxation of capital income is efficient to the extent that it does not alter the allocation of resources.[20] Under this analysis, the tax system should not determine which investments are undertaken. This article will show that the exemption system would improve worldwide economic efficiency as compared to the current US system. The second contribution to the debate is the discussion of the some recent developments in economic theory which have been subsequently confirmed by empirical

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economy, we need to fundamentally rethink out tax code with a view to enhancing American competitiveness." *Unofficial Transcript of Finance Hearing on International Tax Laws* 1999 TNT 50-54.

[17] US TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM (1992)

[18] See Chorvat, note 3 *supra*, at 235, Vogel, note 2 *supra*, at 118

[19] Harvey S. Rosen, PUBLIC FINANCE at 44-48 (5th ed. 1998).

[20] When taxes do not distort the placement of capital This is known as capital export neutrality. This is thought to promote economic efficiency. See Generally, Thomas Horst, "A Note on the Optimal Taxation of International Investment Income." 93 Quart. J. Econ. 793 (1980) and also, Peggy Musgrave, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME: ISSUES AND ARGUMENT (1969). The arguments in favor of the exemption system focus on the allocation of capital amongst MNEs. That is, the tax system should be such that investor do not have an incentive to invest in an MNE based in the United States as opposed to an MNE based in another country. Daniel Frisch *The Economics of International Tax Policy: Some Old and New Approaches* Tax Notes April 1992, 581, 585.The literature on the optimal tax system for international income is extensive. See Vogel note 2 *supra* at 118, as well as Richard Caves, MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS (1996), at 190-206 The proposition that economic efficiency is achieved when taxes do not distort decisions is known as the fundamental theorem of welfare economics. For a discussion of this theorem see Rosen, note 19 *supra*, at 44-48.

research. These findings, which have not yet been applied to the this debate,[21] show that an exemption system would increase efficiency as compared to the current system. The third contribution the article makes is to discuss how the current system distorts international mergers and acquisitions in a way that the exemption system would not. The article also analyzes the other important efficiency arguments concerning the exemption system.

Part I of the article discusses the fundamental rules and consequences of both the US worldwide system and the exemption system. Part II discusses the traditional efficiency argument against the exemption system. This part also shows how recent developments in economic theory refute this argument. Part III demonstrates how the exemption system would improve economic efficiency. Part IV describes how the US tax system should be changed and discusses certain aspects of the current US system that should be retained.

I. Fundamental Concepts of International Taxation

Any income which arises from cross-border transactions is potentially subject to tax in two or more jurisdictions: the residence country and the source country. Under the current international tax system,[22] it is generally left to the residence country to alleviate double taxation.[23] There are two common methods of alleviating double taxation.[24] The first is the "worldwide" or "credit" method in which the residence country taxes foreign

[21] David Hartman, *Tax Policy and Foreign Direct Investment 26* Journal of Public Economics 187 (1985)and Hans Werner Sinn, *Taxation and the Birth of Foreign Subsidiaries* in TRADE WELFARE AND ECONOMIC POLICIES (Horst Herberg and Ngo Van Long eds., 1993). A Lexis search of all law review articles reveals that the Hartman article has only been cited 5 times and never in a discussion of the efficiency of the exemption system versus the worldwide system, and the Sinn article has only been cited once, again not in a discussion of the efficiency of the exemption system versus the worldwide system. Furthermore the NFTC report, note 6 *supra*, cites neither of these articles.

[22] Harris, note 2 *supra* ,at 20-30. And Reuven Avi-Yonah, Commentary to *International Tax Arbitrage and the "International Tax System"*, 53 Tax L. Rev. 167 (2000)

[23] Double taxation is highly inefficient. If foreign investment is subject to two layers of tax, while domestic investment is subject to only one, the tax system would be significantly discouraging investment in foreign countries. Caves, note 20 *supra*, at 90

[24] An additional approach for dealing with foreign taxes is to allow them to be deducted from taxable income. This method is rarely used for income taxes. This does not eliminate double taxation, rather it simply reduces it. Both countries still tax the income. The total tax paid is higher than the tax rate in either country. Harris, note 2 *supra* at, 42.

source income but provides a credit for taxes paid to foreign jurisdictions. The second is the "exemption" method under which the residence country cedes all taxing jurisdiction to the source country. Section A of Part I discusses the worldwide system. Section B discusses the exemption system. Section C concludes Part I by discussing the US system which is nominally a worldwide system, but which diverges from that system in some important ways.

A. Worldwide System

The United States currently uses a form of a worldwide taxation system.[25] Under a worldwide system, a country taxes all the income of its residents, no matter where they earn it. In order to alleviate potential double taxation, the residence country generally permits its taxpayers a foreign tax credit for income taxes paid on income earned in foreign jurisdictions. Under this system, the income earned by an multinational enterprise[26] ("MNE") in a low-tax country will be taxed at least at the residence country's rates.

To illustrate, assume that A, a US MNE, earned $100 in Hong Kong and $100 in the United States. Hong Kong will tax the $100 of income earned within its borders at a rate of 17%. The United States will tax A's worldwide income of $200 at a rate of 35%. However, because of the foreign tax credit, A will only have to pay an additional US tax of $53, rather than $70.[27] Because the total amount of tax A will pay is $70,[28] the Hong Kong income and the US source income are both subject to a total tax rate of 35%, which is the rate A would have paid if all the income had been earned in the United States.

Almost all of the countries that use a worldwide system impose a limitation on the foreign tax credit.[29] The

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[25] Under IRC sections 1, 11, and 61, foreign source income is subject to tax. Under section 901, this income is eligible for a foreign tax credit.

[26] A multinational enterprise is defined here as an enterprise that controls and manages business activities in at least two countries. See Caves, note 20 *supra* at 1.

[27] If the Hong Kong income is earned directly by A, it will be taxable income to A under IRC section 61. If A's tax rate is 35%, A's tentative US tax will be $70 (200 X .35). This will be reduced by a $17 credit permitted under IRC section 901. A will then owe $53 (70-17) in US tax.

[28] $53 to the United States and $17 to Hong Kong

[29] For example, this is the case in the United Kingdom, Australia, Norway, see Slemrod, note 2 *supra*, at 92. and Ault, note 6 *supra*, at 388-389.

foreign tax credit limit is generally equal to the amount of residence country tax on foreign source income.[30] The foreign tax credit limit insures that the tax rate applicable to foreign source income is the higher of the residence country rate or the source country rate.

To illustrate how this occurs, assume that A also operates in Italy where the tax rate is 56%. If A earns $100 in Italy, this income will be subject to $56 of Italian tax. The Italian source income will also be subject to tax in the United States at a 35% rate, but A will receive a tax credit for the taxes paid to Italy.[31] Because the Italian rate of tax is greater than the US rate of tax, A will not pay any tax on this income in the United States. However, because the credit is limited to $35 (the amount of US tax on the Italian income), the total tax rate on this income is the higher Italian rate of 56%.[32]

B. Exemption System

Under an exemption or territorial system, foreign source income generally is not subject to tax in the residence country. The residence country only taxes income earned within its borders. To illustrate, assume that N is a Dutch MNE, and N has a subsidiary in Hong Kong. N earns $100 in the Netherlands, and the subsidiary earns $100 in Hong Kong. The Netherlands has an exemption system[33] and a 35% corporate rate on income earned in the Netherlands.[34] N will pay $17 in tax to Hong Kong, and will only pay tax in the Netherlands on its Dutch source income. N will not pay any tax in the Netherlands on the Hong Kong source income. Therefore, N will have to pay less in total worldwide tax than A ($52 for N versus $70 for A).[35] If N had an Italian subsidiary, its income would also be subject to a tax rate of 56%.[36] Thus if A and N both have operations in the same high-tax jurisdiction, A and

[30] IRC § 904. For the U.K. rules see Ault, note 6 *supra* at 385-391. These limits prevent the worldwide system from achieving full tax neutrality between investments. Caves, note 20 *supra* at 191.

[31] A will receive a foreign tax credit of $56, while the US tax on the income is only $35 dollars. Therefore, A will owe no further US tax.

[32] Generally, if the taxpayer has foreign tax credits that it cannot use on a particular item of income, the taxpayer is permitted to use these credits to reduce US tax on other items of foreign source income. However, this is subject to many restrictions. See discussion in Section III.B *infra*.

[33] Ault at note 6, *supra* , at 384-5

[34] Ibid at 87

[35] $52 = 17 + 35. And A paid tax a rate of 35% on 200% or $70.

[36] Under a worldwide system the higher of the source country rate or the residence country rate applies. Therefore,

N will be taxed alike on this income.

Most exemption systems tax the passive foreign-source income of their residents, because passive income is viewed as having no natural location.[37] For example, someone who owns shares of IBM, will obtain the same pre-tax benefits whether he resides in the United States, Bermuda or Australia. As a result an MNE will have an incentive to shift its passive income to the lowest taxed location. Because this shifting has no economic substance,[38] it is viewed as an abuse of the system, and therefore many exemption systems subject foreign source passive income to tax in the residence country.[39]

C. The US System

It is often said that the US international tax rules are based on a worldwide system.[40] To some extent this is true. Income earned by foreign branches[41] of US corporations is taxed when it is earned abroad. Dividends, interest, rents, royalties and similar kinds of income received by US persons are also subject US income tax.[42] In addition, income taxes paid to a foreign jurisdiction are eligible for the foreign tax credit.[43]

However, the US does not have a pure worldwide system. The largest deviation from the worldwide model is the taxation of income earned by foreign subsidiaries of US MNEs. If foreign source income is earned by a foreign subsidiary of the US MNE, then the income is generally not taxed until it is repatriated to the United

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if the tax rate in the source country is higher than in the residence country, under both a worldwide system and a territorial system, the higher source country rate applies.

[37] For this purpose, passive income includes such items as dividends, interest, and royalties not received from affiliates. The Netherlands, France and Canada, tax these types of income. Ault, note 6 *supra* at 403-406

[38] Whether the income is earned by a US or an Bermudan subsidiary, the activities that generated the income do not change nor are the natural persons enriched by the income different. Therefore, the shifting of such income between subsidiaries does not have economic substance.

[39] Slemrod, note 2 *supra*, at p. 90, NFTC at note 6 *supra*, at 156.

[40] Slemrod, note 2 *supra*, at 93.

[41] A foreign branch is a direct operation of a US corporation in a foreign country. A foreign subsidiary is a foreign corporation which is owned by a US corporation. If the MNE chooses a foreign subsidiary, it must form a foreign corporation to conduct to the business. If it chooses a branch, it conducts the business in the foreign jurisdiction itself. Harris, note 2 *supra, at 5*

[42] IRC § 61

[43] IRC § 901

States.[44] The income tax on repatriated earnings is sometimes referred to as the "repatriation tax."[45] As discussed in Part II. B, this causes the economic effects of the US system to approximate those of an exemption system.

There are some important additional complications to the US system. One set of rules of particular concern are the anti-deferral provisions, found in subpart F of subchapter N of the Internal Revenue Code.[46] These rules cause certain types of income earned by controlled foreign corporations[47] to be included in the taxable income of the US parent in the year earned by foreign corporations, even though that income has not yet been repatriated back to the US parent. As discussed in Part IV, these rules exist to insure that US source income is taxed in the United States.[48]

II. The Traditional Efficiency Argument Against the Exemption System and How Economic Theory and Empirical Research Refutes It

A. The Exemption System Encourages Investment in Low-tax Countries.

The principal argument against the exemption system[49] is that it would distort the decison of where to invest capital.[50] Because owners of capital will invest wherever they can receive the highest after-tax return, they

[44] This complicates the determination of the effective rate of tax, see Chorvat, at note 3 *supra*, at 245 for a discussion of the effect of deferral. The effects of this are examined in Section III below.

[45] If the foreign rate is less than the US rate This tax is equal to US tax rate minus the foreign tax rate. Caves, note 20 *supra* at 92 If the foreign tax rate equals or exceeds the US tax rate, there is no repatriation tax.

[46] IRC §§ 951-963

[47] IRC §957(a) . A controlled foreign corporation is a foreign corporation of which more than 50% of it shares are owned by US Shareholders. A US Shareholder is defined as a US person who owns 10% or more of the voting stock of the foreign corporation. IRC § 957(b)

[48] See discussion Part IV.B , *infra*.

[49] The other major argument against an exemption system is that it would cost too much in tax revenue. This was conclusively dealt with in Grubert and Mutti, at note 10, *supra* at 505 , which showed that the loss of tax revenue would be rather small and might possibly result in a revenue gain.

[50]Grubert and Mutti, note 10 *supra* at 500, and Avi-Yonah, note 10 *supra*, at 1353, and Robert Peroni, J. Clifton Fleming, jr., and Stephen Shay, *Getting Serious about the Deferral of US Tax on Foreign Source Income,* 52 SMU L.Rev. 455 (1999)

will therefore have an incentive to place investments in the lowest tax jurisdiction. The opponents of the exemption system argue that this would result in investment leaving the United States.[51] Because this incentive is created by the tax system, it is inefficient. This is sometimes known as the "runaway plant" argument, because under this analysis, if the US adopted the exemption system, many manufacturing plants currently located in the United States would be re-located to low-tax jurisdictions.

To illustrate, assume a US person A, has $1,000 to invest and has two possible investments: one in the United States and one in Country X. The US investment will give a pre-tax return of $100 while the foreign investment will give a pre-tax return of $90. In the absence of a tax on the income from these investments, A would choose the US investment, because it has a larger return. However, if the income is subject to tax in the source country (and only the source country) and the tax rate in Country X is 10% and the US tax rate is 35%, A will invest in Country X, because that investment has a higher after-tax return.[52] Because the tax system has distorted the investment decision, it has reduced worldwide production by $10 (from $100 to $90).

The opponents of the exemption system argue that the current US system prevents this distortion by insuring that the tax rate on any investment is never less than the US tax rate.[53] In the above example, if A had been subject to tax on his worldwide income at a 35% rate, A would have invested in the United States. Therefore, worldwide production would have remained at $100.

B. Economic Theory and Evidence Contradicts this Argument

The major oversight of this argument is that it neglects the fact that the US tax system generally does not tax active foreign income until it is repatriated to the United States.[54] Two seminal articles, one by David Hartman[55]

[51] Charles Kingson, *International Taxation* (1988) p.451-2, and Peter Merrill and Carol Dunahoo *Runaway Plant Legislation: Rhetoric and Reality* Tax Notes July 8, 1996 p.221.

[52] The Country X investment would give an after-tax return of $81 ($90 (1- .1)) versus the US investment which would give a return of $65 ($100 (1-.35).

[53] See discussion part I, *infra*. The system still does not result in complete neutrality, because of the foreign tax credit limit. Because of this limit, an investor will still prefer a US investment over a higher producing investment in a country with taxes higher than the United States.

[54] There are some provisions which cause active income of foreign subsidiaries to be taxed to US parent immediately(see discussion in Section IV, *infra*),but their effect is more to insure US source income is taxed in the United States. Grubert and Mutti, note 10 *supra* at 500, at Peroni, *supra*, note 5, at 165.

and the other by Hans Werner Sinn,[56] each demonstrate that if the residence country defers taxation on foreign source income until it is repatriated, the foreign subsidiary will retain income[57] until at equilibrium[58] the size of the foreign enterprise is equal to the size it would have been under an exemption system.[59] Under an exemption system, the equation becomes $r_f(1 - t_f) = r_{US} (1 - t_{US})$, because $(1-t_r) = 0$. Notice however, that the equation for a worldwide system with deferral reduces to the same equation , because $(1-t_r)$ appears on both sides of the equation. Therefore, an MNE operating under the exemption system and a mature MNE operating under a worldwide system with deferral will have the same investment behavior. Hartman, note 21, *supra* at 190-195. Therefore, at equilibrium the allocation of capital between mature US MNEs[60] and foreign MNEs will be the same under the current US system and under an exemption system.

This occurs because the repatriation tax affects not only the initial decision to export capital, but also the decision to repatriate capital. Retained earnings are not immediately subject to the repatriation tax, whereas repatriated earnings are. Thus, the tax system creates incentives to retain earnings in the foreign subsidiary. By slowing down capital repatriation, more capital remains in the foreign jurisdiction. For mature subsidiaries, these two effects balance each other at equilibrium. Thus, a worldwide systems which defers the tax on foreign source income until repatriation has the same allocation of capital between US MNEs and foreign MNEs as an exemption system.[61]

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[55]Hartman, note 21 *supra*, at 190

[56]Sinn, note 21 *supra* at 325

[57] This assumes that tax rate in the source country is lower than the rate in the residence country. If the reverse is true, as discussed in Section I.B, *supra* the exemption system and the worldwide system result in the same tax rate.

[58] Equilibrium occurs when the forces acting on the firm to retain earnings are balanced by the forces acting on the firm to repatriate income. Hartman, 21 *supra* at 188, and Sinn, note 21 *supra* at 327.

[59] Under an exemption system, the decision to repatriate income will be based whether the capital will earn more in the United States or in the foreign country. The MNE will retain earnings in the foreign subsidiary until the point where the earnings on the marginal dollar of retained earnings are equal to the return on the marginal dollar of capital invested in the United States or mathematically $r_f(1 - t_f)(1 - t_r) = r_{US} (1 - t_{US})(1 - t_r)$, where r_f = pre-tax rate of return in the foreign country, t_f = the tax rate in the foreign country and r_{US} = pre-tax rate of return in the United States and t_{US} = the US tax rate, and t_r is the amount of the repatriation tax.

[60] The definition of "mature" enterprise is an enterprise that is no longer in need of additional capital infusions. It is able to generate sufficient capital through its own retained earnings. Caves, note 20 *supra*, at 190

[61] Once capital has been exported, any income this capital earns will ultimately subject to $t_{r,}$ the repatriation tax.

To illustrate, assume that under an exemption system A , a US MNE, would have invested $1,500 in country X, a low-tax country. However, under the worldwide system, A would only have invested $1,000, because under this system the income will eventually be subject to a repatriation tax.[62] Under the Hartman-Sinn analysis, in future years, A will have an incentive to retain earnings within the foreign subsidiary, because as long as the earnings remain in the country X they will not be subject to US tax. The incentive to retain earnings in Country X is equal to the initial disincentive to invest in Country X, so that at equilibrium, A will have $1,500 of capital invested in country X , which is the exact amount that would have been invested under the exemption system.[63]

The results of empirical studies agree with the predictions of this model.[64] In addition, a study by Joel Slemrod provides additional evidence for this model.[65] That article found that the allocation of capital between high-tax and low-tax jurisdictions was not correlated with whether the parent corporation was a resident of an exemption system country or a worldwide system country. Even though this study did not involve US MNEs, it does demonstrate that in general worldwide systems with deferral generally lead to the same allocation of capital as exemption systems.

The Hartman/Sinn analysis in connection with the empirical evidence shows that the "runaway plant" argument does not apply to US MNEs because of the deferral element of the US tax system. An exemption system will not cause a flight of investment away from the United States. For mature organizations, the allocation of capital

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Any reinvestment decision does not depend on whether this tax is large or small. As shown in note 59, the term representing this tax (t_r) drops out of the repatriation equation. Therefore, at equilibrium, this will not affect the allocation of capital between low-tax jurisdictions and high-tax jurisdictions.

[62] Explained in footnote 59, *supra*

[63] For proof of this result see note 59, *supra*.

[64] Roseanne Altschuler, T. Scott Newlon, William Randolph *Do Repatriation Taxes Matter? Evidence from the Tax Returns of U.S. Multinationals* in THE EFFECTS OF TAXATION ON MULTINATIONALS CORPORATIONS (ed. Martin Felstein, James R. Hines jr., R. Glenn Hubbard. (1995)) That study found that the permanent amount of repatriation tax did not affect the repatriation rates. Only the after-tax rate of return in the two countries controlled the rates. This is a key prediction of the Hartman-Sinn Model. See also, Jason Cummins and R. Glen Hubbard *The Tax Sensitivity of Foreign Direct Investment: Evidence From Firm-Level Panel Data* in THE EFFECTS OF TAXATION ON MULTINATIONALS CORPORATIONS ed. Martin Felstein, James R. Hines jr., R. Glenn Hubbard. (1995)

[65] *Tax Effects of Foreign Direct Investment in the United States: Evidence from a Cross-Country Comparison* in TAXATION IN THE GLOBAL ECONOMY (Assaf Razin and Joel Slemrod eds., 1990)

by mature US MNEs between foreign and US investment is unlikely to be different under an exemption system than under the current US system.

III. The Exemption System Would Improve Economic Efficiency

While the effects of the current system are in many ways similar to those of an exemption system, this section will show how adopting an actual exemption system would be more efficient than the current US system. First, the exemption system would reduce distortions which currently operate against immature US firms. Second, the exemption system would eliminate distortions which prevent US MNEs from acquiring foreign businesses that they otherwise would acquire. Third, it would be simpler and cheaper than the worldwide system. Fourth, it would eliminate the distortion from incentives that currently exist for certain companies to produce income abroad. Finally, it would eliminate arbitrary distinctions between the taxation of branches and subsidiaries.

A. Worldwide System Discriminates Against Immature US Firms

One of the primary arguments is favor of the exemption system is that unlike the current system it would not discriminate against immature US MNEs.[66] The US tax system causes US MNEs a disadvantage in raising capital.[67] All other things being equal, US MNEs pay more in income tax than MNEs from exemption countries do.[68] The higher worldwide tax burden decreases the after-tax return to investors. This lower return results in a

[66] For example, The NFTC (note 6, *supra* at 56-62) as well as Hufbauer (note 17 *supra* at 54-57) focus on the "competitiveness" of US -based MNEs. Both give some examples of how the US worldwide system hurts US MNEs in their ability to compete with foreign MNEs. They point out that the US system of its taxing multinationals is probably the most far reaching of all of the worldwide systems. That is, the US system causes more income be subject to US rates at an earlier time that any other system.

[67] NFTC note 6 *supra* at 63. These arguments only apply to US MNEs which have a worldwide effective tax rate lower than the US tax rate. These MNEs will have to pay additional US tax on repatriation of dividends. For the US MNEs which have a tax rate greater than the US rate, the foreign tax credit will equal or exceed the US tax on the dividend and so no repatriation tax will be due. In this case the MNE will in many ways be in the same position as if it were operating under an exemption system. (For one difference and the distortion it creates see section III.C)

[68] It is possible for an exemption system MNE to pay more tax than a US MNE if it earns more income in a high-tax country. Everything else being equal however, the US MNE will pay more worldwide tax than an exemption system MNE. because the tax-burden on income earned in low-tax jurisdictions will be higher for the US MNE. Empirical evidence for this is found in Micheal Devereux, Harold Freeman, *The Impact on Foreign Direct Investment: Empirical Evidence and the Implications for Integration Schemes*. 2 International Tax and Public Finance 1 (1995).

higher cost of capital[69] for US MNES.[70] Therefore, US MNEs will receive lower initial infusions of capital and they will allocate a lower portion of its capital to the foreign operations in low-tax jurisdictions as compared with foreign MNEs.[71] This reduces worldwide efficiency by distorting the allocation of capital between U.S. MNEs and foreign MNEs.[72]

To illustrate, assume there are two MNEs (a US MNE and a foreign MNE) competing in the same low-tax jurisdiction. They both have a pre-tax profit of $100. The US MNE is taxed by the United States at a rate of 35% and the foreign MNE at a rate 20%. Assuming that the shareholder level taxes are constant,[73] an outside investor would rather invest in the foreign MNE because it has a higher after-tax return ($80 versus $65). In order for the investor to be indifferent between the two investments, the pre-tax rate of return on the US MNE operations would have to be 23.1% higher.[74] Therefore, the cost of capital will be higher for US MNEs than for foreign MNEs.[75]

If the cost of capital is higher for US MNEs, and if all other things are equal, the US MNE is less efficient

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That study analyzed the cost of capital for US MNEs for outward foreign direct investment into France, Germany, Japan, Italy, the Netherlands and the United Kingdom. It compared this with the cost of capital for MNEs from these countries operating in these countries. The study found that US MNEs's cost of capital was consistently higher than that for all the MNEs from all of the other countries operating in each of these jurisdictions. This was confirmed by Julie Collins and Douglas Shakelford, *Corporate Domicile and Average Effective Tax Rates: The Cases of Canada, Japan, The United Kingdom and the United States* in THE TAXATION OF MULTINATIONAL CORPORATIONS (Joel Slemrod ed, 1996). The increased cost of capital may be due to other factors as well, such as the lack of corporate integration in the United States. For a discussion of the effects of corporate integration on the cost of capital see Harris, note 2 *supra* at 25-35.

[69] The cost of capital is defined as the pre-tax rate of return necessary to cause investors to wish to invest. Hans Werner Sinn, *Taxation and the Cost of Capital: the "Old" View, the "New" View , and Another View* in TAX POLICY AND THE ECONOMY Vol.5. (David Bradford, ed. (1991)) at 25. If the tax rate is higher, the pre-tax rate of return must also be higher to have the same after-tax rate of return.

[70] NFTC , note 6 *supra*, at 57. After-tax return from its investments will be less than if that same MNE were based in a country which permitted an exemption. If investors will equalize the after-tax returns to equity then because the after-tax returns to equity invested in US MNEs is less, less will be invested in them.

[71] This is relative to the allocation it would make if it were based in an exemption country.

[72] Because of the tax disadvantage, their cost of capital is higher. If we assume that MNEs have declining marginal returns to capital, then if cost of capital is higher, less capital will be allocated to US -based MNEs. Under the fundamental theorem of welfare economics, if a tax system distorts behavior it is likely to reduce worldwide output. See discussion at note 20, *supra* .

[73]That is, the shareholder level tax is the same no matter which investment is pursued.

[74] (1-.2)/(1-.35)= 1.231

[75] See note 66 *supra*.

[76] and therefore less competitive. A potentially profitable business might now be unprofitable because of the US system.[77] Thus, the tax system has altered the allocation of capital.

Under this model the higher cost of capital will result in the immature MNE initially under-capitalizing new foreign ventures.[78] However, as discussed before, the foreign subsidiary will retain its earnings at a higher rate than it otherwise would have until it reaches its equilibrium size.[79] This life-cycle model is sometimes referred to as the "nucleus" hypothesis.[80] The empirical evidence indicates that this is an accurate description of the investment behavior of MNEs when they are creating new subsidiaries.[81]

Under the Hartman/Sinn analysis, which shows that once the foreign subsidiary has reached equilibrium it will be the same size it would have been under an exemption system, the effects of the higher cost of capital may seem to be only temporary. However, if under-capitalization makes the business less competitive, it may not survive long enough to reach equilibrium.[82] If a mature US MNE and an immature US MNE are both equally efficient[83] at a new business activity, the mature MNE will be more efficient at exploiting the activity because it has a lower cost of capital. The immature firm may be effectively out-competed in that particular market. Therefore, because the US tax system slows down the response time of immature US MNEs to new business opportunities, as

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[76] If less capital is used or it is more expensive, then either fewer units of other inputs, such as labor will be used, or they will less productive .fewer. In general, the greater the capital supplied to a business, the greater the productivity of the other elements of the business. David Friedman, PRICE THEORY (1990) at 125

[77] Assumedly this will decrease profit because they will already have chosen the optimal mix of capital and labor. Friedman, note 74 *supra* at 218

[78]Sinn, note 21 *supra* at 336-342

[79] Because retained earnings are a cheaper source of capital, the MNEs will be willing to let the capital remain in the subsidiary. See notes 57-59 *supra* and accompanying text.

[80] Sinn, note 21 *supra* at 337

[81] James Hines *The Case Against Deferral: A Deferential Reconsideration* 52 National Tax Journal 385 (1999) at 401-405

[82] Evidence that sufficient capitalization is necessary for a business. This might have long-term effects. There is an extensive literature in business area that states that are advantages to getting into new market niche as fast as possible. See e.g., Thomas Peters, THRIVING ON CHAOS: HANDBOOK FOR A MANAGEMENT REVOLUTION, 1985.

[83] That is, given the same resources (capital, labor etc.), they could both produce the same pretax income)

compared to mature US MNEs and foreign MNEs, it affects competitiveness of global markets and resource allocation. This argument is not an argument about US MNEs versus foreign MNEs as much as immature US MNEs versus foreign MNEs and mature US MNEs.

Even if all the countries of the world adopted the worldwide system, as long as countries have different tax rates immature US subsidiaries will be discriminated against. First, as discussed above mature US MNEs would have a lower cost of capital than immature US MNEs. Second, MNEs based in a low tax country would always have an advantage, because they can retain the benefits of income earned in low-tax countries.[84] Only if all countries were to adopt the territorial system would firms be neutral as to where the parent corporation resides.

B. US System Inefficiently Prevents US MNEs From Acquiring Foreign Businesses.

Another way in which the exemption system would be an improvement over the current system which has not been discussed to date is that the US system creates a disadvantage for US MNEs in acquiring corporations that operate in low-tax areas. Even if a US MNE and a foreign MNE would be equally efficient at operating a target corporation, (i.e., they would have the same pre-tax rate of return) the amount a US MNE would be willing to pay for such a business will be less than what a foreign MNE would be willing to pay for it. The chart below illustrates how this occurs.

	Foreign MNE	US MNE
Pre-tax income	$100	$100
Local tax	10%	10%
Residence Country tax	0	25%
After-tax Value	$90	$65[85]

[84] If the additional tax paid to the residence country results in additional benefits to the firm, it is possible that the incentives may not be quite as clear as presented here. It would depend on the value of those benefits. See discussion in Chorvat, note 3 *supra* at 243-244.

[85] The after-tax value for each scenario is equal to the pre-tax income minus both the local tax and the residence country tax.

Because the foreign MNE would be willing to pay $90 for the target, whereas the US MNE is only willing to pay $65, the foreign MNE will be able to outbid the US MNE. Foreign MNEs will acquire businesses that, but for the US tax system, the US MNE would have acquired. Hence, the US tax system affects resource allocation and efficiency.[86] Unlike the earlier cost of capital argument, this distortion applies both to mature and immature US MNEs.

A similar argument often made by exemption system proponents is that the US system causes US MNEs to become takeover targets.[87] If the parent corporation is not subject to the US tax rules, the after-tax value of the firm would increase. Therefore, the firm is more valuable in the hands of the foreign parent than to the current shareholders. This would make the US firm a take-over target. However, the nature of the US tax rules is such that unless the foreign acquirer is willing to recognize all inherent gain in all of the foreign assets of the US firm, the foreign income of the US firm's assets will still be subject to the US tax

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Of course, if the US MNE can defer the residence country tax, the present value will be less than the value illustrated above. However, it will always be greater than the exemption system MNE's tax burden. The value under an exemption system of income from a subsidiary will be $P\ (1-t_f)^n$ where P is the pre-tax rate of return, t_f is the rate of tax in the source country and n is the number of periods the income is retained abroad. Whereas under an worldwide system the value is $P\ (1-t_f)^n\ (1-r_t)$ where r_t is the repatriation tax. If there is a repatriation tax (i.e., $r_t > 0$), $(1 - r_t)$ will always be less than one, therefore, $P(1-t_f)^n$ will always be greater than $P\ (1-t_f)^n\ (1 - r_t)$.

[86] Henry Manne, *Mergers and the Market for Corporate Control* 73 Journal of Political Economy 110 (1965), and William Carney, MERGERS AND ACQUISITIONS (2000), at 21-31

[87] The NFTC report discusses Daimler-Chrysler and Amoco-BP mergers in which the foreign company emerged as the parent corporation. NFTC, note 6 *supra* at 12.

rules.[88] In fact, the under the current system, a US MNE can transform itself into a foreign MNE if it is willing to pay this price. The insertion of a foreign acquirer is unnecessary. Therefore, this is unlikely to make US MNEs takeover targets.

There is one advantage for a US MNE in being acquired by a foreign corporation. If the firm will ever want to raise additional equity capital for non-US operations, then this can be done more cheaply by the foreign parent.[89] Therefore, if a US MNE and a foreign MNE are already likely to merge, they may decide that it is optimal to have the foreign corporation as the parent rather than the US corporation because of this option.[90]

[88] IRC §367(a). These sections require recognizing all built-in gain in assets transferred to foreign corporations. This includes all goodwill and the net present discounted value of all future earnings of these subsidiaries.

[89] Here we are assuming, as is likely, the foreign parent has a lower cost of capital, see discussion in Section II.B and C

[90] This may explain why in both the BP-Amoco merger and the Daimler-Chrysler merger the foreign corporation was chosen as the parent. John Loffredo, the Vice- President and Chief Tax Counsel at Daimler-Chrysler has made comments to that effect. Barton Massey, *Archer Blasts U.S. International Tax Regime* 85 Tax Notes 12 (July 1, 1999)

As with the analysis in the previous section, even if all the countries of the world adopted the worldwide system, as long as countries have different tax rates US MNEs will have disadvantages in acquiring firms operating in low-tax countries. If the competing MNE is based in a low tax country, it will always have an advantage, because it can retain the benefits of income earned in other low-tax countries. US MNEs will always have a higher worldwide tax burden.[1]

C. US System is More Complicated and Costly Than An Exemption System

The US system of taxing international income is costly as a direct result of its complexity.[2] The US rules dealing with the foreign tax credit, and in particular the foreign tax credit limitation are very complex.[3] To a large extent this is because they are designed to prevent abusive "cross-crediting." Cross-crediting occurs when an activity generates excess foreign tax credits[4] which are then used to reduce the

[1] If the additional tax paid to the residence country results in additional benefits to the firm, it is possible that the incentives may not be quite as clear as presented here. It would depend on the value of those benefits. See discussion in Chorvat, note 3 *supra* at 243-244.

[2] Complexity creates costs, both by requiring more training of those who practice it, and by requiring more of their time while practicing it. See Gordon Henderson, *Controlling Hyperlexis- The Most Important "Law and ..."* 43 Tax Lawyer 177 (1989).

[3] IRC § 904

[4] Because the local tax rate is higher than the US tax rate the activity has generated excess credit. See discussion in

US tax on another item of income.[5] For example, assume a foreign investment generates a pre-tax return of $100 that is taxed at a local rate of 50%. The taxpayer will then have $15 of excess credit.[6] If the same taxpayer also has another investment which earns $100 but is taxed at a 20% rate locally, the $15 of excess credit will offset the $15 that would be due on repatriation to the United States, and the US person would pay no US tax on this foreign source income. To some extent this behavior is desirable. Because most worldwide systems have a foreign tax credit limit, they often cannot fully achieve neutrality between investing in the United States and abroad.[7] However, if excess credits from one activity are permitted to offset US tax paid on another foreign activity, the system draws closer to neutrality.[8]

Using credits generated in an active business to offset taxes that would be paid on passive income is viewed as an abuse of the system. Passive income is highly mobile and if what otherwise would be US

Section I.A, *supra*.

[5] This behavior is known as cross-crediting because the taxpayer is using credits generated by one activity to reduce taxes on another.

[6] The foreign tax credit limitation on this income would be $35, so the excess amount would be $15.

[7] See discussion at note 30 *supra*.

[8] For example, in the above example, because the taxpayer was able to cross-credit, the taxpayer has a worldwide tax rate of 35% and is neutral between investing in the United States and investing abroad.

source income can become foreign source income, the taxpayer can use excess credits to offset US tax on income that is not in a real sense attributable to foreign activities.[9] In order to prevent this, the foreign tax credit system does not allow cross-crediting between active business income and passive income. It does this by creating separate categories of income (often called "baskets"). There are nine separate categories.[10] Cross-crediting is not permitted between separate categories. Active and passive income are generally in separate categories.[11]

A person engaged in a foreign trade or business must allocate all foreign source income among these categories and calculate a separate foreign tax credit limitation for each category. The rules for determining how much income is to be allocated to each basket are quite complex. Furthermore, the calculations are multiplied because the foreign tax credit limit is applied separately to each basket.

With an exemption system much of this

[9] See discussion in Section I.B of the mobility of passive income.

[10] IRC § 904(d). They are 1) passive income, 2) high withholding tax income, 3) financial services income, 4) shipping income 5) dividends from non-controlled, but more than 10% owned foreign subsidiaries, 6) dividends from a domestic international sales corporation, 7) specially defined foreign trade income, 8) distributions from foreign sales corporations, and 9) all other income.

[11] Many of the additional categories are designed to prevent mobile types of active business income (such as shipping income) from offsetting less mobile types of income (such as income from a grocery store).

complexity disappears. If active foreign source income is not taxed, it will not be eligible for a foreign tax credit and no quarantine of credits is necessary.[12] There would simply be one category of income, taxed income.

An additional source of complexity is the incoherence of the residence system. The corporation itself is a fiction.[13] Basing a tax system on the residence of a fictional entity causes incoherence. Normally, income earned by French residents for activities conducted in France cannot be taxed by the United States. However, if the corporation that earned this income is a US MNE, the United States will tax the French source income allocable to French shareholders of US corporations. Therefore, under a worldwide system, the taxation of income is determined by arbitrary distinctions.

Because taxation is based on the residence of a fictional entity, there is a large incentive to move the parent corporation outside of the United States. Many companies have either moved their headquarters or are trying to move their headquarters

[12] Because excess credits are generally the result of active income, it may be possible to eliminate the foreign tax credit. However, the US may decide to keep it to give an incentive to foreign governments to keep their taxes lower. See Slemrod, note 2 *supra*, at 100-102.

[13] Choper, et al. Note 787, at 26-34. William Fischel, *The Corporate Governance Movement* 35 Vand. L.Rev. 1259, 1261-1262 (1982).

out of the United States.[14] Consequently, there is also a large incentive on the part of the US Treasury to prevent this movement.[15] However, the tension between trying to allow mergers and acquisitions that promote economic efficiency[16] and trying to prevent US MNEs from escaping US tax provisions results in very complex rules governing international mergers and acquisitions.[17]

The incentives to engage in this behavior will exist as long as US MNEs are taxed on their worldwide income. The Internal Revenue Service will have to continue to devote resources to prevent more companies from leaving the United States.[18] Furthermore, tax planners devote significant resources to trying to devise ways to circumvent the rules. Exempting active foreign source income would cause these problems to largely disappear. Where the parent corporation of the MNE is a resident would no longer matter.

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[14] Lee Shepard, *News Analysis : The Tax Analogue of the Hotel California* 75 Tax Notes 167 , (April 15, 1997). Tax advisers generally advise new companies to incorporate in a foreign jurisdiction. Herman Bouma, *The Tax Code and Reality: Improving the Connection* 85 Tax Notes 811, 813 (1999)

[15] See IRC section 367(a) and the treasury regulations promulgated under this section for rules to prevent the movement of US corporations to foreign countries.

[16] Mergers and acquisitions are generally efficiency improving (see discussion in Manne, note 85 *supra* at 120 and Carney, note 78 *supra* at 21-23.) The tax system should not create incentives or disincentives for foreign and US MNEs to merge. See note 20, *supra*, and cites therein.

[17] See Treasury Regulation section 1.367(a)-3

[18] See Reuven Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State 113 Harvard Law Review (forthcoming) (May 2000).* Hines, note 79 *supra* at 401-402.

Some have argued that the exemption system would not reduce the complexity of the system very much.[19] However, an empirical study by Slemrod and Blumenthal[20] compared the cost incurred complying with tax laws by European MNEs (most of which are resident in exemption countries) on their foreign source income with the compliance costs of US MNEs on their foreign source income. That study showed that the US system of taxing foreign source income increases the tax compliance burden on US MNEs by about 20 percent. The authors of that study suggest that if we adopt a system similar to that of other countries, we should be able to reduce the compliance burden on US MNEs. This would help to bring US MNEs compliance costs in line with those of MNEs from other countries.[21]

D. The Current System Often Encourages Locating Production Offshore

The basic justification for the worldwide tax

[19] Charles Kingson, *The Foreign Tax Credit and Its Critics,* 9 The American Journal of Tax Policy 1 (1991)

[20] Marsha Blumenthal and Joel B. Slemrod, *The Compliance Cost of Taxing Foreign Source Income: Its Magnitude, Determinants and Policy Implications* in THE TAXATION OF MULTINATIONAL CORPORATIONS (Joel Slemrod ed. 1995). The study found that foreign source income constituted 20% of the US MNEs income, but it caused 40% of their compliance costs. For European MNEs, the compliance costs for foreign source income were proportional to their percentage of overall income.

[21] This improves efficiency because this additional compliance cost applies only to US MNEs, reducing their after tax-income, but not the after-tax income of MNEs from other countries.

system is that it causes firms to be neutral between investing in the United States and investing abroad.[22] And as stated before, one of the more commonly used arguments against the exemption system is that it may encourage US MNEs to place assets outside of the United States. However, the US worldwide tax system paradoxically creates incentives for some taxpayers to place capital in foreign jurisdictions.

Under the US foreign tax credit system, if an excess credit taxpayer can generate low or zero taxed foreign source income, that income may escape taxation altogether.[23] For example, if a foreign subsidiary makes royalty and interest payments to its US parent, these payments are generally deductible abroad.[24] When received by US persons, they are foreign source income.[25] These payments increase the foreign tax credit limit of the US MNE, and allow any excess foreign tax credits to reduce or eliminate the US tax on these payments. In this case, the

[22] See discussion Part II.A *supra*.

[23] Harry Grubert, *Taxes and the Division of Foreign Operating Income Among Royalties, Interest, Dividends and Retained Earnings* 68 Journal of Public Economics 269, 273-5 (1998) and Rosanne Altshuler and Harry Grubert *Balance Sheets, Multinational Financial Policy, and the Cost of Capital at Home and Abroad* NBER working paper 5810, October 1996.

[24] Interest and royalty payments are usually deductible from the payor's taxable income. Ault, note 6 *supra* at p.204.

[25] Under IRC § 862(a)(1), (2),(4), these payments are classified as foreign source income. Further it is likely to be put into the general or active basket because for determining the category of income for income received from a controlled foreign corporation by a US Shareholder, then US person looks-through the payment to the underlying income of the controlled foreign corporation. IRC § 904(d)(3).

income will not be subject to tax in the foreign jurisdiction,[26] nor will it be subject to tax in the United States. Therefore, for those taxpayers who are likely to be in an excess foreign tax credit position, the US system provides an incentive to move income producing activities abroad because any income earned from these activities and paid back in interest or royalties to the United States will not be taxed in either country.

This incentive would disappear if we exempt dividends from active business income, as well as active business income from foreign sources. In general, it is active business income which generates the excess credits.[27] If this income is exempt from US taxation, there would be no excess credit taxpayers.[28] If the taxpayer does not have excess credits to use, these payments would be fully taxed in the United States.

E. The Exemption System Would Equalize the Treatment Between Branches and Foreign Corporations

[26] To understand this, assume that A (a French subsidiary of a multinational group) earns $100 of in income in France. A then makes a deductible payment of $100 to an affiliate in Canada. France will not collect any income tax from these transactions, because A's French income is zero.

[27] Internal Revenue Service, STATISTICS OF INCOME BULLETIN (Fall 1999) p.75

[28] If the income is exempt form US tax, any taxes paid on this income would not be eligible for the foreign tax credit.

The US tax rules treat income earned by branches and income earned by subsidiaries differently.[29] The income from branches is taxed when it is earned to the US owner whereas the tax on income of subsidiaries is deferred.[30] In general, operating as a branch in a low-tax jurisdiction is disfavored.[31] A firm cannot retain any of the tax advantages of operating in a low-tax jurisdiction if this business is conducted by a branch.

In certain circumstances, there is an incentive to use a branch. One such situation occurs if a foreign operation is likely to incur losses in the near future. In this case, these losses can initially offset US income. This would not be true if the business is conducted through a foreign subsidiary. Even though the current rules require that in later years the taxpayer must either reduce its foreign tax credit limit or recognize additional income,[32] there is often a time value of money advantage.[33]

[29] See note 47, *supra*.

[30] Slemrod, note 2 *supra*, at 91. See also IRC Section 61

[31] Slemrod, note 2 *supra*, at 92

[32] Under the over-all foreign loss rules (IRC § 904(f)) and the §367 branch loss rules any foreign loss used to offset US tax, will later reduce the taxpayer's foreign tax credit limit. If the taxpayer is an excess limitation taxpayer, this won't have much effect, because the foreign tax credit limit does not affect the taxpayer's tax.

[33] If the foreign loss reduces US tax on US source income, the effect of increasing US tax on foreign source income will not occur until a later year and generally the taxpayer does not pay interest on this "loan". However, under the IRC § 904(f) rules the foreign loss is allocated first against foreign-source income. Therefore, if the taxpayer has sufficient foreign source income, and is an excess credit taxpayer, the foreign loss won't actually benefit the taxpayer.

If the United States exempts both all foreign source income and loss earned by an active foreign trade or businesses if operated as a branch, and all dividends from foreign subsidiaries paid out of active earnings and profits, this mismatch would largely disappear.[34] There would be no incentive or disincentive to operate as a branch or a subsidiary.

IV. Active Foreign Source Income Should Be Exempt, Other Forms of Income Should be Taxed

This article proposes the United States end the worldwide taxation of active business income of US persons, whether earned directly or indirectly.[35] However, the United States should continue to tax passive income earned by US persons, whether earned directly or indirectly.[36] For this purpose, "passive income" should not include dividends, interest, or royalties received by foreign subsidiaries of US MNEs from affiliated corporations.

Even if the United States adopted an exemption system, certain portions of the US

[34] There could still be an incentive relating to the allocation of interest expense. Interest paid by a subsidiary is not allocated against US income, whereas interest paid by a branch can be. Treasury Regulation section 1.861-8 et seq.

[35] Consequently, foreign taxes paid on this exempt income will no longer be credited against US income tax.

[36] Taxes paid on passive income which is subject to tax in the United States will still be eligible for the foreign tax credit. Passive income the definition of passive income should include dividends are that are received from companies that the shareholder owns less than 10% of the outstanding shares.

international tax rules should be retained. This section will discuss the three most important of the provisions that should be retained.[37] First, passive foreign source income received by US persons should be subject to US tax. Second, passive income earned by controlled foreign corporations should be subject to tax in the United States. Third, the foreign base company rules[38] should also be retained.

A. Passive Foreign Source Income Earned by US Persons

The proposal exempts active business income directly earned by US persons and dividends received from foreign affiliates.[39] There are a number of provisions in the Code which are attempting to insure that foreign source passive income earned by US persons is taxed in the United States. These include the Passive Foreign Investment Company rules (IRC §§1291- 1298) and the Foreign Personal Holding Company Rules (IRC §§551-558). These rules should be retained. These rules generally do not apply to MNEs, but rather to passive

[37] This article will not discuss provisions such as either the Foreign Sales Corporation provisions (IRC §§991-999) or the Domestic International Sales Corporation provisions (IRC §§ 922-927) which are designed to encourage exports. These provisions are therefore beyond the scope of this article.

[38] Foreign Base Company Income is defined in IRC section 954 and discussed in Part IV.C, *infra*.

[39] Under the proposal, the US recipient must own 10% or more of the stock of the foreign payor into for the dividend to be exempt.

investment companies and so are not the focus of this article. However, income from passive investments should not be exempt. If there is a tax advantage to investing in a French corporation as opposed to a US corporation the system will distort investment decisions.[40]

In addition, interest and royalties paid by foreign affiliates would still be includible in income of the US parent. These payments are generally deductible against income earned by the foreign subsidiary. Therefore, if they are not subject to tax in the United States, these payments would escape taxation. As long as the MNE did not operate in the United States, it would pay little or no taxes. This would cause a distortion in favor of foreign investment.

B. Passive Income of the Controlled Foreign Corporation Should Be Taxed

Just as taxing US persons on their foreign source passive income is necessary, it is necessary to tax controlled foreign corporations on their passive income. Merely placing passive investments in a foreign corporation should not change the taxation of

[40] The analysis in this article has assumed that shareholder level taxes were the same no matter which MNE was invested in. Furthermore, the proposal is attempting to eliminate such distinctions. These taxes would create misallocations of capital (see note 20 and cites therein).

the income.

If it did, almost all US persons, both individuals and corporations, would set up foreign corporations and all passive income would be earned in low-tax jurisdictions.[41] This would essentially repeal the taxation of passive income.

On the other hand, dividends, interest, royalties etc. received by controlled foreign corporations from foreign affiliates should not be taxed in the United States. The exemption for dividends seems clear, because they would not be taxed if they were received by a US person. Interest and royalties received by foreign subsidiaries from affiliates should also be exempt. First, they are generally taxable in the country of the recipient corporation.[42] Second, under an exemption system, the United States has no residual claim on active business income. These payments all ultimately derive from foreign active trade or business conducted by the MNE and so should not be taxed in the United States.

One might argue that taxing US MNEs on

[41] If the United States taxed individuals on this income, but not corporations, there would be an incentive to earn passive income through foreign corporations. They could retain earnings in the foreign corporations and never pay US tax. Before the provisions discussed in this section were adopted, many wealthy individuals avoided taxation on their passive income by doing exactly this. See Kingson, at note 49 *supra*, p.452-3.

[42] In both the Netherlands and France, the exemption for foreign source income from a foreign subsidiary only applies to dividends or capital gains on the sale of shares. It does not apply to interest or royalties. Ault , note 6 *supra*, at 403-5.

their passive income while other countries allow their MNEs to earn passive income without taxing it, would put US MNEs at a disadvantage.[43] However, most other countries, even those with exemption systems, tax passive income earned by their MNEs. [44] Furthermore, even if some countries do not tax resident MNEs on their passive income, taxing US MNEs on their passive income will not impair the ability of US MNEs to raise capital for active business projects. Active business income will be taxed alike in both countries. The foreign MNE will only have an advantage in raising capital to the extent it is using that capital for passive investment. There seems little reason for the United States to encourage US MNEs to become passive investors.[45] In addition, even if more capital flows to foreign MNEs to be placed in passive investments, this capital will eventually flow into real investments.[46] The foreign MNE will invest in those assets where the income has the highest after-tax return. On this basis the US MNE is an equal competitor to the foreign MNEs. Hence, the US MNE will receive the appropriate

[43] See discussion in section II.

[44] Ault , note 6 *supra*, at pp. 403-406

[45] As discussed in note 131, *supra*, and surrounding text, this would create an incentive to invest in corporations, which would distort investment decisions.

[46] At base all passive investments (e.g. stock, bonds etc.) derive their income from an active business or real asset.

amount of capital. Therefore, taxing US MNEs on their passive investments will not affect real investment or economic efficiency.[47]

C. Foreign Base Company Income Rules

Some of those who argue for an exemption system also argue that subpart F, particularly the foreign base company rules,[48] should be repealed or altered significantly.[49] The foreign base company rules attempt to insure that US source income is taxed in the United States. Because this is consistent with the exemption system, these rules should be retained.[50] In fact, many countries that have exemption systems have adopted similar rules.[51]

There are two important types of foreign base company income : foreign base company sales income and foreign base company services income. Foreign base company sales income is income earned by a controlled foreign corporation from selling property which is either purchased from a related

[47] Efficiency is concerned with resource allocation, not with ownership. Therefore, even though the capital is owned by the foreign MNE, it used by the US MNE.

[48] IRC § 954

[49] NFTC , note 6 *supra* at 1, also Massey, *supra note 106*, at 13.

[50] Certain modifications are required however. The OECD recently called all countries both exemption systems as well as worldwide systems to adopt rules similar to the US controlled foreign corporation rules. Organization for Economic Co-Operation and Development, *Controlled Foreign Corporation Legislation* (OECD, 1996)

[51] For a discussion of the rules that France has adopted see Ault, note 6 *supra* at 412-413.

party[52] or sold to a related party and is not for ultimate use in the country in which the controlled foreign corporation is incorporated. Foreign base company services income is income earned by a controlled foreign corporation when it performs services for a related party outside the country in which it is incorporated. These rules are designed to prevent a US MNE from inserting a low tax corporation into a transaction simply to lower taxes.[53]

To illustrate, assume that A, a US MNE, will sell computers that were made in the United States to United States customers. A has its Cayman Islands subsidiary purchase the computers from A and sell them to one of A's US subsidiaries. Even though in substance this is all US source income, because of this arrangement, part of the profit from this transaction is now allocated to the Cayman Islands.[54] Because the Cayman Islands will not tax this income, the total tax amount is lowered. The foreign base company income rules would operate in this scenario to cause all the income allocated to the

[52] A related party for this purpose means any affiliated corporation or significant owner of an affiliated corporation. IRC § 954(d)(3).

[53] If the controlled foreign corporation is actually involved in the manufacture of the product, then these rules do not apply.

[54] Because the MNE can allocate all of the risk of the transaction to the Cayman Islands subsidiary, a significant portion of the income can also be allocated to where it will not be taxed. See IRC section 482. Caves, note 20 *supra*, at 192-931

Cayman Islands to be taxed immediately in the United States, thus negating any potential tax advantage form placing the low-tax subsidiary in the transaction.[55] The foreign base company rules help to insure that US source income is taxed in the United States. Rules like this are therefore essential to ensure that income is at least taxed in the source country.

Under an exemption system income is taxed in the source country. The United States should exempt active foreign source business income. However, it should not exempt passive income or income which is in fact, US source income. Therefore, the anti-abuse rules that relate to passive income and US source income should remain in place.

Conclusion

This article has introduced some new analysis into the debate over the exemption system. As this article has showed, the exemption system would improve economic efficiency. The exemption system would not discriminate against new

[55] Under IRC section 954(d), if any of the income generated from activities occurring in the subsidiary, (e.g. the goods are manufactured there), this income is permitted to be exempted from these rules. So if the subsidiary is not simply inserted in the transaction for tax reasons, this income will not be subject to tax in the United States until it is repatriated.

businesses. It would not discriminate against US MNEs in their attempt to acquire foreign businesses. Furthermore, it does not set up arbitrary distinctions between the taxation of foreign subsidiaries and foreign branches. The exemption system would not create the same kinds of distortions to move production offshore that the worldwide system does. Therefore, it does not result in the kinds of economic distortions that a worldwide system must. Beyond this, the exemption system is by its nature simpler and cheaper. Finally, the main efficiency argument against the exemption system conflicts with both economic theory and empirical evidence. Therefore, the United States should adopt an exemption system.

However, in doing so, we must still understand that there are potential abuses of the exemption system. Taxpayers may attempt to have US source income characterized as foreign source income. Also, passive foreign source income of US persons must be subject to tax in the United States. Most other countries with exemption systems, tax passive income earned by their residents and by their MNEs. [56]

[56] Ault, note 6 *supra*, at 403-406