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Optimal International Taxation and Tax  
Competition: Overcoming the Contradictions

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# Optimal International Taxation and Tax Competition: Overcoming the Contradictions

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This paper presents a theory of international taxation based on a new approach to source taxation that reflects world development and synthesizes the objectives of economic efficiency, fairness to taxpayers, and fairness to governments. Adoption of this model results in the preservation of comprehensive income taxation to capital-exporting nations and an expenditure tax base for capital-importing nations. The system would reduce much of the distortion caused by tax competition, eliminating the tax incentive for businesses to use productive assets and technologies outside the country of their development and saving the jobs of many workers.

## I. INTRODUCTION

International tax law today reflects a consensus reached seventy years ago by the international community as to the appropriate divisions of the income tax base among nations. Assuming two independent and mutually exclusive jurisdictional bases for taxation, source and residence, conflict between nations was resolved by establishing that source taxation was primary. As a consequence, residence taxation would unilaterally defer to source.

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This resolution failed to reflect the force of economic principles and equity among nations. The economic tax constructs that foster the economically efficient allocation of capital in the world are Capital Export Neutrality ("CEN") and Capital Import Neutrality ("CIN"). Contrary to traditional wisdom, when one examines the underlying purposes and goals of these doctrines, it can be shown that these doctrines are not incompatible, but are harmonious parts of an optimal economic approach to international taxation. The strength of these economic forces can be seen in how present day nations are moving away from traditional source taxation of capital income.

While economic efficiency allows for several compatible tax options, equity among nations and among taxpayers establishes one optimal approach to the division of the tax base internationally. Equity establishes that each nation has the right to tax the income that is produced in accordance with the value that the nation has added to the world. This follows the principles of CIN establishing exclusive source taxation, but source taxation reinterpreted in accordance with the principle that it is not the place where capital and assets are used that merits the tax, but the place that provided the environment for the creation of that property. This means that the normal return on all capital, debt, equity, intangible assets and tangible assets, is sourced to the country from which it came.

What remains for traditional source or territorial taxation is the income in excess of the normal return on capital, "economic rent." Territorial taxation of economic rent should exclusively belong to the capital-importing nation because that nation has provided the system responsible for the creation of the economic rent.

What is left for the capital-importing nation after the normal return on capital is allocated to the capital-exporting nation is consumption. Thus, traditional source taxation of business can be implemented by a broad-based expenditure tax. Traditional resident taxation is restricted to world-wide taxation of the normal return on capital.

Under these optimal tax principles, the effects of tax competition are minimized because the tax base on capital in all of its forms does not shift when capital is mobile. Low taxation of the returns from assets and technologies by capital importing nations would then no longer influence the decision to locate abroad.

## II. BACKGROUND

### A. The World Economy

Spurred by technological advances and the elimination of international barriers to capital flows and trade,<sup>1</sup> there is a clear trend toward even greater

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<sup>1</sup> VITO TANZI, TAXATION IN AN INTEGRATING WORLD ii (The Brookings Institution 1995).

economic integration among nations. To gain an understanding of present conditions, one must examine the role of capital, trade and other factor movements, and transnational corporations.

The world is quickly embracing the benefits of free trade. Trade increases competition, spawning production efficiencies, technological innovations, and cheaper prices for consumers.<sup>2</sup> It has been remarked that "the more different ... the standards and costs of the world's trading partners, the greater ... [the] nation's gains from trading with them."<sup>3</sup>

The growth in world trade has been phenomenal. Since 1959, world trade has grown at a rate greater than 10% per year, as compared with the Gross Domestic Product (GDP), which has grown at less than 4% per year.<sup>4</sup> In the United States, trade has grown at a rate of over 6% per year, as compared with the GDP, which has grown at a rate of less than 4% per year over the same time period.<sup>5</sup> By 1990, merchandise exports had grown to 7.1% of the GDP in the United States, and merchandise imports had grown to 9% of the GDP.<sup>6</sup>

Exports and imports only account for part of the story. International capital flows are critical components of the world economic scene. The free movement of capital helps its owners and users alike. Capital movements help savers diversify their investments and may also increase rates of returns. Capital movement also aids recipient countries in providing them with a source of capital that may be cheaper than domestic supplies.

Thus, the role of the private investor is taking on a heightened status. Indeed, Foreign Portfolio Investment ("FPI") is greater than Foreign Direct Investment ("FDI").<sup>7</sup> FPI can be defined as all private, non-FDI investments made by nonresidents. FDI is foreign investment undertaken by an association, enterprise, or individual where the investor owns 10% or more of the equity in the activity conducted.<sup>8</sup>

Over the years, worldwide portfolio flows have ranged from one and one-half to three times the amount of FDI.<sup>9</sup> It has been estimated that as of

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<sup>2</sup> GARY BURTLESS, ROBERT Z. LAWRENCE, ROBERT E. LITAN, & ROBERT J. SHAPIRO, *GLOBAPHOBIA, CONFRONTING FEARS ABOUT OPEN TRADE* 20-23 (The Brookings Institution 1998).

<sup>3</sup> *Id.* at 93.

<sup>4</sup> *Id.* at 22.

<sup>5</sup> *Id.*

<sup>6</sup> GARY C. HUFBAUER, *UNITED STATES TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM 6* (Institute For International Economics 1992).

<sup>7</sup> *See id.* at 63.

<sup>8</sup> *Id.* at 63 n.1.

<sup>9</sup> *See* STEPHANY GRIFFITH-JONES, *GLOBAL CAPITAL FLOWS: SHOULD THEY BE REGULATED?* 26 (MacMillan 1998).

1995, the total United States outbound FPI was \$1,300 billion and the total United States inbound FPI was \$1,950 billion.<sup>10</sup>

It is not simply the amount of foreign invested capital that defines the modern economic order, but the mobility of capital flows and its changing patterns. Much of FPI is short-term investment.<sup>11</sup> It is simply astounding to reflect on the sheer volume of financial transactions.

Statisticians have estimated that the ratio of the annual value of financial transactions<sup>12</sup> to the Gross National Product ("GNP") in three countries with the largest financial markets grew dramatically and systematically: the growth was from less than 10% in 1970 to more than 75% in 1990 for the United States; from approximately 10% in 1970 to more than 110% in Japan; and from approximately 10% in 1970 to more than 40% in the United Kingdom.<sup>13</sup> Total net world flows of capital were estimated at \$1174.7 billion in 1993.<sup>14</sup> Of the 1993 world flows of capital, \$672 billion was attributable to portfolio inflows.<sup>15</sup> By comparison, the 1993 level was 500% of the 1987 level.<sup>16</sup>

In addition to the increase of FPI, the mobility of business capital ("FDI") has increased. Net worldwide FDI was \$162.1, \$200.7, 212.5, and 316.4 billion in 1992, 1993, 1994, and 1995, respectively.<sup>17</sup> Statistics for 1990 indicate that United States outbound FDI increased more than 13 times from \$32 billion in 1960 to \$421 billion in 1990.<sup>18</sup> Inbound FDI in the United States increased approximately fifty-eight times from \$7 billion in 1960 to \$404 billion in 1990.<sup>19</sup>

However, the exploitation of FDI is quite different from the exploitation of FPI. Businesses need to exploit their competitive advantage by investing in other countries. This may include the more efficient use of technology and other intangible assets of a business. Oftentimes, a foreign presence is warranted in order to acquire another's technology and expertise.

This is a world of relatively free movement of the factors of production including assets, capital, labor and technologies. Thus, the notion that only trade exploits the competitive advantage of nations is less true today because many elements of the competitive advantage of a nation or business

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<sup>10</sup> HUFBAUER, *supra* note 6, at 72-75.

<sup>11</sup> GRIFFITH-JONES, *supra* note 9, at 26, 30, 33.

<sup>12</sup> Financial transactions are measured as payments through the main interbank fund transfer system.

<sup>13</sup> GRIFFITH-JONES, *supra* note 9, at 23.

<sup>14</sup> *Id.* at 25.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 29.

<sup>18</sup> See HUFBAUER, *supra* note 6, at 4.

<sup>19</sup> *Id.*

are highly mobile. Business is constantly reassessing the merits of any particular nation as a location for business activities that utilize mobile factors of production.

Transnational business enterprises<sup>20</sup> ("TNCs") increasingly dominate international business activity. According to estimates, there were 44,000 TNCs with 280,000 foreign affiliates in 1996.<sup>21</sup> TNCs' share of world output has increased from 4.5% in 1970 to 7.5% in 1995.<sup>22</sup> To gain some appreciation for the size of some of these enterprises, General Motors' net sales exceed the GDP of Poland, Ford Motor's net sales exceed the GDP of South Africa, Exxon's net sales<sup>23</sup> exceed the GDP of Malaysia, and Toyota's net sales exceed the GDP of the Philippines.<sup>24</sup> Indeed, the activities of TNCs may be more important than imports and exports. By example, sales of goods and services of United States foreign affiliates now exceed the total United States exports of goods and services.<sup>25</sup> Recent estimates indicated that sales of United States foreign affiliates in 1995 were \$2.1 trillion as opposed to \$794 billion in United States exports.<sup>26</sup> Additionally, sales of foreign-owned United States affiliates were \$1.5 trillion as opposed to \$896.5 billion in United States imports.<sup>27</sup>

#### B. The Effect of Globalization on Taxation

The increasing pace of globalization has resulted in developed nations' increased concern over effects of globalization on their tax systems and over income tax, in particular. Due to the increasing mobility of capital, economic activity, financial services, and skilled labor, many developed nations see certain tax practices of other countries as unfairly attracting the economic activity that would otherwise have taken place within developed countries, causing an erosion "of the tax base of these countries and distorting the location of such economic activity."<sup>28</sup> Such practices can also cause undesired shifts of part of the tax burden to less mobile tax bases, such as consumption, labor, property, and increased administrative costs and compliance burdens on tax authorities and taxpayers. Larger taxes on labor increase the cost of labor, leading to lower wages or higher unemployment.

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<sup>20</sup> Transnational business enterprises are often called Multinational Corporations (MNC) or Multinational Enterprises (MNE).

<sup>21</sup> JOSEPH P. QUINLAN & KATHRYN STEVENS, 101 TRENDS EVERY INVESTOR SHOULD KNOW ABOUT THE GLOBAL ECONOMY 20-21 (Lincolnwood, Contemporary Books 1998).

<sup>22</sup> *Id.* at 20.

<sup>23</sup> The statistics for Exxon reflect the status prior to Exxon's merger with Mobil Oil.

<sup>24</sup> QUINLAN & STEVENS, *supra* note 21, at 20.

<sup>25</sup> *Id.* at 20-21.

<sup>26</sup> *Id.* at 66.

<sup>27</sup> *Id.*

<sup>28</sup> *Towards Global Tax Cooperation: Report of the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs 5* (OECD 2000).

However one views the propriety of this phenomenon, evidence strongly supports this trend.<sup>29</sup> Data illustrates that the overall level of income taxation in the world has declined.<sup>30</sup>

Even though corporate tax rates generally have declined among developed countries,<sup>31</sup> the ratio of tax revenue to the GDP has not declined.<sup>32</sup> This balance has been the experience of European Union ("EU") members, but in the case of the United States and Canada, corporate tax revenues have decreased by 15% to 20%.<sup>33</sup> United States corporate revenues decreased from 3.9% of the GDP to 3% of the GDP over the period of 1960 to 1996.<sup>34</sup> By contrast, most developed countries have experienced an increase in the percentage of consumption and employment taxes.<sup>35</sup> OECD studies indicated a dramatic upsurge in personal taxation over a thirty-year period. Revenues from personal income tax in the United States rose from 6.8% to 12.3% of the GDP from 1960 to 1996.<sup>36</sup>

For example, 1998 data revealed that income tax and Social Security contributions represent over 40% of wages in Germany and Belgium, and approximately 26% of wages in France, the United Kingdom and the United States.<sup>37</sup> Employee, income, and Social Security taxes represent approximately 50% of the labor cost in several of the most developed EU countries<sup>38</sup> and approximately 30% in the United Kingdom, Canada and the United States.<sup>39</sup>

According to Professor Angelo Cardoni,<sup>40</sup> "the average increase in tax rates on labor in the last 15 years was in the order of ten percentage points. The reverse applies to the taxation of other factors of production, mainly

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<sup>29</sup> Indeed, one recent work in favor of "tax competition" outlines in great detail the flight of economic activity from developed countries to less developed countries (LDC). See D.S. Mitchell, *OECD Tax Competition Proposal: Higher Taxes and Less Privacy*, TAX NOTES 801, 808-810 (Nov. 6, 2000).

<sup>30</sup> A recent study has shown a large decrease in effective tax rates in the manufacturing sector of approximately 27% from 1980 to 1992. See Rosann Altshuler, Harry Grobert, & T. Scott Newton, *Has United States Investment Abroad Become More Sensitive to Tax Rates?* available at <http://www.nber.org/papers/w6383> (last visited Aug. 19, 2001).

<sup>31</sup> See HUFBAUER, *supra* note 6, at 33.

<sup>32</sup> *Id.* at 21.

<sup>33</sup> *Id.*

<sup>34</sup> *Taxes Revisited*, OECD, at 3 (2000).

<sup>35</sup> *The Disappearing Taxpayer*, THE ECONOMIST 22, May 31, 1997.

<sup>36</sup> *Taxes Revisited*, *supra* note 34.

<sup>37</sup> *Taxing Wages in OECD Countries 1998/1999*, OECD, Paris, 2000, T.1, available at <http://www.oecd.org/dat/stats/wages.htm> (last visited Aug. 19, 2001).

<sup>38</sup> The EU countries that are referred to are Belgium, Germany, Italy, and France.

<sup>39</sup> *Taxing Wages in OECD Countries 1998/1999*, OECD, Paris, 2000, T.3, available at <http://www.oecd.org/dat/stats/wages.htm> (last visited Aug. 19, 2001).

<sup>40</sup> Professor Angelo Cardoni of Bocconia University is on the EU Commission.

capital.”<sup>41</sup> A 1997 economic work revealed that about four out of ten and one-half percentage points in unemployment was attributable to the large incidence of tax on labor.<sup>42</sup>

The impact of these forces has not been as acutely felt in the United States because the United States is different from its European counterparts. Generally, the United States is a low tax country, as it taxes a much lower percentage of the GDP than its European competitors.<sup>43</sup> This is reflected as well in much lower taxes on labor income.<sup>44</sup> Additionally, wages in the United States are much lower than in its European counterparts. For example, hourly compensation in the United States manufacturing sector in 1996 was \$18.00 an hour, whereas the average hourly compensation in the European Union manufacturing sector in 1996 was \$22.00.<sup>45</sup> American workers also tend to work more hours than their European counterparts.<sup>46</sup> The American worker is the only worker in the developed world who ranks among the top twenty nations whose workers work the most hours per year.<sup>47</sup> Overall, American workers are the most productive in the world, based on value produced per unit cost.<sup>48</sup> To get a feel for what this means, per dollar spent, American workers are thirty-five times more productive than workers in Niger.<sup>49</sup>

Although American workers have not experienced the unemployment of their European counterparts,<sup>50</sup> the significance of manufacturing jobs to the United States economy has steadily declined; this is even more startling in light of the fact that manufacturing in the United States is more profitable

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<sup>41</sup> Ruud A. Sommerhalder, *Harmful Tax Competition or Harmful Tax Harmonization*, 8 EC TAX REV. NO. 4 at 244, 246 (1999).

<sup>42</sup> G. Tabellini and F. Daveri, *Unemployment Growth and Taxation in Industrial Countries*, CENTER FOR ECONOMIC RESEARCH, RESEARCH DISCUSSION PAPER No. 1681, August 1997.

<sup>43</sup> Recent figures on tax as a percentage of the GDP for several countries showed the following percentages: Denmark at 51.9%; Germany at 38.2%; the United Kingdom at 35.1%; Japan at 28.8%; and the United States at 27.6%. See QUINLAN & STEVENS, *supra* note 21, at 144-45.

<sup>44</sup> See *Taxing Wages in OECD Countries 1998/1999*, OECD, Paris, 2000, T.3, available at <http://www.oecd.org/dat/stats/wages.htm> (last visited Aug. 19, 2001).

<sup>45</sup> BURTLESS, LAWRENCE, LITAN, & SHAPIRO, *supra* note 2, at 70.

<sup>46</sup> QUINLAN & STEVENS, *supra* note 21, at 140.

<sup>47</sup> *Id.* at 156-57.

<sup>48</sup> BURTLESS, LAWRENCE, LITAN, & SHAPIRO, *supra* note 2, at 67; R.E. Hall & C. I. Jones, *Why Do Some Countries Produce So Much More Per Worker Than Others?* 114 Q.J. ECON. 83, 83 (1999).

<sup>49</sup> Hall & Jones, *supra* note 48, at 83.

<sup>50</sup> The unemployment figures for 1997-98 indicated that the United States had less than 5% unemployment and the EU had 11% to 12% unemployment. QUINLAN & STEVENS, *supra* note 21, at 152. However, these figures should be compared with worldwide unemployment which was 30% or one billion workers in 1995 to 1996. *Id.*



today than ever.<sup>51</sup> In the 1950s, manufacturing accounted for one out of three payroll jobs; in 1994, manufacturing accounted for one out of seven payroll jobs.<sup>52</sup> Many blame decreases in American workers' real family income on the loss of jobs resulting from the flight of United States business from the States. While this is partially true, there are other factors such as the competition from immigrants.<sup>53</sup> Perhaps one of the most emotional issues facing the American political order is that of the runaway plant, where goods previously manufactured in the United States are manufactured abroad and are imported into the United States. Today 20% of the goods imported into the United States are imported by United States multinationals.<sup>54</sup> Many blame cheap labor, loose labor and environmental standards in less developed countries as the culprit.<sup>55</sup> Without doubt, there is significant hardship to the workers and the local economy when a home country business removes its manufacturing presence from the home country. Without question, one of the causes of the runaway plant is that manufacturing is much more sensitive today to tax rates.<sup>56</sup>

Despite the fact that the world economy is growing, not all are winners. Only in the United States has unemployment decreased substantially. Even American workers, however, have not seen much of an increase in real wages over past decades. Data on the United States economy, at present the largest and most dynamic economy in the world, indicate that the principle beneficiaries of globalization are stockholders, executives, and workers in successful exporting firms.<sup>57</sup> The standard of living has not increased for all, even though statistics for the United States indicate that during the period from 1969 to 1979, real family income increased on an average for families in all income categories.<sup>58</sup> However, from 1979 through 1995, real family income *decreased* for those in the two lowest quintiles, *increasing* significantly only for those in the top 20%. Major gains accrued only to those in the top 5%.<sup>59</sup> Although recent indications show some growth in real wages for all Americans, the growing gap between the rich and the majority of the population has not been eliminated.<sup>60</sup>

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<sup>51</sup> Manufacturing's decline as a share of the GDP is also attributable to the change in spending patterns from goods to services like education, health, and travel. See BURTLESS, LAWRENCE, LITAN, & SHAPIRO, *supra* note 2, at 52-53.

<sup>52</sup> *Id.* at 51-52.

<sup>53</sup> See *id.* at 88.

<sup>54</sup> QUINLAN & STEVENS, *supra* note 21, at 68.

<sup>55</sup> See John Douglas Wilson, *Theories of Tax Competition*, 52 NAT'L TAX J. 269, 270 (1999).

<sup>56</sup> Altshuler, Grobert & Newton, *supra* note 30.

<sup>57</sup> BURTLESS, LAWRENCE, LITAN, & SHAPIRO, *supra* note 2, at 10.

<sup>58</sup> *Id.* at 26.

<sup>59</sup> *Id.*

<sup>60</sup> *Economic Report of the President*, 1997 at 166, 187, available at <http://www.umsl.edu/services/govdocs/erp/1997/titletoc.htm> (last visited Aug. 19, 2001).

Therefore, most of the population is not sharing in the increased prosperity that the new economic order is bringing.

Thus, there is strong evidence supporting the conclusion that many countries' tax bases are being shifted from capital and business income to labor and consumption. Speaking in broad generalities, European countries have tried to maintain or increase government services by raising tax on less mobile sources of revenue while trying to maintain existing levels of corporate and capital taxation. The United States, even though it also demonstrates some shift from capital to consumption and labor tax, has mainly met tax competition by lowering taxes and by keeping wages low. Thus, it can be generally concluded that the decline in real income for many is, in part, attributable to a greater focus on labor and other less mobile activities for revenue.

### C. The Response of the European Union and the Organization for Economic Cooperation and Development

Some say that tax competition is simply natural competition that leads to increased benefits for all. The European Union ("EU") and the Organization for Economic Cooperation and Development ("OECD") disagreed. Both the EU<sup>61</sup> and the OECD<sup>62</sup> have adopted initiatives to counteract what these organizations perceive as harmful tax competition. The object of both is to eliminate certain tax provisions and regimes in countries that jeopardize the tax systems of members. While the EU is only concerned with the activities of its member states, the OECD has targeted all countries, both members and non-members. The EU is concerned with investment and business taxation in general; the OECD limits its immediate attention to financial services and other highly mobile business income. The OECD's overall concern is clearly relevant to all types of activities, including investment income.

Out of its 1997 Program<sup>63</sup> the EU proposed a legally non-binding Code of Conduct on business taxation, which identifies harmful regimes and provides for an undertaking by the member states not to enact any additional harmful tax regimes. In addition, a directive on investment income was proposed that would have required member states to either impose a withholding tax on portfolio income or adapt a system to provide information on

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<sup>61</sup> *Toward Tax Coordination in the European Union, A Package to Tackle Harmful Tax Competition*. Doc. COM (97) 495 final (Oct. 1, 1997).

<sup>62</sup> HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE 7 (OECD 1998); TOWARD GLOBAL TAX COOPERATION: PROGRESS IN IDENTIFYING AND ELIMINATING HARMFUL TAX PRACTICES, REPORT TO THE 2000 MINISTERIAL COUNCIL MEETING AND RECOMMENDATIONS BY THE COMMITTEE ON FISCAL AFFAIRS, 5 (OECD 2000).

<sup>63</sup> TOWARD GLOBAL TAX COOPERATION, *supra* note 62.

portfolio investment to the payee's country of residence.<sup>64</sup> Since the initial proposal, the EU has deleted the withholding tax alternative from the proposal.<sup>65</sup>

The OECD proposal had two objectives: (1) to identify harmful tax practices of its member states and (2) to identify and deal with tax haven regimes.<sup>66</sup> In the 2000 OECD report, sixty-one member country preferential regimes were identified.<sup>67</sup> Member-states are obligated to remove these practices within five years of the Guidelines' approval.<sup>68</sup> The OECD also identified thirty-five nations that met the tax haven criteria<sup>69</sup> but that had not made an advanced commitment to eliminate harmful tax practices and comply with the principles of the 1998 Report.<sup>70</sup>

The EU and the OECD have been criticized because their formulations do not clearly explicate exactly the problem of tax competition.<sup>71</sup> This is valid because the test for harmful tax competition is in large part based on the bad intent of the low tax jurisdiction. Low rates are not determinative, but must be coupled with other factors that indicate enticement or conspiratorial conduct. These include regimes that provide tax preferences only to non-residents, that lack effective exchange of information,<sup>72</sup> that lack transparency,<sup>73</sup> and that provide these benefits to enterprises that do not engage in real economic activity or have a substantial economic presence in the haven.<sup>74</sup>

Thus, the proposals reflect mixed questions of avoidance and evasion,<sup>75</sup> which may be an inherent problem in dealing with the distinction be-

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<sup>64</sup> *Code of Conduct on Business Taxation*, Doc. COM (97) 564 final (Adopted Dec. 1, 1997).

<sup>65</sup> *Proposed Directive*, Doc. COM (98) 295 final.

<sup>66</sup> See HARMFUL TAX COMPETITION, *supra* note 62, at 10-11.

<sup>67</sup> TOWARD GLOBAL TAX COOPERATION, *supra* note 62, 12-14.

<sup>68</sup> HARMFUL TAX COMPETITION, *supra* note 62, at 70.

<sup>69</sup> TOWARD GLOBAL TAX COOPERATION, *supra* note 62, at 17.

<sup>70</sup> *Id.* at 16. The Advanced Commitment Jurisdictions were Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino.

<sup>71</sup> Alex Easson, *The Tax Competition Controversy*, 18 TAX NOTES INT'L 371, 372 (Jan. 25, 1999).

<sup>72</sup> HARMFUL TAX COMPETITION, *supra* note 62, at 23. "Tax havens typically have in place laws or administrative practices under which businesses and individuals can benefit from strict secrecy rules and other protections against scrutiny by tax authorities thereby preventing the effective exchange of information on taxpayers benefiting from the low tax jurisdiction." *Id.*

<sup>73</sup> *Id.* "A lack of transparency in the operation of the legislative, legal or administrative provisions is another factor in identifying tax havens." *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> Tax avoidance may be defined as the attempt to minimize one's tax obligations when the taxpayer engages in activities or utilizes devices and reports their tax significance to the government on the basis of support for the taxpayer's conclusion found in Code or case law,

tween harmful and acceptable forms of tax competition. Tax havens often connote evasion; some hold themselves out as places where the affairs of taxpayers and particularly their bank accounts will be free from discovery by the tax authorities of their home countries. The importance of tax evasion to the developed world and, in particular, as a motivating force behind the EU and the OECD initiatives, should not be underestimated. The United Nations has estimated that evasion involves more money by a multiple than the proceeds of all types of crimes.<sup>76</sup> Even though one avowed purpose of the EU and the OECD was to eliminate the preferences and to motivate low tax regimes to increase their tax rates, one can conclude that the institutions would be more than satisfied if only their second objective, the sharing of tax information, was accomplished.<sup>77</sup> Indeed, in the EU, the Proposed Directive on investment income has been so transformed.<sup>78</sup>

### III. THE TAX COMPETITION DEBATE

#### A. What Is Tax Competition?

The EU and the OECD's proposals on tax competition have raised considerable emotion and debate.<sup>79</sup> One might seriously ask whether one can address this issue without the accompanying politics. Some indicate that it is all personal opinion: "[t]here is no theoretical definition of tax competition, let alone harmful tax competition. It seems to depend largely on an individual's perception, and on the political persuasion of whoever talks about harmful tax competition, whether that person is in favor of it, or opposes it."<sup>80</sup>

Certainly, after listening to the definitions of politicians, this observation is understandable. Mr. Waigel, the former German Minister of Finance, engaged in the following exchange when asked, "What is harmful tax competition? ... Precisely, I don't know, but when I see it, I recognize it."<sup>81</sup>

Though it is true that the idea of "harmful" tax competition has a political element, this does not mean that the concept of tax competition is not

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or administrative pronouncements. Tax Evasion is the taking of a position that the taxpayer knows or should know to be unsupported by authority or legitimate interpretation.

<sup>76</sup> *Financial Havens, Banking Secrecy, and Money Laundering*, at <http://www.imolin.org/finhaeng.htm> (last visited Aug. 19, 2001).

<sup>77</sup> See Chuck Gnaedinger, *EU Commission Satisfied with United States 'Harmful' Tax Competition Position*, 92 (No. 2) TAX NOTES 170 (July 9, 2001).

<sup>78</sup> See *Proposed Directive*, *supra* note 65.

<sup>79</sup> For views expressing vigorous opposition, see, e.g., *BIAC Tax Committee Statement, A Business View on Tax Competition*, at <http://www.biac.org> (last visited Aug. 19, 2001); Mitchell, *supra* note 29, at 801.

<sup>80</sup> Sommerhalder, *supra* note 41, at 244.

<sup>81</sup> *Id.* at 247.

subject to rational elucidation and the provision of a useful definition. Tax competition is the nation's relinquishment, in whole or in part, of its right to tax an economic activity, with the result that its effective tax is less than that of other countries. Typically, tax competition is a purposeful activity that nations engage in to attract or retain activity. The definition also reflects the notion that the shift of economic activity also shifts the appropriate tax base from the country in which that activity originated to the new country, and that the new country foregoes such taxation for perceived benefit.

Such reduced taxation can effect the allocation of capital and the location of business activities worldwide. A working assumption is that governments choose policies of tax minimization in order to attract mobile activities that will lead to the maximization of public welfare. Without question, however, actions taken by one region to increase welfare may have a dramatic negative impact on the welfare of other regions.<sup>82</sup>

This definition helps focus our understanding of the harmful tax competition debate. Those who see some forms of tax competition as harmful view nations that use tax preferences as "poaching" on the economic activity and the tax base that would have belonged to it. Those who welcome tax competition see taxation as merely one cost factor among many that should be subject to reduction through international competition like any other cost. Framed in this way, tax competition is a question of politics, not economics. One's initial approach depends on one's view of governmental spending, and whether it taxes and spends wisely, maximizing welfare, or whether it overtaxes and spends foolishly. In the latter case, tax, like other facets of life, should be left to the free market and tax competition becomes a successful tool in curbing governmental appetites for revenue.<sup>83</sup>

Tax havens are often the focus of this issue. But one does not need to look far to be aware of the profound effect that tax preferences have on other countries. The proposition that capital flows toward low effective tax rates<sup>84</sup> is dramatically demonstrated in the United States. When tax rates on business capital were dramatically lowered as a consequence of the Economic Recovery Act of 1981,<sup>85</sup> approximately \$1 trillion of additional capital entered the United States.<sup>86</sup> Another tax preference contained in United

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<sup>82</sup> Wilson, *supra* note 55, at 272.

<sup>83</sup> See *id.* at 296.

<sup>84</sup> Wilson, *supra* note 55, at 272.

<sup>85</sup> ECONOMIC RECOVERY ACT OF 1981: LAW AND EXPLANATION (Commerce Clearing House, Inc. 1981). The central feature of the Act was its provision for investment in capital equipment, including accelerated depreciation schedules and investment tax credits. The United States lists these as tax expenditures and thus, the expenditures qualified as tax preferences. Cong. Joint Comm. On Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2000-2004*, TAX NOTES 103, 114 (2000).

<sup>86</sup> TANZI, *supra* note 1, at 137.

States tax legislation is the personal deduction for home mortgage interest.<sup>87</sup> Where a nation grants a deduction for personal interest that others do not, capital flows to that nation away from others, and borrowing is cheaper for the residents of that country.<sup>88</sup> Even though these United States provisions do not run afoul of the OECD's indications of "harmful" tax competition,<sup>89</sup> these preferences have a large and potentially detrimental effect on the world allocation of capital.

In general, tax competition presents trade-offs for many nations. Less tax revenue generally results in either fewer public benefits or higher taxes on less mobile factors. Governments tend to supply certain goods and services that have proved to be unsuitable for private markets.<sup>90</sup> Since tax competition more closely links taxation with public benefit, non-competitive goods and services are the types of public goods and services that disappear under tax competition models.<sup>91</sup> One study has even concluded that where both home country and host country<sup>92</sup> compete for capital with reduced rates and, consequently, reduced benefits, the home, the host and even the business enterprises are worse off.<sup>93</sup>

Politics go even deeper, however. Truly efficient tax competition restricts governments in their endeavor to reallocate goods and services in a nation state to achieve social reforms and the redistribution of wealth. Instead, efficient tax competition means that governments must tax in a way that the amount paid reflects the value of goods and services received by the taxpayer.<sup>94</sup>

The proposed benefits of tax competition, however, depend upon whether it is available to all. In other words, where taxpayers can vote with their feet, they will choose the tax and the level of services that comports with their personal choice or need. Those taxpayers who cannot vote with their feet are at a disadvantage to those who can.

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<sup>87</sup> 26. U.S.C. § 163(h). The United States also lists the personal deduction for home mortgage interest as a tax expenditure. See Cong. Joint Comm. On Taxation, *supra* note 85, at 112.

<sup>88</sup> Wilson, *supra* note 55, at 272.

<sup>89</sup> See Easson, *supra* note 71, at 372; see also HARMFUL TAX COMPETITION, *supra* note 62, at 23.

<sup>90</sup> Wilson, *supra* note 55, at 295.

<sup>91</sup> *Id.*

<sup>92</sup> For purposes of this article, the "home country" denotes the capital-exporting country, which can be considered to be the country of the residence of the taxpayer who owns it. "Host country" refers to the capital-importing country or the country in which the capital is used.

<sup>93</sup> Wilson, *supra* note 55, at 287.

<sup>94</sup> Tax competition is often championed by those who do not favor redistributive policies. See C. Neil Stephens, *A Progressive Analysis of the Efficiencies of Capital Import Neutrality*, 30 LAW & POLICY IN INT'L BUS. 159, 184 (1988-1989).

Those who promote tax competition typically belong to the international business community. To gain directly from tax competition, one's person or activities must be mobile. Thus, tax competition benefits owners of capital and economic activities that are easily transportable, whether in actuality or in form. This can include certain highly skilled workers whose talent is much in demand. Most income of labor and the consumption of those who labor are not particularly mobile due to culture, geography, immigration regulations or language. Thus, consumption taxes and employment taxes are not, at present, greatly threatened by tax competition. In addition, some business activity, especially in the service sector, is concentrated in local markets and cannot take advantage of low tax jurisdictions. Other business activity, due to size and lack of sophistication, is at a disadvantage in their efforts to compete against firms that can reduce costs through tax arbitrage.

Indeed, because some tax bases are captive and others are mobile, governments only need compete for the more mobile ones. Where competition is fierce, governments may be willing to bargain away their tax base so that it is disproportionately low in terms of the value of the benefit provided to the economic activity through government goods and services, as when governments grant total exemption or tax holidays for businesses in less developed countries or regions. Certainly, the prospect of additional jobs to a region with high unemployment may be thought to be worth the tradeoff. One difficulty of tax competition from the point of view of host countries is that it shifts the burden of the public benefits from the more mobile activities to the less mobile activities – labor and consumption.

The concerns raised by the harmful tax competition debate always center on the high tax jurisdictions' loss of tax base to the low. The previous discussion, however, suggests that tax competition may be harmful to the country offering the incentive. The benefits of tax competition to host countries are temporary, and this is particularly important to less developed countries that see tax incentives as the panacea for development. Firms attracted by tax incentives are always looking for a better deal. Studies have shown that tax incentives result in excessive firm turnover; once the tax preference has ended, enterprises leave.<sup>95</sup>

Thus, some conclude that tax incentives do not work for host countries.<sup>96</sup> Since the objective of tax competition is to attract an investment that might not otherwise have produced a minimally acceptable return after taxes, the benefit to the host country may be far outweighed by the costs to the host for goods and services provided to the enterprise. If, alternatively,

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<sup>95</sup> Wilson, *supra* note 55, at 295.

<sup>96</sup> A.J. EASSON, TAXATION OF FOREIGN DIRECT INVESTMENT: AN INTRODUCTION 164 (Kluwer Law Internat'l 1999).

an enterprise would locate in the host regardless of whether or not the tax incentive was provided, the host gives up its tax without consideration.

Thus, tax competition is inefficient from a global perspective, and, in many cases, from the perspective of the host. Moreover, the impact of tax preferences and low-tax regimes on home countries may be due to the economic consequences of granting preferences, the benefit of which may be mitigated over time due to their economic consequences.<sup>97</sup> This occurs because the flow of capital and importation of business and the inefficiencies of granting tax preferences have certain significant economic consequences to a host which can change the relative attractiveness of the host over the years.<sup>98</sup>

Havens, however, do not operate under the same economic rules. When enterprises engage in FDI, certain economic consequences to the home and host occur. To illustrate, consider a home enterprise engaging in manufacturing in a host.

FDI that flows from home to host results in a capital imbalance. Economic principles require that imports and exports of capital, goods, and services must be in equilibrium.<sup>99</sup> The host net goods and services imports must equal its net capital imports.<sup>100</sup> Assuming that the host country has an imbalance, that is, capital imports exceed capital exports, then economic principles require that this discrepancy must be balanced by an increase in the host's imports of goods and services. Though this effect may not happen overnight, it must occur for the nation's money will appreciate in value, its exports will become more costly and decrease in amount, and the price of foreign imports will be cheaper and increase in volume.<sup>101</sup>

Thus, we can see economically potent effects on the host from FDI, which results in certain benefits like increased jobs, increased imports of goods and services, and a higher standard of living. These consequences are independent of the way in which the host or home taxes.

However, there are some potential costs for the host. By opening its borders to the benefits of FDI, it also exposes its residents to competition from home enterprises. Costs such as labor increase.<sup>102</sup> Capital may be withdrawn causing the reverse economic effect. The host economy is more

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<sup>97</sup> HUFBAUER, *supra* note 6, at 152.

<sup>98</sup> *Id.*

<sup>99</sup> BURTLESS, LAWRENCE, LITAN, & SHAPIRO, *supra* note 2, at 33-34.

<sup>100</sup> *Id.* This works in the opposite way when a nation experiences a trade deficit. Where imports of goods and services exceed exports, additional capital must be imported to balance the accounts.

<sup>101</sup> *Id.* at 104. A similar result takes place within the home country. FDI increases capital exports, which means either that capital imports will increase, that goods and service exports will increase, or that goods and service imports will decrease.

<sup>102</sup> J.R. Hines & E.M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, at <http://www.nber.org/papers/w3477> (last visited August 19, 2001).



integrated into the world order, and the host has less control of its destiny. The consensus, however, is that the benefits of importing production factors far outweigh the detriments of such importation.

### 1. Tax Havens

Tax havens and similar tax preference regimes largely remove the effects of the economic laws considered here by insulating themselves from the effect of FDI and non-resident business. This is accomplished principally in two ways: by ring fencing and by maintaining the currency of business enterprise in foreign specie.

First, ring fencing is the process of restricting the benefits of limited taxation to so-called non-resident enterprises that are not permitted to do business in local markets and to compete with local enterprises.<sup>103</sup> Thus, the serious economic consequences of competition are eliminated. Similar economic effects are found in other countries where special enterprise zones are provided.

Second, nations can protect themselves from these economic effects by requiring the business enterprise to conduct its affairs in non-local currency. Usually the laws, in addition to the practical necessities of being located in a small country, require that FDI, incomes, and expenditures (except for small amounts for local purposes) be carried out in a currency other than that of the havens. Thus, these non-resident businesses do not affect the haven's essential economy by increasing imports or increasing currency value. Though transactions are booked in the havens, much of the real economic activity occurs elsewhere.<sup>104</sup>

Overall, low tax rates typically found in small havens, and not in hosts that provide significant markets for goods and services, favor capital intensive over labor intensive activities.<sup>105</sup> The relative mobility of investment permits the separation of this income factor from the market host (or the home) country and its placement in havens. Though financial services are capital intensive, there is a substantial service component. Any service factor requiring large labor costs can be performed outside the offshore financial center.

Examples of this are the widespread use of havens for insurance and banking. For insurance one typically finds captive insurers,<sup>106</sup> either the self-insurers of TNCs or the subs of insurance providers. Captives typically provide a reinsurance function, which is almost entirely a capital income producing function.

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<sup>103</sup> See HARMFUL TAX COMPETITION, *supra* note 62, at 27.

<sup>104</sup> *Id.* at 22.

<sup>105</sup> See Wilson, *supra* note 55, at 280.

<sup>106</sup> For an account of the tax implications of captive insurance, see W. Barker, *Federal Income Taxation and Captive Insurance*, 6 VA. TAX REV. 267 (1986).

Banking is also often found in small havens. Once again, a bank often provides the function of a repository of capital. Few banks or insurance companies have an actual physical presence. There is little true investment by these financial intermediaries in haven countries.

Many tax havens are referred to as offshore financial centers (OFCs), which are principally involved in the financial services sector and in FPI. Many OFCs are countries that have less than 200,000 inhabitants.<sup>107</sup> For example, the Cayman Islands is reported to be the fifth largest banking center in the world,<sup>108</sup> having approximately 580 banks (with \$500 billion in holdings), 2,238 mutual funds, 499 insurance companies and 40,000 offshore entities in total.<sup>109</sup> The Bahamas is also another major center, with sixty insurance companies, 580 mutual funds, 418 banks and 100,000 offshore entities in total.<sup>110</sup> The Channel Islands and the Isle of Man have approximately \$525 billion in foreign-owned assets.<sup>111</sup> Financial services account for 80% of Isle of Jersey's income, the minimum nonresident account now being \$100,000.<sup>112</sup> The list goes on, with the result that the country of Niue, a state with only 2,000 inhabitants, has 3,000 offshore business entities.<sup>113</sup> In all, statisticians estimate that about \$8 trillion worldwide is invested in offshore accounts and entities.<sup>114</sup> Thus, considerable amounts of capital are temporarily located in tax havens, and significant financial service sector activity is at least nominally located in these states.

## 2. Other Preferential Tax Regimes

Havens are not alone in relying on tax preferences to compete in the world market. Many countries enact tax provisions that are meant to attract highly mobile activities, and the economic effects can be similar to those experienced by traditional tax havens.

The search for tax preferences represents a change in the underlying objective behind FDI. In the past, one of the primary reasons for FDI was

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<sup>107</sup> Hines & Rice, *supra* note 102, at 3.

<sup>108</sup> Mitchell, *supra* note 29, at 810 n.114. The four leading banking centers, in order by size, are New York, London, Tokyo, and Hong Kong. *Id.*

<sup>109</sup> United States Dep't of Treas., 27 Fin. Crimes Enforcement Network (FinCen Advising) (July 2000); Michael Allen, *Tax Havens Cave in to Global Pressure*, THE WALL ST. J., June 20, 2000.

<sup>110</sup> United States Dep't of Treas., *supra* note 109, at 13; William Allen, *Statement by the Bahamas to the OECD Forum on Harmful Tax Practices*, OECD (August 30, 1999).

<sup>111</sup> Michael Peel & Francesco Guerrea, *OECD Eyes Deal with Island Tax Havens*, FINANCIAL TIMES, August 4, 2000.

<sup>112</sup> *Tax Haven Island's Referendum Call Prompted by Government Support for Efforts to Increase Financial Transparency*, FINANCIAL TIMES, August 29, 2000.

<sup>113</sup> United States Dep't of Treas., *supra* note 109, at 22.

<sup>114</sup> Mitchell, *supra* note 29, at 808 n.74.

market access. Today, tax advantage is compatible with market access in unified markets like the EU and NAFTA.

Also, market access does not mean that all activities need to be performed in the host country that consumes the goods and services. Many activities can be effectively provided outside the market without adversely affecting access. Moreover, while trade in goods and services are generally comparable, services can present some different wrinkles. Goods are actually sent from the country of manufacture to the country of purchase. Services, being intangible, are often not sent from one place to another in the same fashion. A document like an insurance policy can be sent to the country of the beneficiary, but the document is only evidence of the service. Certainly, the insurance company may need direct contact with its customer and may need a local establishment. In many cases, however, modern communications can obviate the need for physical contact and a service provider can be in another country.

The importance of tax factors to business has led to the growth of what can be called intermediate companies in areas other than insurance and financial services. Many countries provide special tax regimes for holding companies, coordination centers (often referred to as operational or regional headquarters), distribution centers, R&D centers and licensing centers. These incentives are often provided only to nonresidents.

Intermediate hosts or havens provide these special tax regimes because they attract enterprises that would not otherwise locate in the host or haven. These companies provide either a conduit function or a service function.<sup>115</sup> Conduit enterprises typically share the same economic characteristics as small havens; they are ring-fenced, keep their transactions in non-local currencies, or engage in transactions where imports roughly equal exports. This insulates the local economy from significant effects.

Companies that provide service functions, like coordination centers and R&D centers, engage in activities that are not directly in competition with local business. However, depending on the exact nature of the activity, it can have a significant physical presence with a concomitant effect on the local economy.

It appears that tax havens and nations utilizing tax preferences for intermediate companies have benefited from tax competition. Principally, the presence of foreign business provides some tax revenue, increased employment income, and an increased labor tax base.<sup>116</sup> Foreign firms may pay higher wages,<sup>117</sup> and in some cases there can be positive externalities on account of the diffusion of new technologies and production techniques.<sup>118</sup>

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<sup>115</sup> Easson, *supra* note 71, at 80-81.

<sup>116</sup> Hines & Rice, *supra* note 102, at 29.

<sup>117</sup> *Id.* TNCs may not pay higher wages in LDCs where unemployment is high.

<sup>118</sup> *Id.*

There also may be a downside to foreign presence, including increased labor costs for local firms, pollution and undue political influence exercised by foreign firms on small countries.<sup>119</sup>

It is the large havens, referred to as the "Big 7,"<sup>120</sup> that have benefited the most by their status. Significant value has been added to their economies by TNCs, and, surprisingly at little cost to tax revenues.<sup>121</sup> The only conclusion is that the Big 7 offers TNCs the possibility of significant profit due to factors other than low tax. The Big 7 appears to be the location of most of the physical activity undertaken by TNCs in tax havens.<sup>122</sup>

It is probable that the reason for this is that investment in many developed and developing economies results in the commitment of real resources. Capital movements, however, do not necessarily trigger the movement of real resources.<sup>123</sup> OFCs and certain intermediate structures that specialize in conduit operations do not result in the movement of real resources to a low tax regime, because the purpose of incentive is not to attract capital to be used in the host. Though linking two activities together is a real economic activity, it is not the activity of utilizing capital to produce income. Capital movements to tax havens "may simply reflect accounting transfers in which profits are allocated to countries with low tax rates."<sup>124</sup> Thus, the evidence indicates that the United States and other nations TNCs report significant income in tax havens even when little physical activity takes place there.<sup>125</sup> In United States firms, profits are reported that are disproportionate to the quality of factors utilized by firms in the tax havens.<sup>126</sup>

To illustrate, developing countries' share of portfolio equity was less than 2% in 1980 and was 30% in 1990;<sup>127</sup> the increase was largely attributable to the growth in the use of tax havens. Estimates of foreign investment by G-7 countries in a number of Caribbean and South Pacific OFCs increased five-fold to over \$200 billion from 1985 to 1994.<sup>128</sup>

Focusing on OFCs, asset statistics reveal that countries with 0.3% of the world's population and 0.3% of the world's GDP attract 24% of United States FDI.<sup>129</sup> Financial services dominate this investment, including, principally, banking (60% of total assets in havens) and other financial activi-

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<sup>119</sup> *Id.*

<sup>120</sup> *Id.* at T. 2, 3. The "Big 7" consists of Hong Kong, Ireland, Liberia, Lebanon, Panama, Singapore and Switzerland. *Id.* at T. 1 n.5.

<sup>121</sup> *Id.* at 30.

<sup>122</sup> *Id.* at 3.

<sup>123</sup> TANZI, *supra* note 1, at 73.

<sup>124</sup> *Id.* at 73 n.15.

<sup>125</sup> Hines & Rice, *supra* note 102, at 24.

<sup>126</sup> *Id.* at 30.

<sup>127</sup> GRIFFITH-JONES, *supra* note 9, at 27.

<sup>128</sup> Easson, *supra* note 71, at 162.

<sup>129</sup> Hines & Rice, *supra* note 102, at T. 1, 9, 11.

ties like insurance (23% of total assets in havens).<sup>130</sup> Financial services, constituting 84.3% of tax haven assets and over 20% of total United States FDI, only accounts for less than 0.5% of United States TNC employment.<sup>131</sup>

Thus, there is convincing evidence that many TNCs present in OFCs are pocketbook companies without real assets located in the haven and without any physical activity taking place in the haven. Oftentimes, these centers are used merely to book capital overnight before it returns to the country of origin.<sup>132</sup>

Free capital mobility results in the flow of capital from high to low tax jurisdictions. The intense competition for mobile activities is generally causing countries to reduce their tax rates to zero on these activities.<sup>133</sup> Nations' fear of tax disintegration, or a fevered race to the bottom with regard to mobile tax bases such as capital and corporate profits, is indeed a reality.<sup>134</sup> Whether one sees this as good or evil may ultimately depend upon one's view as to whether capital income should be taxed at all. Assuming that nations are not willing to abandon taxation of capital income, then this issue cannot be addressed solely as a question of political choice until one considers the fundamental premise of tax competition, that is, what is each nation's appropriate base for the taxation of international economic activities. Only after examining appropriate international taxation can we truly answer the question of what the problem of tax competition is and if it is harmful.

#### B. The Present Approach to International Taxation

Where economies are closed, there need be little concern for a proper jurisdictional basis for the imposition of income taxation. Where either the economic activities that give rise to the taxable base or the persons or entities involved have either foreign components or allegiance, then nations must grapple with the question of the appropriate basis for taxation. Though a nation's laws differ, there is a worldwide consensus on the fundamental approach to transactions with international dimensions. Taxation today is based on one of two jurisdictional precepts: source taxation and residence taxation.<sup>135</sup>

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<sup>130</sup> *Id.* at T. 9.

<sup>131</sup> *Id.*

<sup>132</sup> See Mitchell, *supra* note 29, at 809.

<sup>133</sup> See Wilson, *supra* note 55, at 295.

<sup>134</sup> ASSAF RAZIN & CHI-WA YUEN, *Optimal International Taxation and Growth Rate Convergence: Tax Competition vs. Coordination*, 6 INT'L TAX & PUB. FIN., 61, 69 (Kluwer, 1999).

<sup>135</sup> Most of the world uses the words residence or domiciliary taxation to identify this second basis for taxation. Residence is meant to include policies like that of the United States that taxes citizens on their worldwide income. See 26 U.S.C. § 61 (1994).

The key to international tax principles is to focus on the appropriate connecting factors: the elements that connect the tax base to the taxing jurisdiction in such a way as to suggest taxation is appropriate. Source jurisdiction is a direct method of attribution; it proposes that a country has the right to tax income that has "arisen" in the country. It is *in rem* jurisdiction; it attempts to place the transaction or economic activity giving rise to the income in a particular country. Thus, the nation that has the power over the activity which gives rise to the income has the right to tax it.

Residence, on the other hand, is an indirect method of attributing income to a particular country. Residence taxation does not look directly at the economic activity that produced the income, but instead looks to the person or entity that is the taxpayer. Residence taxation is *in personam* jurisdiction; it is based on the relationship of the taxpayer to the taxing jurisdiction, and, where the relationship is sufficient, seeks to tax that person on income irrespective of the country of source. Thus, the nation that has a special relation to a person and, hence, has the power over that person, has the right to tax that person on his or her worldwide income.

With two arguably independent bases for taxation, conflict among jurisdictions is bound to arise. In such cases, taxpayers may find themselves subject to double or triple taxation on the same income by different jurisdictions. Three possible areas of conflict may arise: (1) residence v. residence, (2) source v. source, and (3) source v. residence. Such jurisdictional overlaps can result from differing approaches to residence taxation, from differing approaches to source taxation, or from jurisdictions applying independent bases for taxation (source versus resident conflicts). Considerations of how these conflicts arise and what countries do about them is necessary to complete the general outline of international principles today.

Though there is no principle of international law that requires a nation to relinquish jurisdiction to tax once it is properly asserted,<sup>136</sup> nations have largely tried to ameliorate the consequences of double taxation. Conflicts resulting from different definitions of residence are difficult to resolve without bilateral agreement because unilateral action would require a nation to give up an approach that seemed obviously right to it. Many countries, however, simply do not tax on the basis of residence alone, or restrict their resident-taxation to limited kinds of income.

Source conflicts can be significant because most nations tax at least some types of income on this basis and, once again, conflicts are difficult to resolve without bilateral action. Whose rule should give way is a matter for negotiation, not simple concession.

The third and clearly the most important conflict is that between source and residence. This conflict is the most devastating because it is inherent in

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<sup>136</sup> RAMON J. JEFFERY, *THE IMPACT OF STATE SOVEREIGNTY ON GLOBAL TRADE AND INTERNATIONAL TAXATION* 43-44 (Kluwer 1999).

the concept of two independent jurisdictional bases for taxation. Here, as in some of the approaches to source and resident rules, international consensus has been established by work done by international organizations. Today, the doctrine is that "source jurisdiction is considered primary."<sup>137</sup> That means that resident-nations unilaterally should defer to source nations. Today, this approach has become a fundamental maxim of international tax law.

There is, however, nothing *apriori* to the approach that residence must defer to source. Indeed, this approach was initially the result of the triumph of politics over theory. Today, it is justified by custom and the accepted application of theories of economic efficiency. By examining how the world came to its present posture we shall begin to see the important issues that the present approach has failed to address and why this approach does not truly satisfy the tests of economic efficiency.

Until the 20<sup>th</sup> century, the world gave little attention to the subject of international taxation partly because comprehensive income taxation was still a relatively new form of taxation.<sup>138</sup> Only two nations, the United Kingdom and the United States, had adopted comprehensive taxation of income, both foreign and domestic, in the nineteenth century.<sup>139</sup> Additionally, except for the internationally and commercially oriented powers of the Netherlands, the United Kingdom, and the United States, most countries' economies were relatively closed,<sup>140</sup> and most countries had currency control legislation in place. Thus, most taxation was strictly territorial in nature.<sup>141</sup>

The aftermath of World War I found nations in great need of revenue. The norm became an over-expansion of source jurisdiction, with nations assuming that the easy fix to their revenue needs was to be found in the taxation of foreigners.<sup>142</sup> Thus, certain trading nations unilaterally determined to sacrifice their domiciliary taxation in order to facilitate free trade.<sup>143</sup> In this context, the League of Nations began to deal with the problem of international double taxation in 1921.<sup>144</sup> This led to the adoption of model con-

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<sup>137</sup> AMERICAN LAW INSTITUTE, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION, FEDERAL INCOME TAX PROJECT 8 (Tentative Draft No. 10, April 1, 1983). This principle is often reversed when countries enter into tax treaties. See *infra* notes 263-267.

<sup>138</sup> The first truly comprehensive income tax system was that of the United Kingdom, began in 1799. See Barker, *A Comparative Approach to Income Tax Law in the United Kingdom and the United States*, 46 CATH. L. REV. 7, 12 (1996).

<sup>139</sup> *Id.*

<sup>140</sup> TANZI, *supra* note 1, at 15.

<sup>141</sup> JEFFREY, *supra* note 136, at 43.

<sup>142</sup> MICHAEL B. CARROLL, LEAGUE OF NATIONS: PREVENTION OF INTERNATIONAL DOUBLE TAXATION AND FISCAL EVASION: TWO DECADES OF PROGRESS UNDER THE LEAGUE OF NATIONS 7-8 (June 22, 1939).

<sup>143</sup> *Id.* at 8.

<sup>144</sup> *Id.* at 11.

ventions in 1928.<sup>145</sup> The importance of this work to international taxation cannot be overemphasized. "[T]he fundamental structure for international taxation of income announced nearly seven decades ago in the 1928 League of Nations Model Treaty forms the common basis for more than twelve hundred bilateral tax treaties now in force throughout the world."<sup>146</sup>

The success of the League's work was due to two quite different, but equally important, reports: the first being a theoretical study of double taxation entrusted to four economists<sup>147</sup> and the second a study conducted by a group of technical experts charged with the study of double taxation and evasion from the perspective of administration and practicality.<sup>148</sup>

The role of the economists was to try to systematically tackle the question of appropriate international taxation.<sup>149</sup> The report of the technical experts, on the other hand, was to suggest a workable outcome for the times.<sup>150</sup> The economic advisors' goal was to achieve equity among nations. They ultimately recommended that the country of source should exempt all non-resident income, thus abolishing source taxation and establishing resident taxation as the only appropriate jurisdiction to tax. Since their economic theory ceded very little income tax jurisdiction to source countries, simply allocating all taxation to resident countries made good practical sense.<sup>151</sup>

The final proposals of the League of Nations were based largely on the recommendations of the committee of technical experts recommending source over residence.<sup>152</sup> Though the committee recognized the economic justification of the economic advisors,<sup>153</sup> its proposal was to refrain from adopting "any one single solution,"<sup>154</sup> but to adopt an approach that would establish source as supreme but would provide the basis for a modification of this hierarchy in favor of residence through treaties between nations. In its final form, the League adopted three model conventions that set forth different ways double taxation could be eliminated depending on the fiscal

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<sup>145</sup> *Id.* at 20.

<sup>146</sup> Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of United States International Taxation*, 46 DUKE L.J. 1021, 1023 (1997) (citing Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996)).

<sup>147</sup> See generally, Bruins, Einaudi, Seligman & Stamp, LEAGUE OF NATIONS, REPORT ON DOUBLE TAXATION (Apr. 3, 1923).

<sup>148</sup> See generally, LEAGUE OF NATIONS, REPORT OF THE TECHNICAL EXPERTS, DOUBLE TAXATION AND TAX EVASION (Feb. 7, 1925).

<sup>149</sup> CARROLL, *supra* note 142, at 11.

<sup>150</sup> *Id.*

<sup>151</sup> *Id.* at 41-42.

<sup>152</sup> *League of Nations, Report of the Technical Experts, supra* note 148, at 15. See also Graetz & O'Hear, *supra* note 146, at 1027.

<sup>153</sup> *League of Nations, Report of the Technical Experts, supra* note 148, at 14.

<sup>154</sup> *Id.*



peculiarities and objectives of the nations party to the convention, that is, choices that would depend on their level of trade and whether they were debtor or creditor nations.<sup>155</sup>

In coming to this resolution, the League had some aid from a late arrival, the United States.<sup>156</sup> Although in its original 1913 tax act, the United States had adopted the deduction from income method for foreign taxes to eliminate double taxation,<sup>157</sup> in 1918, the United States adopted, to the surprise of even its proponents, the foreign tax credit with little opposition or even notice.<sup>158</sup> The purpose of this change was to provide equity to individual taxpayers by eliminating double taxation.<sup>159</sup>

Contrary to the common sense view that capital-exporting nations might grow tired of subsidizing the tax revenues of foreign governments, this American policy had a basis in reality because of the economic and political conditions of the time. After World War I, the export of American goods depended considerably on the export of capital.<sup>160</sup> Additionally, as a practical matter, most nations were limited to source taxation. Thus, the tax system reflected the United States government's objectives to encourage the export of capital and to favor other nations' tax systems for reasons that may not have reflected appropriate tax principles.

Thus, the United States, a country committed to comprehensive income taxation, combined with the debtor nations to establish the primacy of source. The claims of the United Kingdom to a fair recognition of resident-principles in keeping with the report of the economic advisors were ignored.<sup>161</sup> Thus, the international tax rules that developed that elevated source over residence were the product of several factors: the need to act equitably towards individual taxpayers, the need to recognize that income tax systems in their infancy rely on source taxation and the United States' pragmatic view that exporting capital was in the national interest. The result was a clear repudiation of the concept of equity among governments, which had been the central focus of the economic experts.

#### IV. THE ERROR OF INTERNATIONAL TAX PRINCIPLES

Our present system of international tax is the heritage of a time when there were few nations engaging in global taxation, few exporting capital, significant worldwide legislation restricting the flow of capital leaving most

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<sup>155</sup> CARROLL, *supra* note 142, at 21, 22.

<sup>156</sup> The United States experts joined the deliberations in 1927. CARROLL, *supra* note 142, at 11.

<sup>157</sup> See Act of Oct. 3, 1913, ch. 16, 38 Stat. 114, § 2, 38 Stat. at 167.

<sup>158</sup> See Revenue Act of 1918, ch. 18, §§ 222(a)(1), 238(a), 240(c), 40 Stat. 1057, 1073, 1080-82 (1919).

<sup>159</sup> Graetz & O'Hear, *supra* note 146, at 1049-50 n.118.

<sup>160</sup> *Id.*

<sup>161</sup> Graetz & O'Hear, *supra* note 146, at 1050.

nations, fairly closed economies and unsophisticated income tax systems. Obviously, the world today does not reflect these conditions, with free and ever-increasing trade, a tendency toward free capital and other factor movement and ever-growing worldwide economic integration. Such changes should at least make one consider whether the political compromise of the past is still the best solution today.

Moreover, the political compromise was one-sided and ignored certain critical elements of appropriate international tax principles. It reflected one overriding objective to the exclusion of all others, that of individual equity. The resolution ignored the most current economic analysis of the day provided by the economic experts on the equitable division of the tax base, thus ignoring equity among nations. The solution did not anticipate that many nations would move away from source-based taxation of income due to the compulsion of economic forces. Finally, the solution ignored the economic efficiencies or lack thereof of different approaches to international taxation, and how international tax principles impact national and worldwide prosperity. The force of these factors aim international taxation in a different direction. Proper appreciation of these factors' importance to the rational allocation of tax jurisdiction leads to an optimal approach to international taxation relying on a set of principles and actual tendencies of nations in world taxation that lead to fair and efficient taxation.

#### A. Inter-nation Equity

When considering international tax avoidance or evasion, one thought is that it is immaterial which country gets the tax as long as some country imposes tax on the transactions or persons at issue. Indeed, part of the OECD solution to the tax competition problem is for tax havens to impose tax, thus making it less likely that the tax base will flow to these havens.<sup>162</sup> Should legal principles only address equity to an individual taxpayer or should tax law be concerned with whether nations who tax have a justification for doing so, or that those having such a justification get their rightful share?

Suppose two investors have equal amounts of money to invest. One chooses a taxable investment, the other, a tax-exempt. Is this equitable between these taxpayers because it is the outcome of free choice?<sup>163</sup> The government gets taxes only from one taxpayer, whereas both taxpayers get benefits from the government. When considering tax alone, it is inequitable because one taxpayer pays for the benefits conferred on the other. This scheme can only be thought equitable if one takes governmental subsidies

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<sup>162</sup> See HARMFUL TAX COMPETITION, *supra* note 62.

<sup>163</sup> Some conclude that this is equitable. See HUGH S. AULT & DAVID F. BRADFORD, TAXING INTERNATIONAL INCOME: AN ANALYSIS OF THE UNITED STATES SYSTEM AND ITS ECONOMIC PREMISES, TAXATION IN THE GLOBAL ECONOMY 11, 29 (Assaf Razin and Joel S. Pempod, eds., Univ. of Chicago Press 1990).

into account, and assumes that the forgone taxes represent a government expenditure of equal value to another and, hence, the non-taxpayer is in reality paying taxes. Even so, equity exists between the taxpayers only if the foregone taxes are fully capitalized in the rate of return of the tax-exempt investment, and other income being equal, the return to each taxpayer is the same after tax.

Consider, on the other hand, a taxpayer "A," resident of country "X," who invests in country "Y." From the point of view of the individual investor, it is typically a matter of indifference to which country she pays tax. If both countries X and Y effectively impose the same rate of tax, then it is immaterial to which country the tax is paid, and the investor should place her investment where she gets the highest rate of return.

This state of affairs is not one that country X, or by representation, the taxpayers of country X should view with indifference. The investment in country X as opposed to Y would produce tax revenues. Assuming that Taxpayer A, as a resident of country X, has the same claim on society whether her money is invested at home or abroad, the shortfall in revenues due to country X's failure to tax must be made up with either additional assessments on the taxpayers of country X or by a reduction in benefits to all. Thus, country X and its taxpayers are quite interested to which country the tax base belongs.<sup>164</sup> Nor can the absence of tax be considered a government expenditure that is accomplishing country X's governmental objective; it is in fact accomplishing another government's objective, that of country Y.

#### B. Fundamental Concepts of Equity and Their Application to International Taxation

In the early part of the 20<sup>th</sup> century, comprehensive income taxation was in its infancy. Except for the United Kingdom and the recent return to comprehensive income taxation in the United States, most nations of the world taxed income on a sporadic, schedular basis.<sup>165</sup>

International taxation for schedular countries, therefore, focused on income from items and the justification for taxation depended upon whether the economic events could be said to be situated in the jurisdiction. Global

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<sup>164</sup> Indeed, assuming tax rates of 50% in two countries, and country Y received all of the tax, then the foreign investment must be twice as profitable as the home's investment to be as profitable from the home country's perspective. See Peggy Richman, *Taxation of Foreign Investment Income: An Economic Analysis*, JOHN HOPKINS PRESS 12-20 (1963). The loss to the home country would be greater if the capital and profits were not repatriated.

<sup>165</sup> "Synthetic or global taxation begins with a holistic approach to income; income is treated the same no matter what its kind or source. Moreover, synthetic taxation often is linked to residence as opposed to a source principle of international taxation. Schedular systems, on the other hand, separate income into its constituent parts; they take as their starting point solely the sources of income and restrict themselves to taxing incomes which originate from *internal, domestic* sources." Barker, *supra* note 138, at 16 (footnote omitted).

taxation looks at income as a whole and considers of first importance the circumstances of the individual. Thus, unlike global systems, which look to the totality of a taxpayer's circumstances to assess tax, schedular systems take taxpayer's affairs piecemeal and tend not to take individual circumstances into account. Thus, the rationale of schedular taxation becomes on one level simply power over the acts within a nation's borders, and, on an equitable level, the connection between the activities and the benefits conferred by government. International source taxation is typically identified by flat rates applicable to all, few deductions and a total absence of consideration for personal circumstances.<sup>166</sup>

Comprehensive income taxation, on the other hand, is identified by progressive tax principles, full deductions and allowances that comprehensively take into consideration the circumstances of the taxpayer. Due to its quite different nature, modern theory supporting comprehensive income taxation has shifted its justification from benefit received to ability to pay. Ability to pay theory depends upon as comprehensive an assessment of the taxpayer's circumstances as is possible. Taxation follows taxpayers' control over resources and does not rely directly on the actual benefit the taxpayer receives either from the government or from living in the society.

The economic experts based their approach to appropriate tax base allocation on the more comprehensive theory of ability to pay.<sup>167</sup> Certainly, it made sense to reject a theory that did not address the concerns of comprehensive taxation<sup>168</sup> and provided a simplistic or partial notion of taxpayer equity.<sup>169</sup>

This led the economic experts to the development of the theory of economic allegiance to properly allocate the tax base.<sup>170</sup> They recognized a potential objection to using a faculty theory of taxation when dealing with the source-based taxation of items.<sup>171</sup> They concluded that a faculty theory was the appropriate theory of income tax because persons, not things, pay taxes.<sup>172</sup>

Faculty theory assumes a special relationship between the taxpayer and the taxing jurisdiction. It is that relationship that justifies taxation that is not directly related to the benefits one receives, that makes it defensible that a taxpayer may pay much more than the value of what one receives and that justifies worldwide taxation over activities of a taxpayer, who may not have

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<sup>166</sup> See HIGH J. AULT, *COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 431, 445 (Kluwer 1997); see also 26 U.S.C. § 871.

<sup>167</sup> *League of Nations, Report on Double Taxation*, *supra* note 147, at 18.

<sup>168</sup> *Id.*

<sup>169</sup> *Id.* It was remarked that the theory of ability to pay (or the faculty of the taxpayer) "includes what there is of value in the benefit theory." *Id.*

<sup>170</sup> *Id.* at 20-22.

<sup>171</sup> *Id.* at 18.

<sup>172</sup> *Id.* at 18-19.

directly benefited from governmental services. In short, ability to pay reflects residence taxation, the special relationship between the taxpayer and the state that justifies such taxation. It does not justify source-based taxation where there is no special relationship between state and a non-resident and where there is no obligation on the part of the state to pay benefits like education, health and Social Security irrespective of the taxpayer's contribution. There should be no obligation on the part of a non-resident to pay taxes without the provisions of demonstrable government services. Thus, implicit in ability to pay as a justification of tax jurisdiction is its almost total incompatibility with source taxation.

Thus, the primary theory of source-based international taxation, other than raw power, can only be the exchange or cost-benefit principle. A government supplies services, and a government generally has the right to tax those who directly benefit or have activities that "fall in a class that may fairly be presumed to benefit."<sup>173</sup> On the other hand, the primary theory of residence-based taxation today is ability to pay. Ability to pay affects both what is included in the tax base and the amount of tax due from the particular individual based on the size of her tax base and her personal circumstances.

The equity of source-based taxation is the equity of the exchange theory. Fairness to a taxpayer is achieved by taxing her according to her benefit. Intergovernmental equity is irrelevant because the source country charges for what it provides. Fair exchange, however, is not remotely possible unless the source state restricts itself to user charges. The equity of residence-based taxation, however, is that a taxpayer contributes according to her ability to pay, which is primarily societal equity. It is also individual equity when viewed from the perspective of the taxpayer as a social being, treated as a whole with all the benefits and burdens of social life. Consideration of these various facets of equity can help complete the puzzle of optimal international taxation.

### C. International Taxation and Economic Efficiency

Since the inception of the modern international tax regime, economists have often considered the question of what factors govern an economically efficient international tax regime. Their work has given us a different perspective for analyzing economic efficiency and some important considerations for resolving conflicts arising from the doctrine's different approaches.

In general, an efficient tax is a neutral tax, that is, the incidence of the tax should not change the relative prices of goods and services in the private

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<sup>173</sup> DAVID R. TILLINGHAST, *TAX ASPECTS OF INTERNATIONAL TRANSACTIONS* 3 (Matthew Bender 1984).

sector.<sup>174</sup> Taxes are considered to be efficient if resources are used in such a way that maximizes their output.<sup>175</sup> A tax can be inefficient when its incidence distorts economic decision making from a track, which would have been followed in the absence of the tax. That is because economic activity should be free to find its most efficient levels. An inefficient tax creates an excess burden on society, typically expressed in terms of a cost that is disproportionate with the tax revenue raised.<sup>176</sup>

The intensity of the distortion caused by taxation is largely dependent on two factors: the rate of tax and the elasticity of the tax base. The lower the rate and the less elastic the tax base, the lower the effect taxation will have on economic decision-making.<sup>177</sup> A tax base is elastic if it is relatively mobile. Open economies with free factor movements create the strong possibility of high tax base elasticity.<sup>178</sup>

There are three economic doctrines that advance different approaches to the ideal of economic efficiency in international taxation that deal with the distortions created by potentially mobile tax bases. These are Capital Export Neutrality ("CEN"), Capital Import Neutrality ("CIN") and National Neutrality ("NN").<sup>179</sup>

In brief, CEN espouses the view that capital should be taxed at the same rate whether utilized in the home country or in the host country. CEN examines efficiency from the perspective of the home country; neutrality is achieved where the decision of whether to invest at home or abroad is unaffected by taxation because the tax incidence will be the same. CEN's effect is to provide for the efficient allocation of capital between the home and host.

The traditional view is that CEN theory supports resident-based taxation. While it is true that CEN justifies resident-based jurisdiction, it does not require that the home country actually receive any tax, and it is satisfied if the host country taxes the income at the same rate as would have been the case if the home country had been the sole taxing nation.

CIN theory, on the other hand, holds that capital should be taxed at the same rate as that imposed on domestic capital in the capital-importing nation. CIN is said to promote the efficient allocation of capital worldwide. CEN deals with the efficient allocation of the home nation's *supply* of capital, whereas CIN provides for the efficient provision of the capital-

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<sup>174</sup> Norman Ture, *Taxing Foreign Source Income*, in *United States Taxation of American Business Abroad*, AEI HOOVER POLICY STUDIES 38 (1975).

<sup>175</sup> RICHARD A. MUSGRAVE AND PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 193 (McGraw-Hill 1973).

<sup>176</sup> *Id.*

<sup>177</sup> See TANZI, *supra* note 1, at 4.

<sup>178</sup> *Id.* at 12-13.

<sup>179</sup> For one of the earliest accounts of these approaches, see R.A. Musgrave, *Criteria for Foreign Tax Credit*, in *Taxation and Operations Abroad*, TAX INSTITUTE SYMPOSIUM (1959).

importing nation's *demand* for capital.<sup>180</sup> The prevailing thought is that CIN mandates territorial, source-based taxation only, implemented by the capital-exporting nation exempting foreign-sourced income.<sup>181</sup> Whereas it is true that there is no room for resident-based tax where the host imposes the same level of tax on all capital income whether domestic or foreign, were the host to exempt non-resident capital income and still tax its own residents' capital income, the home country would be required to impose the host country's tax rate on the home country's residents in order to satisfy the predicate for CIN.

The third doctrine, NN, provides that both the home and the host can tax capital, thus creating the possibility of international double taxation. Under this approach, the home country defers in part to the host country by providing a deduction against income for the foreign taxes paid. No matter how small the host country's tax, this method will always result in a tax larger than would have been the case if the home or host alone had taxed. Clearly, NN promotes resident-based taxation since it penalizes the exporting owner of capital, and hence, the capital-importing nation.

As a general proposition, with tax harmonization, neutrality would be achieved with either CIN or CEN. Assuming the free flow of capital, if all countries adopted the source principle of taxation and the tax rates were the same, international savings would be allocated efficiently because the rates of return on capital and after tax returns would have to be the same in order to attract capital.<sup>182</sup> Similarly, if all countries adopted only residence taxation with the same rates, the tax would not disturb the return on capital crossing national lines.<sup>183</sup>

Since harmonization is not presently obtainable and nations might still be interested in the proper allocation of the tax base, one still searches for the optimal theory. How can one choose between maximizing world savings that CIN promotes and the efficient allocation of world investment promoted by CEN. Surprisingly, the overwhelming answer economists provide is that CEN is the optimal theory.<sup>184</sup>

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<sup>180</sup> Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 94 Q. J. ECON. 793, 796 (1980).

<sup>181</sup> BRIAN J. ARNOLD AND MICHAEL J. MCINTYRE, *INTERNATIONAL TAX PRIMER* 7 (Kluwer 1995).

<sup>182</sup> Assaf Razin and Efraim Sadka, *International Tax Competition and Gains from Tax Harmonization*, 37 ECON. LETTERS 61, 69-70 (1991).

<sup>183</sup> *Id.*

<sup>184</sup> See, e.g., Richman, *supra* note 164, at 8; RAZIN & YUEN, *supra* note 134, at 69. For others, see also Klaus Vogel, *Worldwide vs. Source Taxation of Income - A Review and Re-evaluation of Arguments (Part II)*, INTERTAX 311-312 (1988). Cf. Ture, *supra* note 174, at 38. Ture supports CIN because he believes that each nation should respect the peculiarities of other states tax laws, and allow each nation to be the sole arbiter of the effect of tax policy within its borders. *Id.* at 37. As will be shown, this permits the host to be the arbiter of the home's tax policies as well.

Strictly speaking, economic principles of efficiency are not concerned directly with fairness to taxpayers, but with the efficient allocation of capital and the effect tax has on worldwide savings. Each theory has goals. If the theory does not accomplish its goals, it would not be a correct economic choice.

Thomas Horst provided an economic proof that international economic efficiency depends on the relationship between the supply and demand for capital.<sup>185</sup> Though his proof was demonstrated in terms of absolute options,<sup>186</sup> the real world lies at neither extreme, but someplace in between, and the relations between supply and demand are relative. In general, where the elasticity of the supply of savings, its potential for expansion or contraction, is greater than the elasticity of the demand for savings, CIN principles would promote increased savings in the home country and would better supply the host country's demand for capital. An appropriate assumption was that the supply for capital, not just the demand, for capital varies with the rate of return, and that lower tax rates in host countries would create a higher return.<sup>187</sup>

Where the opposite occurs, when demand is more elastic than supply, because demand increases in a greater proportion to supply for capital where the rate of return is greater, then CEN is optimal. In essence, where demand is greater than supply, CEN ensures that a home nation's capital will be allocated between foreign and domestic uses solely on the basis of the rate of return before taxes. CEN ensures that a nation's capital will not be dissipated and be largely engaged in foreign use. In other words, CIN supposes that lower rates will increase savings creating excess capital, and that host nations will benefit from this extra capital. If CIN does not operate as expected, CIN would be an unmitigated disaster for the home country.

NN, on the other hand, supposes that supply and demand for capital are both fixed. Basically, any augmented supply of capital would simply substitute for pre-existing capital. Thus there would be no reasons to encourage additional savings.<sup>188</sup>

Horst assumed that the savings rate was responsive to tax levels, and cited studies on the subject. The issue, however, is not whether there is responsiveness, but whether the supply of capital would increase at a greater rate than the demand for capital, or whether savings is more responsive to higher rates of return than demand is to lower costs of capital. The evidence is quite to the contrary. The prevailing wisdom is that there is a high elasticity of demand over savings and that savings are not particularly elas-

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<sup>185</sup> See Horst, *supra* note 180, at 793.

<sup>186</sup> *Id.* at 794.

<sup>187</sup> *Id.* at 793.

<sup>188</sup> *Id.* at 796.



tic.<sup>189</sup> In other words, the evidence does not indicate that taxation has any effect on savings or that low tax rates promote savings.<sup>190</sup>

Thus, the precondition for the effectiveness of CIN is missing. The world's expanding demand for capital in the face of available supplies is leading many nations to abandon taxation of the capital income of non-residents. The precondition for NN is also missing because neither supply nor demand is fixed, and thus a penalty on the taxpayer is harmful. NN is arbitrary and puts the interests of the home nation above all others. It is contrary to world economic integration and prosperity. Today, it is rarely considered as a viable alternative. Economic reality affirms the preconditions for CEN. Only CEN, therefore, satisfies the criteria of efficiency.

Even if savings are more responsive to lower tax rates than demand is to the lower costs, CEN may be the only solution. Economists suggest that even assuming this possibility, CIN would not be a viable solution.<sup>191</sup> The argument is that CIN is only workable with tax harmonization and uniform rates. Where rates are not uniform, tax competition will have major effects on the resource allocations across countries even though it may increase the supply of capital, and nations who can will adopt resident taxation of capital income to protect their economies even though in this case it would only be a second-best alternative.<sup>192</sup>

The truth of this conclusion, that countries are likely to adopt resident principles, is strongly indicated by the practical effect that capital export has on capital-exporting and capital-importing nations. Without considering the tax effects, the capital-exporting nation experiences a large income loss due to the loss of capital-produced income and the lower productivity of the home countries' labor force resulting from decreases in capital,<sup>193</sup> offset by a small increase in the income from remaining capital.<sup>194</sup>

The capital-importing nation, on the other hand, has a large incentive to lower its tax rate on non-resident capital in order to attract it. The host experiences a large economic gain due to the additional income generated

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<sup>189</sup> See A. Goolsbee, *Investment Tax Incentives*, 113 Q.J. ECON. 121 (1997). See generally, Reuven S. Avi-Yonah, *Comment on Peroni, Fleming and Shay, Getting Serious About Curtailing Deferral of United States Tax on Foreign Source Income*, 52 SMU L. Rev. 531, 534 n.16 (1999).

<sup>190</sup> See *Taxation and Household Savings* (OECD) (1994); TANZI, *supra* note 1, at 91. There may be a negative impact on savings where tax rates are very high. *Id.*

<sup>191</sup> Razin & Sadka, *supra* note 182, at 75.

<sup>192</sup> *Id.* at 71, 75.

<sup>193</sup> Though there is not perfect substitutability, empirical studies show that direct investment abroad reduces domestic investment levels, and foreign direct investment (imported) increases domestic investment. See Hines & Rice, *supra* note 102, at 20. A recent study concludes that capital export entails a loss for workers. See D. Rodrik and J. van Ypersele, *Capital Mobility, Distributive Conflict, and International Tax Coordination* 1 (unpublished paper), available at <http://www.nber.org/papers/w7150> (last visited August 19, 2001).

<sup>194</sup> RICHMAN, *supra* note 164, at 17.

by the imported capital and the increase in productivity of domestic labor offset by a small decrease in the income from preexisting domestic capital.<sup>195</sup>

Where the tax in country X and country Y is the same, the investor is indifferent as to the location of her investment unless the rate of return before taxes is higher in Y than in X. Certainly, in that case, capital would flow to Y from X because of greater returns, and this would be efficient from the world's perspective. If the return would be less in Y than in X, capital would stay in X, which would also be efficient.

But under the principles of tax competition, if only Y taxes and X does not tax the income on exported capital, and Y's rate on domestic capital is less than X's rate on domestic capital, then the rate of return on investment in Y could be less than X before taxes and still produce a higher rate of return for the investor after taxes.<sup>196</sup> Capital would flow from X to Y, but this would not be efficient because capital would not be employed at its most productive use. Therefore, CIN for savers "would be highly non-neutral with respect to international capital flows."<sup>197</sup>

Thus, only resident principles ensure that, in a non-harmonized world, capital is efficiently allocated. This only means, however, that capital is taxed to the extent it would have been in X by either X or Y, which is the traditional approach of CEN. Equitable principles suggest, however, that the tax base belongs to the home country to compensate it for loss of income and potential for economic growth due to the loss of capital.

There is a corollary to the preceding analysis that focuses on the capital-importing country and the effects of a CIN analysis upon it. Oftentimes, CIN is analyzed in terms of its effect on individual taxpayers, and its supporters rely on the notion that economic activity conducted in a host country should be on a level playing field, that it should be subject to the same tax levels as domestic host country enterprises.

CIN principles assume that capital income is fully taxed by the host country in the same fashion as domestic capital. The efficiency conditions of CIN break down, however, where the market does not follow the condition. In this case, the condition would be that capital income of non-residents was taxed in the same way as residents. If this is not the case, then following the theory will no longer guarantee its efficiency result.<sup>198</sup>

As demonstrated, theories of tax competition indicate that nations should tax residents on their worldwide capital income, and, equally as important, that these nations should not tax their non-residents at all on their

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<sup>195</sup> *Id.*

<sup>196</sup> Empirical studies confirm that TNCs are willing to receive a lower return on capital in low tax jurisdictions. See Hines & Rice, *supra* note 102, at 12.

<sup>197</sup> *Id.* at 8.

<sup>198</sup> See, e.g., *id.* at 6.

capital income.<sup>199</sup> This is because in a world of competition for capital any tax by a host nation on capital will typically be passed on to the borrower.<sup>200</sup> With capital mobility, capital will flow to low taxed jurisdictions.<sup>201</sup> Tax competition implies that importing countries must lower their tax rates, and, as long as they can still effectively tax their residents, this need be on non-residents only. Assuming free capital mobility, if CIN principles are strictly followed, all domestic capital will be exported, foreign investors will supply all of the capital needs, and capital income in general will be tax exempt.<sup>202</sup> The logical result of CIN is a shift of the entire tax base to less mobile factors, mainly labor.<sup>203</sup>

The world does not follow CIN principles in the taxation of capital incomes, even though studies show that large nations like the United States are not exposed to the same risk of capital flight as are small nations.<sup>204</sup> After all, capital needs to go where it is productive, and large nations use considerable capital. Even so, the impact of tax competition on the taxation of capital imports is understood by both large and small nations alike.

Worldwide, source taxation of capital income is on the decline, and in many cases has been unilaterally eliminated. The OECD reports that in general the countries that host the markets do not tax interest income on euro-bonds and deposits.<sup>205</sup> Withholding taxes on interest income has been abolished in a number of major countries.<sup>206</sup> Studies indicate that most countries do not tax bank account interest, many do not tax securities, and most tax dividends at a reduced rate.<sup>207</sup> The United States, the world's largest capital importing nation, has followed this trend. In general, domestic source interest from certain portfolio investments held by non-resident aliens and foreign corporations is exempt from United States tax.<sup>208</sup> Capital gains of non-residents are also typically exempt.<sup>209</sup>

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<sup>199</sup> Razin & Sadka, *supra* note 182, at 75.

<sup>200</sup> *League of Nations, Report on Double Taxation*, *supra* note 147, at 8.

<sup>201</sup> Razin & Sadka, *supra* note 182, at 69.

<sup>202</sup> *Id.* Countries that have followed source only taxation of capital income have experienced a severe flight of capital. This was the experience of several Latin American countries which have traditionally adopted territorial taxation only. See HUFBAUER, *supra* note 6, at 67 n.9.

<sup>203</sup> TANZI, *supra* note 1, at 14.

<sup>204</sup> See HUFBAUER, *supra* note 6, at 66 n.7.

<sup>205</sup> Mitsuhiro Fukao & Mesaharu Hanazaki, *Internationalization of Financial Markets and the Allocation of Capital*, 8 ECON. STUDIES 35 (OECD 1987).

<sup>206</sup> TANZI, *supra* note 1, at 131.

<sup>207</sup> See Fukao & Hanazaki, *supra* note 205, at 35.

<sup>208</sup> See 26 U.S.C. § 871(h) (1994) (referring to individual portfolio interest); 26 U.S.C. § 871(i) (1994) (referring to individual deposits); 26 U.S.C. § 881(c) (1994) (referring to foreign corporation portfolio interest).

<sup>209</sup> See 26 U.S.C. § 871 (1994) (indicating that capital gains are not included in the income of non-resident aliens under § 871). Moreover, since the passage of § 865, the capital

Several conclusions are warranted. World practice demonstrates that source-only taxation does not achieve CIN objectives of efficiency because nations regularly relinquish taxation over the capital income of non-residents. Foreign capital simply does not compete on a "level playing field" with domestic capital. This practical state of affairs is driven by the economic truth that CIN is an unsatisfactory way of allocating the world's supply of capital. Capital export neutrality is the only starting point in international tax for promoting efficiency in capital allocation.

CEN is satisfied as long as the rate of tax on exported capital is the home country's rate. Equity to the individual taxpayer is satisfied as long as she is not subject to double taxation. These objectives would be satisfied with either resident-based taxation or, generally, with dual taxation, residence and source, with the host's rate being no greater than the home's, and with a foreign tax credit allowed by the home. These objectives, however, would not be satisfied by the exemption of foreign-source income due to the possibility that nations do not tax, or only tax lightly, non-resident capital income. Resident taxation, with a foreign tax credit, that allocates the tax between the states according to the decision of the host, however, does not achieve inter-nation equity.

This may not seem to be a very important question to a world that sees the steady deterioration of source-based capital taxation. But some, like the OECD, have taken positions opposed to this trend and have encouraged an increase in source-based taxation.<sup>210</sup> This course of action does comply with CEN theory. It does not, however, take cognizance of the economic forces behind the trend, nor does it accomplish the equitable treatment of nations by allocating the tax base fairly. An optimal system should be efficient, it should take into consideration the practicalities of capital-importing and capital-exporting nations, it should be equitable to individual taxpayers and it should be equitable to nations and their taxpayers.

#### D. Equitable International Taxation of Capital

Exclusive home country taxation of capital is clearly established when one focuses on the home nation and its right to tax its residents' total income.<sup>211</sup> The taxpayer receives many benefits as a person because the taxpayer is that nation's own. There is wide agreement that a nation has the right to tax its residents on their total income because their rights to the protection and services provided by the state are matched by their duties to the state, among which is the duty to pay taxes.<sup>212</sup>

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gains of non-resident alien individuals would not typically be sourced within the United States. 26 U.S.C. § 865(a)(2) (1994).

<sup>210</sup> HARMFUL TAX COMPETITION, *supra* note 62, at 21.

<sup>211</sup> HUFBAUER, *supra* note 6, at 65.

<sup>212</sup> HANS KELSEN, GENERAL THEORY OF LAW AND STATE 75 (Anders Wedberg trans., Russell & Russell 1961).

It is the resident country that has the meritorious case to tax income on a comprehensive basis solely on account of the taxpayer's ability to pay because that country's obligations to its residents and citizens are not dependent on that taxpayer's actual ability to pay for them. Thus, equity to home nations and all of their residents places the tax base for capital income exclusively within the domain of the home country, and this fully comports, and indeed it informs the judgment, with the economic theories and realities.

The equity of CIN is the equity of the exchange theory, which is the only theory justifying piecemeal, source-based taxation.<sup>213</sup> The host may tax in accordance with the benefit the host confers on the investor. The benefit conferred on the taxpayer by the host in terms of government goods and services, however, is small in comparison to the good that the taxpayer's capital showers on the host. The source country confers the benefit of the protection and maintenance of the particular income source.<sup>214</sup> The services provided are the legal provisions that protect the investment and the infrastructure, mainly the stock and other financial exchanges that may facilitate the investment.<sup>215</sup> Even proponents of CIN admit that the few benefits the investor derives are not particularly important to her because the investor simply will charge a premium for any enhanced risk.<sup>216</sup>

Moreover, the host reaps a huge reward from the import of foreign capital. The home suffers a large economic loss. Under an exchange theory of taxation, the bargain between taxpayer and host is completely one-sided in favor of the host. It is not, however, the individual taxpayer who suffers, but the taxpayer's home nation.

Although the equity of CEN is the equity of taxation based on ability to pay, it is also the equity of taxation based on benefit. Even under the benefit theory of taxation, the capital-exporting nation deserves the exclusive right to tax the income due to the positive contribution it has made to the world order.

By providing governmental policies, institutions and laws, nations foster the development of capital, skills and technologies. The home has provided benefits to its resident with respect to her capital. Home nations merit the tax base on capital income because it "creates the economic climate favorable to the creation of portfolio capital by practicing public fiscal virtue and by nurturing private thrift."<sup>217</sup> The benefit provided by the home state was "the historical costs to the nation involved in the accumulation of

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<sup>213</sup> See TILLINGHAST, *supra* note 173, at 3; Richman, *supra* note 164, at 16.

<sup>214</sup> *League of Nations*, *supra* note 148, at 41 (citing *Report of the Royal Commission on Income Tax*, 1920, Cmd. 615 (London: H.M. Stationary Office 1920)).

<sup>215</sup> These could more appropriately be paid for by user charges.

<sup>216</sup> Vogel, *supra* note 184, at 316.

<sup>217</sup> HUFBAUER, *supra* note 6, at 67.

capital."<sup>218</sup> In a sense, the nation as a whole may be said to have created the property.<sup>219</sup> Since the home nation's capital produced the income, the income from that capital belongs to the home, which is ultimately responsible for the production of this value. Thus, the home's meritorious conduct should be rewarded by assigning to it the exclusive right to tax.

Thus, ideally, capital income should be taxed on the basis of residence only. That means that the home country may choose whether or not to tax capital income as its policy dictates, but if it does tax capital income, it should neither allow an exemption for exported capital nor a foreign tax credit.

Although it is inappropriate for the source country to tax capital income at all, those countries will still be free to do so. But this is not a calamity for the world, or for individual taxpayers. In the first place, it is highly unlikely nations will do so because source taxation will increase the cost of capital to the importing nation. That is because the additional cost to the lender will no longer be subsidized by some home's foreign tax credit.<sup>220</sup> Either the additional cost would be passed on to borrowers, or the capital would simply not be invested there. Thus, economic reality would necessitate appropriate tax behavior and the proof is that even in a world where international taxation favors taxation by hosts, the trend is away from taxation of nonresident capital income.

In a sense, this system would empower nations. To the extent that a nation perceived foreign capital to be a detriment to its societies, it could discourage foreign capital simply by taxing it. The result would be either a higher cost of capital to borrowers in the host country or less capital in the host country, creating a positive externality for other nations, for capital would seek more productive uses and locations.<sup>221</sup> The foreign tax credit of home countries thwarts this policy by preventing its appropriate economic effect.

## V. INTERNATIONAL TAXATION OF BUSINESS: THE SOLUTION

The prior discussion addressed the question of optimal taxation of capital in such a way that it did not specifically examine it in light of capital's role in business. When one turns to business activities, however, one is confronted with a whole new set of considerations.

FPI connotes the foreign investment of capital by individuals and businesses. FDI connotes the foreign use of capital in that taxpayer's trade or business. FPI investors look to countries where they can get the best return

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<sup>218</sup> Richman, *supra* note 164, at 23.

<sup>219</sup> *Id.*

<sup>220</sup> Source countries that tax bear the cost of their tax when home countries do not tax foreign source capital income.

<sup>221</sup> Wilson, *supra* note 55, at 275.

on their money, taking into consideration the relevant risks. FPI users are interested in where they can get the best return on their assets. FDI users have more complicated motives, exporting capital to access markets and resources, and to maintain their competitive advantage. With FPI, a tax advantage is often sufficient to attract capital to a foreign investment. Thus, nations are quick to give up source-based taxation for the benefit of imported capital. A FDI of capital in a country in which that capital is intended to be used would rarely be made solely for the tax advantages. There are many important cost factors that go into the decision to locate business activity in a particular place. Tax is, however, becoming one of the more important factors. That is why source nations' approach to the exercise of tax jurisdiction presents a much more complex picture.

Most studies before the 1990s found that the tax implications of foreign investment were a relatively minor consideration in most FDI decisions.<sup>222</sup> By contrast, studies since 1990 have indicated that tax is becoming an increasingly important factor in locational decisions.<sup>223</sup> Recent quantitative evidence indicates that investment and financing is quite sensitive to tax treatment<sup>224</sup> because of the increasing mobility of the factors of production, which yields a wide range of choices to business taxpayers.<sup>225</sup> While this is particularly true in the financial service sector, manufacturing as well has become much more export-oriented, and correspondingly more sensitive to tax rates.<sup>226</sup> Proponents of CIN and source-based tax rationalize their approach on the simple basis that these approaches are the only pragmatic solutions. Such analysts believe that FDI will flow to low tax regimes despite what the developed countries do, and since companies will take advantage of the opportunities of low tax and gain the competitive advantage, it might as well be ours.<sup>227</sup>

CIN stresses practical fairness to business taxpayers. Its principle has been persuasively summarized as follows: fairness requires that "a taxpayer who conducts an enterprise in another country – or market – and thus utilizes the other country's facilities (public goods) can be sure of being taxed no more than anyone else who, under the same circumstances, uses these facilities to the same extent."<sup>228</sup> Moreover, the justification for source taxation of business income on the basis of benefits received by the taxpayer is much stronger in the case of a business enterprise conducted in a foreign

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<sup>222</sup> EASSON, *supra* note 96, at 12.

<sup>223</sup> COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION, at 115 (Luxembourg 1992).

<sup>224</sup> Hines & Rice, *supra* note 102, at 41.

<sup>225</sup> EASSON, *supra* note 96, at 17.

<sup>226</sup> *Id.* at 18.

<sup>227</sup> HUFBAUER, *supra* note 6, at 58-59.

<sup>228</sup> Vogel, *supra* note 184, at 314.

country. Such an enterprise is typically more interested in governmental goods and services than the FPI investor.<sup>229</sup>

Two arguments detract from the weight of this argument. First, international business benefits considerably from government goods and services provided by the home country as well as those provided by the host, so benefit analysis is not determinative on which country should have the right to the tax bases or as to how much.<sup>230</sup>

Second, under an exchange theory of taxation, the host country has benefited in many ways through the importation of a business and its capital. This includes all the advantages of having imported capital,<sup>231</sup> including increased employment. In addition, businesses import other assets, including new skills and technology that can lead to the increased productivity of the local economy. In particular, highly skilled personnel contribute disproportionately to their wage value to an economy's growth rate.<sup>232</sup> Thus, advanced technology, expertise, embodied knowledge and highly skilled labor all provide many positive externalities to the host. That is why host nations are eager to attract foreign business activity, even when they need to use tax preferences and subsidies to do so.<sup>233</sup>

These large gains to the host economies represent large potential economic losses to the home economy. As in the case of FPI, FDI removes capital from the home country. In addition to the effects of FPI, FDI also exports technology and labor that might have been utilized in the home country and which could have contributed greatly to the growth rate in the home country. The utilization of invention and technology and the talents of highly skilled workers may each be more important to the economic success of a nation than capital.<sup>234</sup>

Thus, the conflicting objectives of CEN and CIN, and a conflict between individual equity and inter-nation equity and economic efficiency confront international taxation of business income. To some, both economists and legal scholars, there is no correct solution since CEN and CIN are mutually exclusive and cannot be reconciled.<sup>235</sup> A second approach is to accept that both have important yet competing objectives, and a balance

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<sup>229</sup> See Vogel, *supra* note 184, at 313. One author suggests that where tax monies are put into infrastructure rather than redistribution, the source country should have the exclusive right to tax. See Stephens, *supra* note 94, at 159.

<sup>230</sup> See Richman, *supra* note 164, at 16.

<sup>231</sup> See discussion *supra* note 196.

<sup>232</sup> See TANZI, *supra* note 1, at 35; Assaf Razin & Chi-Wa Yuen, *Understanding the Problem or Economic Development: The Role of Factor Mobility and International Taxation*, at 21, at <http://www.nber.org/papers/w7115> (last visited August 19, 2001).

<sup>233</sup> See HUFBAUER, *supra* note 6, at 67-68.

<sup>234</sup> Robert E. Hall & Charles I. Jones, *Why Do Some Countries Produce So Much More Output Per Worker Than Others?* 114 Q.J. ECON. 83, 83-84 (1999).

<sup>235</sup> EASSON, *supra* note 96, at 11; JEFFERY, *supra* note 136, at 6.



should be struck.<sup>236</sup> These have tried to separate these concepts pragmatically, asserting an approach of relative neutrality even while fully aware of the theoretical problem of relativism.<sup>237</sup>

Finally, there are those economists and legal scholars who have concluded that one concept of economic efficiency is the optimal solution. Those economists supporting CEN are in the considerable majority.<sup>238</sup> Few support CIN,<sup>239</sup> but there is substantial support for CIN among lawyers and in the business community.<sup>240</sup> Neither articulated solution is totally satisfactory because, *under present analysis*, CIN sacrifices equity to home countries, whereas CEN places home country enterprises at a competitive disadvantage. Also, CIN is based on what is now appearing to be a faulty premise that host nations actually tax foreign concerns on their domestic-sourced income where in fact the landscape is littered with jurisdictional thresholds for source taxation, tax preferences and low tax regimes for non-residents.

Though current thought is based on reasoned discourse, an examination of the principles and purposes of economic efficiency, equity and practical necessity leads to an understanding that CIN and CEN are not mutually exclusive, but each is an essential element of one theory of optimal international taxation. This theory is, simply, that CEN is a moment of a reconstituted CIN approach to optimal international taxation.

This statement should cause puzzlement to anyone who is aware of my conclusion that CEN is the optimal theory for the taxation of capital. What is being suggested here is that part of the problem of assessing CIN and CEN principles is that an assumption has been made about their implications that is simply incorrect. The dialogue has assumed that CEN leads to residence-based, worldwide taxation of income. It is also assumed that CIN is established solely through the territorial taxation of income. Neither proposition is correct.

CIN and CEN, as their very terms advertise, deal with taxation and the efficient allocation of capital. Economic proofs have been directed at establishing which nation should have the right to tax the *income from capital*. Apparently without explanation, it has been assumed that these concepts apply as well to other kinds of income. It is time to determine why.

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<sup>236</sup> Vogel, *supra* note 184, at 319-20; Horst, *supra* note 180, at 798.

<sup>237</sup> JEFFERY, *supra* note 136, at 8-9.

<sup>238</sup> See, e.g., Vogel, *supra* note 184.

<sup>239</sup> *Id.*

<sup>240</sup> See *International Chamber of Commerce, Avoidance of Double Taxation, Exemption v. Tax Credit Method*, RESOLUTION OF ICC COUNCIL AND REPORT OF COMMISSION OF TAXATION (Feb. 1955); BIAC, *supra* note 79, at 1; see also Klaus Vogel, *Worldwide vs. Source Taxation of Income — A Review and Re-evaluation of Arguments (Part I)*, 8-9 INTERTAX 216, 221-222 (1988).

CEN is a theory of capital allocation, which seeks the efficient allocation of capital between nations. Taxation should be the same whether capital is invested at home or abroad so that the decision to invest domestically or in foreign countries will not be affected by tax considerations. As pointed out above, this rationale has been shown to be determinative in establishing the home's right to tax. Moreover, inter-nation equity has established that this is an exclusive right.

The economic case for CIN has consistently been made in terms of the fair and efficient treatment of *business income*, the rationale being that a foreign enterprise should be on the same tax basis as domestic enterprises in the host state. Commentators fail to analyze what this really means. Does it mean that host states have the exclusive right to tax all income territorially situated within its borders?

Source jurisdiction is not a matter of naked power because jurisdiction based on power no longer makes sense in open economies striving for the benefits of free trade and enhanced factor mobility. Source jurisdiction instead is a matter of economic allegiance; there must be an economic foundation for the assertion of source jurisdiction.<sup>241</sup> This allegiance is more than just a superficial context; there must be a just or equitable basis for the assertion of such jurisdiction.

This article has established that CEN achieves the goal of efficiency and that only residence taxation of capital income advances CEN and the equitable division of the tax base for capital income. What this article will also show is that this outcome is also fully compatible with the principles and objectives of CIN. To fully appreciate this, one must apply the principles of capital taxation to the taxation of FDI.<sup>242</sup>

#### A. The Factors of Business Income

What prompts a business to engage in FDI? It is because the business perceives that it has an economic advantage that it wishes to exploit. The advantages and sources of the ultimate profits gained by engaging in FDI can be capital, tangible and intangible assets including technical and industry expertise, headquarters efficiencies and a skilled workforce. Much of what a business is all about, and what its true value is, is attributable to its intellectual capital. This value can often be the essence of a company's operations.<sup>243</sup> Thus, much of what a business exports is not cash or physical assets, but intangible assets. Financial service enterprises illustrate this

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<sup>241</sup> See F.A. MANN, *FURTHER STUDIES IN INTERNATIONAL LAW* 8-11, 14-15 (Clarendon, Oxford 1990).

<sup>242</sup> Hufbauer, who asserts CEN theory as the appropriate theory for the taxation of FPI, questions its relevance to FDI because capital flows are dominated by FPI. See HUFBAUER, *supra* note 6, at 60.

<sup>243</sup> OECD online, *Intellectual Capital* (Paris, June 2, 1999), at <http://www.oecd.org/news/release/nn99-54a.htm> (last visited Aug. 19, 2001).

principle well, for "what is really exported consists principally of embodied knowledge and skilled labor."<sup>244</sup>

Thus, income is derived internationally by businesses from factor inputs including capital, tangible assets and intangible assets. Income is also derived from the labor, environment, infrastructure and public benefits of the country in which the various activities are carried out. Which country can be said to be the source of the income based on the economic affinity of the income to the local? Which country has the meritorious case to tax? Following the lead of our previous analysis, the country that is the source of the assets that provides the income-producing value should get the exclusive right to tax. This is both CIN and CEN,<sup>245</sup> or more expansively stated, Value Export Neutrality, and Value Import Neutrality.

#### B. Redefining the Source Rules

The key to understanding what is wrong with the present approach to international tax is found in an examination of how income is actually sourced. Though the importance of actually allocating income to particular jurisdictions is critical to CIN advocates and practical international taxation, consideration of rules is rare. "The idea that income has a locatable source seems to be taken for granted, but the source of income is not a well-defined economic idea."<sup>246</sup> As pointed out in a special report of the American Law Institute:

There has never been a comprehensive rationale for the source rules that now exist, either in the United States or elsewhere; and it is difficult, if not impossible, to articulate generally valid and neutral principles for assigning a geographic source to income. The process seems, however, to require a balancing of the strength of conflicting claims and considerations as they apply to particular types of income.<sup>247</sup>

Adding to this confusion, one learns that the rules on source often seek to implement different objectives that lead to inconsistent source rules.<sup>248</sup> Where countries tax both on the basis of residence and source, the rules do double duty, determining both the domestic source for nonresidents in order to tax and the foreign source for residents in order to provide appropriate re-

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<sup>244</sup> INGO WALTER, GLOBAL COMPETITION IN FINANCIAL SERVICES: MARKET STRUCTURE, PROTECTION AND TRADE LIBERALIZATION 106 (Harper Business 1988).

<sup>245</sup> The principles of CEN apply to any factor input that is internationally mobile. See RAZIN & YUEN, *supra* note 134, at 68 n.12.

<sup>246</sup> AULT & BRADFORD, *supra* note 163, at 30 (Assaf Razin and Joel S. Pemrod, eds., Univ. of Chicago Press 1990).

<sup>247</sup> AMERICAN LAW INSTITUTE, *supra* note 137, at 42.

<sup>248</sup> United States Dep't of Treas., International Tax Reform: An Interim Report 1 (Jan. 1993).

lief from double taxation. These rules can reflect nations' differing views on practicality, preservation of the tax base, efficiency and ensuring competitiveness.<sup>249</sup> Sometimes domestic source will be dictated because of the perception that others are not taxing the income in question.<sup>250</sup> Thus, some nations apply different standards for residents and nonresidents.<sup>251</sup>

The approach to defining source also differs among nations. One method is to take a systematic approach and define the source of income in statutory rules.<sup>252</sup> A second approach determines rules on courts' case-by-case analysis.<sup>253</sup> A third approach leaves sourcing to the decisions of administrative officials.<sup>254</sup> Considering the lack of economic guidance on income location and the conflicting objectives of nations, it should not be surprising that "complexity and arbitrariness are hard to avoid."<sup>255</sup>

The difficulty is that tax jurisdiction traditionally was strictly territorial. Modern thought and practice today seeks an economic reason for taxation, that is, that the income in question benefits from its location, especially in terms of government goods and services. Therefore, it is incorrect to try to find a strictly territorial income location. Moreover, finding such a territorial location is becoming less and less possible.<sup>256</sup>

Source rules can be studied and delineated from the same perspective that illustrated that capital exporting countries have the exclusive right to tax the income from their residents' capital, wherever it is derived. From this systematic treatment of appropriate capital income taxation on the basis of economic efficiency, fairness to taxpayers and fairness to nations, a model for source taxation can be derived.

The starting point for providing a rationale for the taxation of interest income today is that its source is where the money is used, for that is the place where capital is producing income and that is the place whose laws protect its use.<sup>257</sup> Though this approach appears straightforward, its en-

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<sup>249</sup> *Id.* at 2-3.

<sup>250</sup> *Id.* at 30.

<sup>251</sup> The United States applies the same standard. See 26 U.S.C. §§ 861, 862, 863, 865.

<sup>252</sup> The United States follows this approach. See 26 U.S.C. §§ 861, 862, 863, 865.

<sup>253</sup> Australia, for example, uses this approach. See J.S. Lockhart, *Australia*, in 65b STUDIES ON INTERNATIONAL FISCAL LAW, RULES FOR DETERMINING INCOME AND EXPENSES AS DOMESTIC OR FOREIGN 211 (1980).

<sup>254</sup> See Ignace Claey's, *Belgium*, in 65b STUDIES ON INTERNATIONAL FISCAL LAW, RULES FOR DETERMINING INCOME AND EXPENSES AS DOMESTIC OR FOREIGN, *supra* note 253, at 277, 288.

<sup>255</sup> See Ault & Bradford, *supra* note 163, at 31.

<sup>256</sup> For example, with the growth of Internet commerce, which utilizes devices such as smart money and wire transfers, it will become increasingly more difficult to determine the location of the economic activity.

<sup>257</sup> Argentina is an example of this approach. See Juan Carlos Visshi, *Argentina*, in 65b STUDIES ON INTERNATIONAL FISCAL LAW, RULES FOR DETERMINING INCOME AND EXPENSES AS DOMESTIC OR FOREIGN, *supra* note 253, at 171, 172.

forcement assumes that there is a measurable amount of capital that actually can be located in a particular country.<sup>258</sup>

Of all the sourcing rules, it is nearly impossible to try to directly locate money in a world where investors are free to move, and in fact do move, their capital often to take advantage of the highest returns. Thus, nations typically choose surrogate principles of sourcing income that attempt to indirectly access the substance of what was quite difficult to get at directly. Under one rule, the source of the interest income depends on the residence of the debtor, which may work reasonably well as a principle determining the place of use in the case of many individual borrowers, but in the case of business, may not. Under a second rule the interest income source depends on the place to which the principle is made available. A third rule considers the place to which interest payments are made. Finally, a fourth rule considers the place of residence of the bank through which interest payments are made.<sup>259</sup> The likelihood that most of these rules would actually link the income to a country where the money was used is small.

Moreover, the source country's right to tax interest, if ever exercised, is often limited or eliminated. The United States Model Treaty allows only residence taxation of interest income.<sup>260</sup> The OECD Model Treaty and the U.N. Model provides limited source taxation of interest income with reduced rates.<sup>261</sup>

As shown above, however, it is not the physical location of the money that gives a nation the right to tax, but the benefit provided to the transaction. When one can't even determine where the money actually is, how can one argue that a particular host has provided any benefits. Assuming a locatable use, the host has not provided any demonstrable benefits to the taxpayer. The home country, however, has provided many to its resident as resident and to its resident as capital owner.<sup>262</sup>

The argument for allocating the taxation of the normal return from moneyed capital to the home country applies equally to physical assets. Though the objectives of FDI may be different, an appropriate economic assumption is that there is "[p]erfect substitutability between physical and financial capital."<sup>263</sup> Imported capital assets represent value exported from home countries. This value was added to the world by enterprises resident

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<sup>258</sup> See Ault & Bradford, *supra* note 163, at 33.

<sup>259</sup> Vogel, *supra* note 240, at 227.

<sup>260</sup> United States Model Income Convention of September 20, 1996, United States Dep't of Treas., Article 11.

<sup>261</sup> Articles of the OECD Model Tax Convention on Income and on Capital (June 30, 1998), Article 11; United Nations, United Nations Model Double Taxation Convention Between Developed and Developing Countries 121-137 (1980).

<sup>262</sup> See text at *supra* notes 193-97.

<sup>263</sup> RAZIN AND YUEN, *supra* note 134, at n.4.

in the home. The fair market value of these assets when exported represents capital originating in the home.

The same economic principles of CEN and CIN apply to assets as well. Neutrality requires that the choice of whether to use assets at home or abroad should be unaffected by tax considerations. Equity among governments requires the assignment of the tax base exclusively to the home because its meritorious conduct provides the environment for the production of the goods, its economy suffers a large loss in income and jobs on account of its export, and the host benefits greatly, disproportionately to the benefit it provides.

Present rules for sourcing tangible assets are the most arbitrary. Source often begins with the characterization of a transaction as a sale or a lease. Sales are sourced under several theories. Two possible theories, which source sales at the place where negotiation occurred or the place where title passed, leave all countries largely at the whim of the taxpayer.<sup>264</sup> Some rules already source income at the residence of the owner. The United States sources non-inventory sales in the country of the seller's residence.<sup>265</sup> The United States also sources a sale of manufactured goods in the residence country to the extent of the fair market value of the goods at the border.<sup>266</sup>

Leasing, on the other hand, is sourced at the place where the property is used.<sup>267</sup> Since physical assets can typically be easily located, there is no need to rely on a surrogate or indirect approach to sourcing.

Thus, even though the sale of an asset for fair market value is economically equivalent to the lease of that asset, form controls the allocation of the tax base.<sup>268</sup> The weight of the country of residence's claim is such that it has been proposed that the source of rental income be the residence of the lessor.<sup>269</sup>

It is only this latter rule, sourcing lease payments on the basis of the residence of the lessor, which would effectuate a policy of assigning the normal return on capital to the country of residence. To see this, one must realize that there are two tax incidents that must be examined. The first is directed at the business operating in a host country that is treated as a sepa-

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<sup>264</sup> See Robert J. Patrick, Jr., *General Report*, in 65b STUDIES ON INTERNATIONAL FISCAL LAW, RULES FOR DETERMINING INCOME AND EXPENSES AS DOMESTIC OR FOREIGN, *supra* note 253, at 15, 21.

<sup>265</sup> 26 U.S.C. § 865 (1994).

<sup>266</sup> See Visshi, *supra* note 257, at 174; American Law Institute, *supra* note 137, at 65-68.

<sup>267</sup> See Patrick, *supra* note 264, at 24. See also 26 U.S.C. § 861(a)(4) (1994).

<sup>268</sup> See Harry Grubert & T. Scott Newlon, *The International Implications of Consumption Tax Proposals*, 48 NAT'L TAX J. 619, 623 n.9 (1995).

<sup>269</sup> COMMITTEE ON FISCAL AFFAIRS, OECD, TRENDS IN INTERNATIONAL TAXATION 13-14 (1985).

rate taxpayer under international principles (permanent establishment).<sup>270</sup> The second is directed at the business as a nonresident that is treated as any investor, either selling or leasing property to the permanent establishment. Where lease payments would be considered sourced according to the lessor's residence, the income on the capital invested, based on the fair market value of the capital good when exported, would be allocated solely to the home. Looking first to the permanent establishment, it does not pay tax on the normal return generated by the asset because it is deducting its expenditure for lease payments. Deduction of these current expenses shifts income from the payor to the payee. The deductible payment represents the investor's return of capital and normal return on capital. Since the investor's income would not be sourced in the host, the normal return on the capital, based on the fair market value of the asset when imported, would be exempt from host country tax.

Sourcing lease payments in the host changes the previous analysis. Although the treatment of the permanent establishment would be the same, the treatment of the investor would be different. The rent payments would now be income subject to host tax. The host would normally allow the taxpayer depreciation deductions to allow for the portion of the asset used up, but if all that is allowed is economic depreciation, then the normal return on the investor's capital is fully subject to host taxation. Accelerated depreciation (in excess of economic depreciation) allowed by the host would work as a partial relinquishment of the host's traditional source tax base.

Surprisingly, the investor's sale of the asset to the permanent establishment does not cure the problem of the host's unwarranted source jurisdiction even assuming that it is not host source. From the investor's perspective, if she receives full payment, she is free of host taxation on the value of its asset, and hence, its normal return on capital. The permanent establishment, however, now pays the tax.

The permanent establishment receives income through the use of the asset, which is fully subject to host tax. If the permanent establishment only receives economic depreciation, it is being taxed on the normal return on its capital invested in the asset, which is really the return of the foreign investor who put up the capital. If the permanent establishment financed the asset acquisition, its ability to deduct the interest shifts the tax on the asset's normal return to the creditor. If the creditor was the investor, then the normal return is sourced under the traditional interest rules in the host. Thus, the difference between a sale without a host resident financing and a lease assuming the host exercises its full source taxation, is simply which aspect of the taxpayer, the investor or the permanent establishment, pays the tax. Only where the permanent establishment borrows the purchase price

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<sup>270</sup> See, e.g., OECD Model Tax Convention, *supra* note 261, Article 9(2).

from an unrelated party does the normal return on the asset escape host country taxation.

Intangible assets also represent taxpayer-owned capital or value. As such, the principles developed herein that are applicable to the taxation of capital apply equally to intangible capital. Economic efficiency dictates the same outcome. One economist, concluding that the case for residence based taxation is so compelling, has coined a special term, "Technology Export Neutrality" ("TEN").<sup>271</sup> In keeping with CEN principles, the decision to use technology at home or abroad should not be affected by tax considerations. Without equal home country taxation of the income from intangibles whether used at home or abroad, taxpayers will be driven by lower tax rates to use their intangible elsewhere.

The issue of which country is entitled to the income produced by intangible property and the appropriate source of that income may be much more controversial than in the case of capital and tangible assets. Under current principles, intangible property is treated the same as tangible, that is, where intangibles are leased or sold for an amount contingent on productivity and use, royalties are sourced where used or, indirectly, according to the residence of the lessee-purchaser.<sup>272</sup> Both the United States Model Treaty and the OECD Model Treaty reverse the effect of this rule and provide for residence-based tax of royalty income only.<sup>273</sup> The U.N. model suggests that the host country should tax royalty income only at a limited rate.<sup>274</sup>

The case for sourcing royalty income like a sale of any other asset to the residence of the seller/lessor is quite logical.<sup>275</sup> This is because the fair market value of the property at the time of the export is equal to the present value of the expected return over the life of the property.<sup>276</sup> The argument for host country taxation is based on the benefit derived by the taxpayer from the host country. The host provides the legal protection under which the intangible is being exploited.<sup>277</sup> This, of course, is only significant in the case of legally protected assets like patents and trademarks.

Once again, however, the benefit reaped by the host is disproportionate to the detriment it suffers. Along with all of the positive effects associated with the importation of capital, such as the gain in income from imported capital and the increase in employment, technology import has a spillover

<sup>271</sup> HUFBAUER, *supra* note 6, at 95-98.

<sup>272</sup> See 26 U.S.C. §§ 861(2)(4), 862 (1994). See also AMERICAN LAW INSTITUTE, *supra* note 137, at 91.

<sup>273</sup> United States Model Convention, *supra* note 261, Article 12(i), OECD Model Tax Convention, *supra* note 261, Article 12(i).

<sup>274</sup> See UNITED NATIONS, *supra* note 261, at 138-148.

<sup>275</sup> Grubert & Newlon, *supra* note 268, at 623 n.9.

<sup>276</sup> *Id.*

<sup>277</sup> AMERICAN LAW INSTITUTE, *supra* note 137, at 80.



effect that benefits others who did not incur the expenditure and develop the technology.<sup>278</sup> Successful technology, the only kind exported, typically earns amounts greatly exceeding a normal return on the capital invested in that particular asset. This gain in income and employment is the home nation's loss.

The case for exclusive home country taxation of the income produced by intangibles is even stronger than in the case of income from moneyed capital and tangible assets. Many commercial enterprises are heavy users of intangible capital.<sup>279</sup> Statisticians estimate that the value of intangible capital to business may be as high as one-third of all assets.<sup>280</sup>

Intangible capital includes not only assets like patents, trademarks and trade secrets, but also includes good will, customer service and relations, sales expertise, production, headquarters efficiencies and profits lost to establish markets, including all of the training and skills acquired by a workforce.<sup>281</sup> Many costs associated with the creation of intangible assets are expensed under most income tax systems, principally those for R&D, workforce development, education and training and advertising. Expensing, or taking a deduction for the full cost of a long-lived asset, is the equivalent of exempting from taxation all of the income produced by that asset.<sup>282</sup> Where the asset is used in the country in which it is produced, taxing the actual income generated by the intangible makes up for the immediate deduction of the costs and the government ends up even, owning zero net tax, assuming a normal return. But if income from the intangible assets is not fully taxed because the home country's tax system defers in some manner to the host country's tax system, then the home country suffers a loss and has provided a second full tax incentive to exported intangibles only.<sup>283</sup> This second tax incentive becomes a subsidy to the host, or an assignment of tax to the host, when the host taxes the intangible income.

The loss to the home is actually much larger than this simple explanation would indicate. Enterprises often invest in the development of intangible assets that prove to be short-lived or worthless. When R&D or

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<sup>278</sup> Don Fullerton & Andrew B. Lyon, *Tax Neutrality and Intangible Capital*, 2 TAX POLICY AND THE ECONOMY 1988 at 63, 66 (1988).

<sup>279</sup> *Id.* at 65.

<sup>280</sup> *Id.* at 74.

<sup>281</sup> *Id.* at 72; HUFBAUER, *supra* note 6, at 86-90.

<sup>282</sup> "If the statutory rate is constant, the marginal effective tax rate is zero on intangible capital because an immediate deduction for the outlay is equivalent in present value to exempting from tax all future income generated from the asset." Fullerton & Lyon, *supra* note 278, at 67.

<sup>283</sup> The United States system now requires that the expense for R&D be allocated between United States and foreign source income, 26 U.S.C. § 864(f) (1994). This has no relevance for host country taxation of United States enterprises, but only has relevance to the United States foreign tax credit.

advertising does not succeed, these enterprises do not earn even a normal return on their capital investment. On the other hand, when R&D succeeds, taxpayers often earn many times the normal return on their capital investments. Allowing current deductions for the cost associated with intangibles places the government in the role of a joint venturer with the taxpayer, sharing the losses through giving up tax revenues and gaining a larger tax with highly successful endeavors.

This view is the opposite of conventional wisdom on the subject.<sup>284</sup> The American Law Institute views the licensing of intangibles for contingent consideration as a joint venture between licensee and licensor, where the licensor shares in the business success of the one who uses the asset.<sup>285</sup> Though a fixed sale price for the fair market value of the asset may be difficult to determine in the case of technology, that fact does not detract from the fact that contingent prices are property market values. It is the market that establishes the contingent price as the normal return. This value was added to the world by the home's system, and only the home, which has put up its tax capital, and not the host, which puts up nothing to develop the intangible, is a joint venturer in the undertaking and is entitled to the normal return on expenditures and their value.

Exemption of the return on intangibles by the host, which is the economic equivalent of expensing the cost of producing technology, also satisfies the purpose behind CIN by providing the same stimulus to increase technology's world supply by exempting imported as well as domestic technology income. Host country taxation of technology-produced income would be economically inefficient because it would discriminatorily favor domestic technology where the host had provided any incentive to its development. Thus, host taxation of the normal income from intangibles is non-neutral and discriminatory. Host country taxation would clearly be poaching the benefit the home country has provided to the world, since the home country provided a subsidy for its development.

Thus, even under a CIN principle, what one would be recognizing is that territorially, the source of income derived from the use of a host country enterprise for capital, tangible and intangible assets, and related services or assets such as know-how or show how should be attributable to the home country as the place responsible for its creation.<sup>286</sup> It is the home country's infrastructure, laws, educational system and people that provided value to

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<sup>284</sup> See AMERICAN LAW INSTITUTE, *supra* note 137, at 80.

<sup>285</sup> *Id.*

<sup>286</sup> It should come as quite a surprise that the principle proponent of CIN in the legal community, Klaus Vogel, supports this idea fully. He stated: "Viewed under the aspects of economic efficiency, not of equity, it cannot really be doubted that the value of an immaterial good or know-how has been produced in the country of the head enterprise, and, therefore, should be taxable there, even if realized in another country." Vogel, *supra* note 184, at 320.

enterprises and fostered the creation of the factors that led to the income. The home has promoted capital formation, skill acquisition and asset and technology transfer. CIN principles are satisfied when we consider a foreign enterprise located in the host that is required to purchase or acquire all such things abroad. It is irrelevant whether that enterprise in the host country is foreign or domestic; to the extent it acquires assets from abroad, it must pay value for them. Neither the enterprise located in the host, nor the investor resident in the home states, should be taxed on the normal return on these assets.

So far, the discussion has only directly considered activity that either was between strangers or that was taxed as if it were between strangers on an arms-length basis. These principles, however, apply with equal weight to equity capital. There is no sufficient economic difference between the ordinary return on debt and the ordinary return on equity capital. Though interest income from debt already receives practical treatment close to the ideal suggested herein, that is deductible by the user in the host and tax exempt or nearly exempt for the nonresident owner, equity investments do not receive such practical treatment. Under general principles, the return on equity is not deductible by the business user. This includes the normal return on invested capital, whether cash or the fair market value of tangible and intangible assets imported to the host and contributed to the activity.

As previously stated, economic depreciation allowed by the host simply provides for a recovery of the capital investment but assigns all income to the host. This assumes that economic depreciation would be based on the fair market value of the property when imported.<sup>287</sup> Were the depreciation based on less, the host taxes an amount of income that exceeds the amount of income that could even arguably be determined as having been earned in the host. Also, where the enterprise is in corporate form, repatriated earnings in the form of dividends paid to nonresidents are often subject to withholding taxes in the host country (though such taxes are often substantially reduced by treaty).

Capital Gains on the sale of the business may be exempt, however. Such taxation of corporations preserves classical economic double taxation of corporate income even in those countries that have adopted integrated corporate shareholder systems for their own residents. Not only is the normal return on capital taxed twice, but both taxes are assigned to the host.

As demonstrated, the normal return on capital belongs to the home's tax base. Taxpayers, therefore, should receive a deduction for a reasonable return on equity obtained from nonresidents. This could be accomplished

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<sup>287</sup> In the United States, for example, basis (tax cost) for depreciation of imported assets is limited to historic cost. See Rev. Rul. 55-62, 1955-1 C.B. 212 (1955). This could distort the allocation of income between home and host United States depending on whether the United States allowed accelerated depreciation. See generally, Keith Engle, *Importing Assets into Domestic Taxing Jurisdiction: Learning from Canada*, 52 TAX LAWYER 275 (1999).

by treating cash equity as debt, and all assets, tangible and intangible, as having been sold fully financed at their fair market value. Market interest, deductible by the enterprise and exempt to the nonresident owner, would be imputed to all capital. Alternatively, all assets could be treated as having been leased, with the lease payments deductible to the user and exempt to the non-resident owner.

In the case of a corporation, dividends, like interest, should be home country source and exempt from host taxation. Thus, the normal return on equity capital would be properly assigned away from the host to the home country. The home country can tax the normal return on equity capital without providing a foreign tax credit. Were market interest instead imputed to equity capital, the home could tax such currently.

What remains to the enterprise after deducting the normal return on the income from these imported factor inputs is the income that is truly derived in the host. This remaining income is produced by the factors associated with the host country: its infrastructure, its skilled labor force and its capital or other assets. Such income reflects the earnings on the value that the host has added to the world. All contributions by the home have been accounted for. What is left is economic rent, the income in excess of the costs and the normal return on all assets. This economic rent is site-specific and must be allocated to the host. As such, meritorious taxation belongs to the host exclusively.

Conferring exclusive jurisdiction to the host over economic rents satisfies fully the purpose behind CEN and CIN. The decision to use capital in any form, whether at home or abroad, is unaffected by tax because the normal return on the capital is taxed at home country rates. Capital is attracted to the host, not because of its tax structure, but because of the greater return on the investment. Capital finds its most profitable use that is economically efficient. A greater return is found in the host because of the benefits it provides to investment.

Equity, therefore, assigns the tax to the host due to its worthiness. This system promotes sovereignty and self-determination as to tax policy. The host may choose whether or not to tax and, if so, how much. The host derives the benefit or suffers the consequence of its choices. If the host's tax rate is lower than the home country or the norm among nations, the host has given up revenue on the value its system has added in exchange for lower prices for its residents and the rest of the world. If the host taxes more heavily, it has increased the price of goods for the benefit of higher taxes and increased public benefits. Vis-à-vis the rest of the world, this is economically efficient. The host poaches on no other nation's tax base, nor is it permitted to steal excess tax from the home through the operation of the foreign tax credit mechanism. Not only do we achieve inter-nation fairness,

but also achieve taxpayer fairness since source and resident-based tax no longer conflict.<sup>288</sup>

There is a tension between the principles of residence taxation based on ability to pay and the non-taxation by a home state of economic rents earned in a host state. Home state's clearly appropriate goal of including foreign-sourced economic rent in its tax base to protect the integrity of progressive principles should be recognized for its detrimental effect, true poaching on the host's tax base.<sup>289</sup> If resident states resolve this issue in favor of worldwide taxation, it should, at the least, provide a foreign tax credit for this income only.

### C. Source Taxation: A Consumption Tax Model

The allocation of the tax base on the basis of merit postulates that a source nation's right to tax an activity is related to the economic value that can be said to be created by a taxpayer attributable to that state's system. In other words, it is the value added by an activity that can fairly be said to be contributed to the world by a nation that is within the appropriate tax base of that nation.

The use of a consumption tax term is not happenstance. What economics and equity confirm is that the portion of the income tax base that is appropriate for source taxation is consumption. That is so because once one has removed the normal return of capital from the tax base, what one has left is consumption.<sup>290</sup> It is not suggested that host nations are limited to product taxes like sales or value added tax, but that host nations can use broad-based expenditure or business consumption taxes, sometimes referred to as cash flow taxes.

The suggestion that a broad-based consumption tax is the appropriate tax structure for international business income is not new. Indeed, several have ably set forth its value and the basic principles under which it would operate.<sup>291</sup>

Past discourse concerning the consumption tax for international business, however, has assumed the premise that consumption taxation would

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<sup>288</sup> There may still be conflicts between different nations of resident taxation, but any of these today have been resolved by treaty.

<sup>289</sup> Several nations maintain progressive principles often referred to as exclusion with progression by including excluded foreign income in the tax base only for calculations. See Vogel, *supra* note 240, at 218.

<sup>290</sup> See HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (University of Chicago Press 1938).

<sup>291</sup> See, e.g., Charles E. McClure, Jr., *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm*, 45 NAT'L TAX J. 145, 145 (1992).

replace income taxation entirely as the international norm.<sup>292</sup> Whatever the merits of such a proposal, it is not this author's object to reconcile nations' different claims to income taxation by abolishing it. Instead, assuming the continued reliance on income taxation, the question is, how can one resolve the conflicting claims to this base? Unlike the view that consumption tax is the most equitable basis of taxation for source taxation in a world where consumption tax is the norm,<sup>293</sup> the conclusion of this analysis is that consumption tax is the most equitable and jurisdictionally appropriate income tax for source countries in a world adopting income taxation as the norm.<sup>294</sup>

In general, the object of a business consumption tax is to tax the economic rents accruing to a business venture.<sup>295</sup> An economic rent is the return on investment that is over and above the normal rate of return on investment. This would be the income left after accounting for all costs, including the return on all factor inputs.

There are several ways a consumption tax may be designed, and the Meade Commission carried out much of the work.<sup>296</sup> The basic R-type model starts with a comprehensive income tax base and allows immediate deductions for the costs of all materials, labor and fixed assets. Under the R base, the recipient of interest and dividends is not taxed, whereas the payor is not entitled to a deduction.<sup>297</sup> The modified R & F type changes the treatment of financial instruments. Loans (and equity) are deductible by the creditor and included in the income of the debtor, and repayments are income to the creditor and deductible by the debtor.<sup>298</sup> In both an R and an R + F system, flows of equity are ignored and are treated just as loans are in an R system, meaning that dividends are not deductible. Thus, an advantage of consumption tax systems is that all capital is treated equally; there should be no critical difference between the treatment of inflows and outflows of debt or equity and their returns.

Though economically equivalent for most enterprises, there are differences in the actual results. Where the principle activity is banking, or an activity in which the object is the income from the different returns on borrowing and lending, then the R & F system, which treats interest re-

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<sup>292</sup> *Id.* See Grubert & Newlon, *supra* note 268; see also Peggy B. Musgrave, *Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm*, 45 NAT'L TAX J. 179, 182 (1992).

<sup>293</sup> McClure, *supra* note 291, at 149.

<sup>294</sup> McClure did not address the problem of whether source or resident nations had the right to tax capital income, stating, "Whether the normal return to capital should be taxed, if at all, by countries of residence or by countries of source is less clear. Under consumption-based taxes, these returns are not taxed at all." *Id.*

<sup>295</sup> *Id.* at 145.

<sup>296</sup> The Structure and Reform of Direct Taxation, Report of a Committee Chaired by Professor J.E. Meade; The Institute for Fiscal Studies (1978).

<sup>297</sup> *Id.* at 230-31.

<sup>298</sup> *Id.* at 233.

ceived as income and interest paid as deductible, captures this difference. Since this difference is more attributable to services than the return on capital, it is an appropriate amount for a consumption tax base. For non-financial intermediates, either the R or R + F type captures economic rents.

An expenditure tax system does not tax the normal returns from capital because the deduction of all capital expenditures is the economic equivalent of exempting the normal return from capital. Thus, an expenditure tax system taxes the super normal returns of an activity in the host. This makes practical sense as the tax captures the host's appropriate source tax base and is likely to result in substantial revenue because businesses locating in foreign states will be rent seekers expecting to earn appreciable economic rents.

Thus, expenditure tax systems duplicate an income tax system that allows deductions for the costs of all factor inputs that are current expenses and the normal return on all factor inputs that are capital expenditures. This is because expenditure taxes remove the income from these factor inputs from the activity located in the host, leaving only economic rent subject to source tax. Where the enterprise is treated as a separate entity or corporation, the expenditure tax shifts the income from these factor imports to the investor whether that person is foreign or domestic. Where the owner of that input is a domestic person, as it would be if the foreign enterprise sought debt or equity capital in the local market, the host nation would be free to tax that return under its own income tax system. Where the owner of that input is a foreign person, then the investor should normally be exempt from taxation. The exemption of the income from the capital of the investor is equivalent to an expenditure tax system. Indeed, it is an R-based system under another name. The R system is preferable to an R + F system because it is simpler and easy to administer, and is also fairer to the taxpayer engaged in new investments in a country due to time use of money concerns.

#### D. Tax Competition Under the Principles of Optimal Taxation

In one sense, CEN and CIN are not helpful concepts in analyzing tax havens because CIN and CEN are theories for the proper allocation of capital, and havens and other conduit regimes do not affect the real allocation of capital worldwide, though they may facilitate its flow.<sup>299</sup> Present sourcing rules, however, have encouraged the nominal location of capital in low-tax regimes. Optimal taxation, however, changes the analysis of tax competition dramatically.

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<sup>299</sup> TANZI, *supra* note 1, at 137.

The tax-induced activity of OFCs and of regimes offering inducements to conduit activities do little to add to the world's store of value.<sup>300</sup> Yet under the systems of international tax in place today, an inordinate amount of income is allocated to these countries. As long as that is the case, tax competition and havens will thrive at the expense of value exporters. Applying optimal international tax principles, the only base for source taxation should be value-added. Thus, host regimes that do not tax the income of non-residents from capital in all of its forms are not in error because they are simply foregoing a tax base that they really are not entitled to. Neither havens nor any other host country has a meritorious case for the taxation of non-resident capital income.

Countries are only entitled to the taxation of economic rent generated by foreign enterprises. Limiting the taxation of OFC financial activity and conduit activities solely to economic rents would probably leave little, if anything, in OFCs' tax base. Thus, the little income tax that OFCs collect may be greatly disproportionate to that which they are really entitled to. The problem is not that OFCs tax insufficiently, but that some likely tax too much, and capital-exporting countries, through the foreign tax credit, subsidize such tax on TNCs and FPI.<sup>301</sup>

The problem of tax competition has another dimension. The preferences just discussed deal with the nominal as opposed to the real location of significant economic activity. Some providers of physical activity requiring the use of capital, as in the case of manufacturing or service providers may locate in a country with tax rates lower than the home state.

The effect of this under optimal international tax is as follows. Taxation of the income from all exported factors of production would belong to the home state; only economic rent would be subject to the host's jurisdiction. Were conditions such that the host provided an enhanced opportunity for a greater return than the home country, the factors of production would flow there whether or not the rates of tax were lower. Thus, the lower rates work to the advantage of the enterprise and, thus, to the advantage of the capital owners in the home state.

Where economic rents could not be earned in the host by the home enterprise, it would simply not invest there. This is unlike the world today where lower tax rates inefficiently entice the home's capital abroad.

Tax competition could still be a factor even under optimal international tax in the case of hosts vying for highly mobile activities, like distribution

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<sup>300</sup> Normally, hosts benefit from imported capital with an increase in income from that capital. See text at note 195, *supra*. In many cases, havens only benefit from an increase in the income from labor. That is due to the fact that the capital is on its way to some place else, oftentimes, back to the place where it began.

<sup>301</sup> A small tax on capital by tax havens is workable where the income is effectively taxed by home jurisdictions allowing a foreign tax credit. It is not practical where home countries use an exemption method because capital from these countries will seek out no tax regimes.



centers, coordination centers and R & D centers which may require a substantial presence in a host country. If one assumes that more than one suitable location offers similar opportunities to earn economic rents, then tax competition would determine which country becomes the situs.<sup>302</sup>

This is not a terribly significant problem when compared with the problem of tax competition today, which shifts the capital income tax base. Moreover, by definition, nations will be attracting physical activities that may impose burdens more in line with the benefits foreign investments bring. Significant investment will affect one or all of the following: it will increase the value of the currency, increase the amount of imports and exports, and increase the cost of labor.<sup>303</sup> These effects can change the competitive position of the host over time. Either nations will not perceive the tradeoff as worth it and not engage in tax competition, or tax competition will tend to drive down the tax rates on these activities to zero.<sup>304</sup> Thus, though optimal international taxation does not completely eliminate tax competition, it drastically reduces its effect. Only tax harmonization or totally effective residence-based taxation can completely eliminate the effects of tax competition.

## VI. CONCLUSION

Optimal international tax is source taxation, but source reinterpreted according to the principle of the place where the income-producing value originates. Only the home has the right to tax income from capital and the factors of production attributable to its residents. Though this sounds like resident-based tax, it is actually redesigned source-based tax. The concept of residence is only relevant as an indirect method of finding the value's origin. Moreover, the effect is not strictly that of resident-based tax because the host nation has the exclusive right to tax economic rents.

Optimally, the home country could tax income sourced within that country, which would include exported factor income worldwide. It would not provide a foreign tax credit as under resident tax principles because the home would not need to defer to the source; it is the source. Eliminating the foreign tax credit and taxing only capital income in all of its forms would eliminate considerable expense and complexity.

The host nation should limit its income taxation to economic rents, allowing a deduction for the normal return on all imported factor inputs. As has been shown, this is equivalent to a business expenditure or consumption tax. The implementation of an expenditure tax for host nations would greatly simplify international taxation.

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<sup>302</sup> For this reason, Hufbauer advocates that nations should provide favorable tax regimes for headquarter's activities of TNCs. See HUFBAUER, *supra* note 6, at 135.

<sup>303</sup> See *supra* text accompanying notes 97-98.

<sup>304</sup> See *supra* text accompanying note 133.

Nations may not necessarily comply with these conditions, but other nations should not subsidize the offending nation. Thus, where a host nation chooses to go beyond taxation of economic rents, the home nation will not provide a foreign tax credit or exemption system and the effect of such a tax will ultimately be born by the host economy.<sup>305</sup>

It is important to note that properly assigning tax jurisdiction between countries does not require an actual exercise of that jurisdiction by host or home. Indeed, what equitable allocation results in is the empowerment of each nation with respect to its proper tax base, freeing it to make the decision that is best for that country. Should a home country choose not to tax capital income, that decision belongs to it and it alone. Foregoing tax on capital income would not create any inefficiencies worldwide because whether capital is taxed or not, tax has been removed as a factor as to whether capital should be invested at home or abroad, or whether business activity will take place at home or abroad. The decision to use capital, technology or any other value abroad will be made on the basis of whether the foreign system provides an advantage due to its natural endowments, good government, abundant resources, or skilled and efficient labor. It has been said that tax competition disappears with resident-based tax.<sup>306</sup> Tax competition also wanes with equitable source-based tax of capital income by the resident country.

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<sup>305</sup> This is only precisely true for new investment, which, as long as the investor is informed about the tax, she will pass its incidence on to the borrower. Old investment, unless the possibility of the new tax was anticipated, will lose. See League of Nations, Report on Double Taxation, *supra* note 148, at 7.

<sup>306</sup> See Wilson, *supra* note 55, at 282.

