ENDING THE TAXATION OF FOREIGN BUSINESS INCOME

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From the inception of the income tax, there has been a debate[1] about the best way to tax foreign-source income.[2] While there are innumerable variations in this debate, the participants can be divided into two major camps: those who favor taxation by the country of residence of the taxpayer[3] (sometimes referred to as a "worldwide" system), and others who believe income should only be taxed in the source country[4] (sometimes referred to as a "territorial" or an "exemption" system). The member nations of the Organization for Economic Co-operation and Development are evenly divided between the two systems.[5] Because the United

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1. For a history of this debate, see PETER HARRIS, CORPORATE/SHAREHOLDER INCOME TAXATION AND ALLOCATING TAXING RIGHTS BETWEEN COUNTRIES 72–88 (1996); *see also* Joel Slemrod, *The Taxation of Foreign Direct Investment: Operational and Policy Perspectives* 11–38, *in* BORDERLINE CASE: INTERNATIONAL TAX POLICY, CORPORATE RESEARCH AND DEVELOPMENT AND INVESTMENT (James M. Poterba ed., 1999); Klaus Vogel, *World-Wide vs. Source Taxation of Income—A Review and Reevaluation of Arguments, in* INFLUENCE OF TAX DIFFERENTIALS ON INTERNATIONAL COMPETITIVENESS 117–66 (Charles McLure et al. eds., 1990).

2. Foreign-source income is income that is generated from activities conducted outside of the U.S. *See* Terrence Chorvat, *Taxing International Corporate Income Efficiently*, 52 TAX L. REV. 225, 227 (2000).

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

4. The "source" country is the country in which the activities that generated the income occurred. *See id.* at 227.

5. National Foreign Trade Council, THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY, PART ONE: A RECONSIDERATION OF SUBPART F 57, Table 6-1 (1999) [hereinafter "NFTC"]. Some countries exempt active foreign source income by statute (such as the Netherlands and France), others by treaty

States taxes the worldwide income of U.S. persons,[6] the U.S. system is in form a worldwide system.[7] However, most of the important trading partners of the United States have adopted territorial systems.[8]

This Article will demonstrate that when compared with an exemption system the current U.S. system discriminates against immature businesses and creates economic distortions for all U.S. multinationals. Furthermore, a great benefit of an exemption system is that it is simpler and cheaper.[9] Therefore, this Article proposes that the United States adopt a form of exemption system. However, some of the elements of the current system should be retained: the United States should continue to tax passive foreign source income, and certain anti-abuse rules should remain in place.[10]

While the debate over whether a worldwide or an exemption system is superior is an old one,[11] it is very much of current interest as well. On March 25, 1999, the National Foreign Trade Council issued a widely read and controversial report, which set forth a case for reducing the U.S. taxation of foreign source income.[12] This report was jointly released by Congressman William Archer, the Chairman of the House Ways and Means Committee.[13] It also received positive comments from William Roth, the Chairman of the Senate Finance Committee.[14] Both the Senate Finance Committee and the House Ways and Means Committee have held hearings and introduced legislation consistent with the report's conclusions.[15] Furthermore, there have been some widely read recent studies in the

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(such as Canada and Germany). *See* HUGH J. AULT, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 402–406 (1997).

6. A U.S. person is any person (corporation or individual) who is subject to income tax in the U.S. on a residence basis. This includes all corporations incorporated in one of the 50 states or the District of Columbia. For individuals, it includes all citizens and permanent residents, as well as those who reside here for most of the taxable year. *See* Internal Revenue Code ("I.R.C.") § 7701(a)(1), (4), (30) (1994).

7. For a discussion of the U.S. system, see *infra* Part I.C.

8. This includes, for example, Canada, The Netherlands, France, and Germany. *See* AULT, *supra* note 5, at 402–06. However, Japan and the United Kingdom have worldwide credit systems. *See* AULT, *supra* note 5, at 385–88.

9. *See* Reuven Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplificaton*, 74 TEX. L. REV. 1301, 1354–55 (1996); Harry Grubert & John Mutti, *"Taxing Multinationals in a World with Portfolio Flows and R&D: Is Capital Export Neutrality Obsolete?* 2 INT'L TAX AND PUBLIC FINANCE 439 (1995).

10. *See infra* Section IV.B.

11. *See* HARRIS, *supra* note 1, at 75; Vogel, *supra* note 1, at 118.

12. *See* NFTC, *supra* note 5, at 53.

13. *See Archer Joins NFTC in Releasing Council's Subpart F Report*, 1999 TNT 58-5, March 25, 1999, *available in* LEXIS, Fedtax library, TNT file.

14. *See U.S. Congressman Roth Applauds NFTC's Subpart F Report*, 1999 TNT 58-39, March 25, 1999, *available in* LEXIS, Fedtax library, TNT file.

15. On June 24 and 30, 1999, the House Ways and Means Committee held hearings discussing the NFTC report and the U.S. international tax system. *See* 1999 TNT 118-108, 1999 TNT 126-52, *available in* LEXIS, Fedtax library, TNT file. Former Chairman Archer stated that the U.S. international tax rules are antiquated, "unbelievably complex," and put U.S. businesses at a competitive disadvantage. *See* Ryan Donmeyer, *Will*

area. For example, one highly cited study by Gary Hufbauer[16] argued for an exemption system for foreign source income of businesses.[17]

Those arguing in favor of adopting an exemption system have done so almost entirely on grounds of increasing the "competitiveness" of U.S. firms.[18] They argue that because our major trading partners have adopted exemption systems and their firms are not subject to tax on a worldwide basis, U.S. firms are at a competitive disadvantage.[19]

This Article adds to the debate in three ways. First, it makes the case for the exemption system purely on grounds of enhancing worldwide economic efficiency.[20] That is, the Article looks to whether the policies at issue increase worldwide income, as opposed to "competitiveness," which only looks to increasing the profits of U.S. firms.[21] The key to the analysis of efficiency is resource allocation.[22] In general, the taxation of capital income is efficient to the extent that it does not alter the allocation of resources.[23] Under this analysis, the

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Congress Have Time, Stomach to Reform International Provisions, 85 TAX NOTES 1487 (Dec. 20, 1999).

On March 11, 1999, the Senate Finance Committee held hearings on the U.S. international tax system. In these hearings, Senator Roth stated, "[T]o stay at the cutting edge of this dynamic and promising international economy, we need to fundamentally rethink our tax code with a view to enhancing American competitiveness." *Unofficial Transcript of Finance Hearing on International Tax Laws*, 1999 TNT 50–54.

The proposed legislation includes the Houghton Bill to simplify international taxation, H.R. 2018, 105th Cong. (1999) (TNT 1999-2132, proposed June 21, 1999) and the Breaux-Mack Bill, S. 572, 106th Cong. (1999).

16. *See generally* GARY CLYDE HUFBAUER, U.S. TAXATION OF INTERNATIONAL INCOME: BLUEPRINT FOR REFORM (1992).

17. In addition, at the 1999 annual meeting of the National Tax Association, two economists, Harry Grubert and John Mutti, proposed adopting an exemption system along the lines set forth in this article. *See* HARRY GRUBERT & JOHN MUTTI, DIVIDEND EXEMPTION VERSUS THE CURRENT SYSTEM FOR TAXING FOREIGN BUSINESS INCOME (unpublished manuscript, on file with the Author).

18. *See generally, e.g.*, NFTC REPORT, *supra* note 5.

19. *See generally* NFTC REPORT, *supra* note 5.

20. This Article analyzes the question of whether the exemption system would be better than the current system of a partial foreign tax credit with deferral. It concludes that the exemption system is an improvement over what we have. The Author does not attempt to compare the exemption system to a pure system without deferral. Clearly however, some of what is said in the Article bears on that question.

21. *See* Chorvat, *supra* note 2, at 235; Vogel, *supra* note 1, at 118.

22. *See* HARVEY S. ROSEN, PUBLIC FINANCE 44–49 (5th ed. 1998).

23. When taxes do not distort the placement of capital, it is thought that this promotes economic efficiency. *See generally*, PEGGY MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME: ISSUES AND ARGUMENT (1969); Thomas Horst, *A Note on the Optimal Taxation of International Investment Income*, 93 QUART. J. ECON. 793 (1980). The arguments in Parts II and III *infra*, in favor of the exemption system focus on the allocation of capital amongst multinational enterprises ("MNEs"). That is, the tax system should be such that investors do not have an incentive to invest in an MNE based in the U.S. as opposed to an MNE based in another country. *See* Daniel Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, TAX NOTES 581, 585 (April

tax system should not determine which investments are undertaken. This Article will show that the exemption system would improve worldwide economic efficiency as compared to the current U.S. system. The second contribution to the debate is the discussion of some recent developments in economic theory which have been subsequently confirmed by empirical research. These findings, which have not yet been applied to this debate,[24] show that an exemption system would increase efficiency as compared to the current system. Third, the Article discusses how the current system distorts international mergers and acquisitions in a way that the exemption system would not. The Article also analyzes the other important efficiency arguments concerning the exemption system.

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

I. FUNDAMENTAL CONCEPTS OF INTERNATIONAL TAXATION

Any income which arises from cross-border transactions is potentially subject to tax in two or more jurisdictions: the residence country and the source country. Under the current international tax system,[25] it is generally left to the residence country to alleviate double taxation.[26] There are two common methods of alleviating double taxation.[27] The first is the "worldwide" or "credit" method in

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1992). The literature on the optimal tax system for international income is extensive. *See* RICHARD CAVES, MULTINATIONAL ENTERPRISE AND ECONOMIC ANALYSIS 189–213 (2d. ed. 1996); Vogel, *supra* note 1, at 118. The proposition that economic efficiency is achieved when taxes do not distort decisions is known as the fundamental theorem of welfare economics. For a discussion of this theorem, *see* ROSEN, *supra* note 22, at 44–49.

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

25. *See* HARRIS, *supra* note 1, at 20–30; *see also generally* Reuven Avi-Yonah, Commentary to *International Tax Arbitrage and the "International Tax System,"* 53 TAX L. REV. 167 (2000).

26. Double taxation is highly inefficient. If foreign investment is subject to two layers of tax, while domestic investment is subject to only one, the tax system would significantly discourage investment in foreign countries. *See* CAVES, *supra* note 23, at 190.

27. An additional approach for dealing with foreign taxes is to allow them to be deducted from taxable income. This method is rarely used for income taxes. This does not eliminate double taxation, rather it simply reduces it. Both countries still tax the income.

which the residence country taxes foreign source income but provides a credit for taxes paid to foreign jurisdictions.[28] The second is the "exemption" method under which the residence country cedes all taxing jurisdiction to the source country.[29] Section A of Part I discusses the worldwide system. Section B discusses the exemption system. Section C concludes Part I by discussing the U.S. system, which is nominally a worldwide system, but which diverges from that system in some important ways.

A. Worldwide System

The United States currently uses a form of a worldwide taxation system.[30] Under a worldwide system, a country taxes all the income of its residents, no matter where they earn it.[31] In order to alleviate potential double taxation, the residence country generally permits its taxpayers a foreign tax credit for income taxes paid on income earned in foreign jurisdictions.[32] Under this system, the income earned by a multinational enterprise[33] ("MNE") in a low-tax country will be taxed at least at the residence country's rates.[34]

To illustrate, assume that A, a U.S. MNE, earned $100 in Hong Kong and $100 in the United States. Hong Kong will tax the $100 of income earned within its borders at a rate of 17%. The United States will tax A's worldwide income of $200 at a rate of 35%. However, because of the foreign tax credit, A will only have to pay an additional U.S. tax of $53, rather than $70.[35] Because the total amount of tax A will pay is $70,[36] the Hong Kong income and the U.S. source income are both subject to a total tax rate of 35%, which is the rate A would have paid if all the income had been earned in the United States.

Almost all of the countries that use a worldwide system impose a limitation on the foreign tax credit.[37] The foreign tax credit limit is generally equal

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The total tax paid is higher than the tax rate in either country. *See* HARRIS, *supra* note 1, at 320.

28. *See infra* Part I.A.

29. *See infra* Part I.B.

30. Under I.R.C. §§ 1, 11, and 61, foreign source income is subject to tax. Under § 901, this income is eligible for a foreign tax credit. *See* I.R.C. §§ 1, 11, 61, 901 (2000).

31. *See* AULT, *supra* note 5, at 381.

32. *See* AULT, *supra* note 5, at 381.

33. An MNE is defined here as an enterprise that controls and manages business activities in at least two countries. *See* CAVES, *supra* note 23, at 1.

34. *See* AULT, *supra* note 5, at 381; *see also infra* notes 35 and 36 and accompanying text.

35. If the Hong Kong income is earned directly by A, it will be taxable income to A under I.R.C. § 61. *See* I.R.C. § 61 (2000). If A's tax rate is 35%, A's tentative U.S. tax will be $70 (200 X .35). This will be reduced by a $17 credit permitted under I.R.C. § 901. A will then owe $53 (70 - 17) in U.S. tax.

36. Fifty-three dollars to the U.S. and $17 to Hong Kong.

37. For example, this is the case in the United Kingdom, Australia, and Norway. *See* AULT, *supra* note 5, at 388–91; Slemrod, *supra* note 1, at 34–35.

to the amount of residence country tax on foreign source income.[38] The foreign tax credit limit ensures that the tax rate applicable to foreign source income is the higher of the residence country rate or the source country rate.

To illustrate how this occurs, assume that A also operates in Italy where the tax rate is 56%. If A earns $100 in Italy, this income will be subject to $56 of Italian tax. The Italian source income will also be subject to tax in the United States at a 35% rate, but A will receive a tax credit for the taxes paid to Italy.[39] Because the Italian rate of tax is greater than the U.S. rate of tax, A will not pay any tax on this income in the United States. However, because the credit is limited to $35 (the amount of U.S. tax on the Italian income), the total tax rate on this income is the higher Italian rate of 56%.[40]

B. Exemption System

Under an exemption or territorial system, foreign source income generally is not subject to tax in the residence country.[41] The residence country only taxes income earned within its borders.[42] To illustrate, assume that N is a Dutch MNE, and N has a subsidiary in Hong Kong. N earns $100 in the Netherlands, and the subsidiary earns $100 in Hong Kong. The Netherlands has an exemption system[43] and a 35% corporate rate on income earned in the Netherlands.[44] N will pay $17 in tax to Hong Kong, and will only pay tax in the Netherlands on its Dutch source income. N will not pay any tax in the Netherlands on the Hong Kong source income. Therefore, N will have to pay less in total worldwide tax than A ($52 for N versus $70 for A).[45] If N had an Italian subsidiary, its income would also be subject to a tax rate of 56%.[46] Thus if A and N both have operations in the same high-tax jurisdiction, A and N will be taxed alike on this income.

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38. I.R.C. § 904 (2000). For the United Kingdom rules, see AULT, *supra* note 5, at 385–91. These limits prevent the worldwide system from achieving full tax neutrality between investments. *See* CAVES, *supra* note 23, at 191.

39. A will receive a foreign tax credit of $56, while the U.S. tax on the income is only $35 dollars. Therefore, A will owe no further U.S. tax.

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

41. *See* AULT, *supra* note 5, at 381.

42. *See* AULT, *supra* note 5, at 381.

43. *See* AULT, *supra* note 5, at 384–85.

44. *See id.* at 87.

45. Fifty-two dollars = $17 + $35. And, A paid tax a rate of 35% on 200%, or $70.

46. Under a worldwide system, the higher of the source country rate or the residence country rate applies. *See supra* Part I.A. Therefore, if the tax rate in the source country is higher than in the residence country, under both a worldwide system and a territorial system the higher source country rate applies.

Most exemption systems tax the passive foreign-source income of their residents, because passive income is viewed as having no natural location.[47] For example, someone who owns shares of IBM will obtain the same pre-tax benefits whether he resides in the United States, Bermuda, or Australia. As a result, an MNE will have an incentive to shift its passive income to the lowest taxed location. Because this shifting has no economic substance,[48] it is viewed as an abuse of the system, and therefore many exemption systems subject foreign source passive income to tax in the residence country.[49]

C. The U.S. System

It is often said that the U.S. international tax rules are based on a worldwide system.[50] To some extent this is true. Income earned by foreign branches[51] of U.S. corporations is taxed when it is earned abroad. Dividends, interest, rents, royalties, and similar kinds of income received by U.S. persons are also subject to U.S. income tax.[52] In addition, income taxes paid to a foreign jurisdiction are eligible for the foreign tax credit.[53]

However, the United States does not have a pure worldwide system. The largest deviation from the worldwide model is the taxation of income earned by foreign subsidiaries of U.S. MNEs. If foreign source income is earned by a foreign subsidiary of the U.S. MNE, then the income is generally not taxed until it is repatriated to the United States.[54] The income tax on repatriated earnings is sometimes referred to as the "repatriation tax."[55] As discussed in Part II.B, the repatriation tax causes the economic effects of the U.S. system to approximate those of an exemption system.

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47. For this purpose, passive income includes such items as dividends, interest, and royalties not received from affiliates. The Netherlands, France, and Canada tax these types of income. *See* AULT, *supra* note 5, at 403–06.

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

49. *See* AULT, *supra* note 5, at 411–13; NFTC, *supra* note 5, at 156.

50. *See* AULT, *supra* note5, at 411–13.

51. A foreign branch is a direct operation of a U.S. corporation in a foreign country. A foreign subsidiary is a foreign corporation which is owned by a U.S. corporation. If the MNE chooses a foreign subsidiary, it must form a foreign corporation to conduct the business. If it chooses a branch, it conducts the business in the foreign jurisdiction itself. *See* Slemrod, *supra* note 1, at 12–13.

52. *See* I.R.C. § 61 (1994).

53. *See* I.R.C. § 901 (1994).

54. This complicates the determination of the effective rate of tax. *See* Chorvat, *supra* note 2, at 245, for a discussion of the effect of deferral. The effects of this are examined in Section III *infra*.

55. If the foreign rate is less than the U.S. rate, this tax is equal to U.S. tax rate minus the foreign tax rate. *See* CAVES, *supra* note 23, at 92. If the foreign tax rate equals or exceeds the U.S. tax rate, there is no repatriation tax.

There are some important additional complications to the U.S. system. One set of rules of particular concern are the anti-deferral provisions, found in subpart F of subchapter N of the Internal Revenue Code.[56] These rules cause certain types of income earned by controlled foreign corporations[57] to be included in the taxable income of the U.S. parent in the year earned by foreign corporations, even though that income has not yet been repatriated back to the U.S. parent. As discussed in Part IV, these rules exist to ensure that U.S. source income is taxed in the United States.[58]

II. THE TRADITIONAL EFFICIENCY ARGUMENT AGAINST THE EXEMPTION SYSTEM AND HOW ECONOMIC THEORY AND EMPIRICAL RESEARCH REFUTE IT

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

The principal argument against the exemption system[59] is that it distorts the decision of where to invest capital.[60] Because owners of capital will invest wherever they can receive the highest after-tax return, they will have an incentive to place investments in the lowest tax jurisdiction. The opponents of the exemption system argue that this would result in investment leaving the United States.[61] Because this incentive is created by the tax system, the tax system is inefficient. This is sometimes known as the "runaway plant" argument, because under this analysis, if the United States adopted the exemption system, many manufacturing plants currently located in the United States would be relocated to low-tax jurisdictions.[62]

To illustrate, assume U.S. person A has $1000 to invest and has two possible investments: one in the United States and one in Country X. The U.S. investment will give a pre-tax return of $100, while the foreign investment will give a pre-tax return of $90. In the absence of a tax on the income from these investments, A would choose the U.S. investment, because it has a larger return.

56. *See* I.R.C. §§ 951–963 (1994).

57. *See* I.R.C. § 957(a) (1994). A controlled foreign corporation is a foreign corporation of which more than 50% of its shares are owned by U.S. shareholders. A U.S. shareholder is defined as a U.S. person who owns 10% or more of the voting stock of the foreign corporation. *See* I.R.C. § 951(b) (1994).

58. *See infra* discussion Part IV.B.

59. The other major argument against an exemption system is that it would cost too much in tax revenue. This was conclusively dealt with in Grubert & Mutti, *supra* note 9, at 505, which showed that the loss of tax revenue would be rather small and might possibly result in a revenue gain.

60. *See* Avi-Yonah, *supra* note 9, at 1353; Grubert & Mutti, *supra* note 9, at 500; Robert Peroni, et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455, 457 (1999).

61. *See* CHARLES KINGSON, INTERNATIONAL TAXATION 451–52 (1988); Peter Merrill & Carol Dunahoo, *Runaway Plant Legislation: Rhetoric and Reality*, TAX NOTES 221 (July 8, 1996).

62. *See* KINGSON, *supra* note 61, at 451–52.

However, if the income is subject to tax in the source country (and only the source country) and the tax rate in Country X is 10% and the U.S. tax rate is 35%, A will invest in Country X, because that investment has a higher after-tax return.[63] Because the tax system has distorted the investment decision, it has reduced worldwide production by $10 (from $100 to $90).

The opponents of the exemption system argue that the current U.S. system prevents this distortion by ensuring that the tax rate on any investment is never less than the U.S. tax rate.[64] In the above example, if A had been subject to tax on his worldwide income at a 35% rate, A would have invested in the United States. Therefore, worldwide production would have remained at $100.

B. Economic Theory and Evidence Contradicts This Argument

The major oversight of this argument is that it neglects the fact that the U.S. tax system generally does not tax active foreign income until it is repatriated to the United States.[65] Two seminal articles, one by David Hartman[66] and the other by Hans Werner Sinn,[67] each demonstrate that if the residence country defers taxation on foreign source income until it is repatriated, the foreign subsidiary will retain income [68] until at equilibrium[69] the size of the foreign enterprise is equal to the size it would have been under an exemption system.[70] Therefore, at

63. The Country X investment would give an after-tax return of $81 ($90 (1 - .1)), versus the U.S. investment which would give a return of $65 ($100 (1 - .35)).

64. *See supra* discussion Part I. The system still does not result in complete neutrality because of the foreign tax credit limit. Because of this limit, an investor will still prefer a U.S. investment over a higher producing investment in a country with taxes higher than the U.S.

65. There are some provisions which cause active income of foreign subsidiaries to be taxed to the U.S. parent immediately (*see infra* discussion in Part IV), but their effect is more to ensure U.S. source income is taxed in the U.S. *See* Grubert & Mutti, *supra* note 9, at 500; Peroni, *supra* note 60, at 465.

66. Hartman, *supra* note 24, at 107.

67. Sinn, *supra* note 24, at 325.

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

69. Equilibrium occurs when the forces acting on the firm to retain earnings are balanced by the forces acting on the firm to repatriate income. *See* Hartman, *supra* note 24, at 110–11; *see also* CAVES, *supra* note 23, at 192.

70. Under an exemption system, the decision to repatriate income will be based on whether the capital will earn more in the U.S. or in the foreign country. The MNE will retain earnings in the foreign subsidiary until the point where the earnings on the marginal dollar of retained earnings are equal to the return on the marginal dollar of capital invested in the U.S., or mathematically: $rf(1 - tf)(1 - tr) = r_{US}(1 - t_{US})(1 - tr)$, where rf = pre-tax rate of return in the foreign country, tf = the tax rate in the foreign country and r_{US} = pre-tax rate of return in the U.S. and t_{US} = the U.S. tax rate, and tr is the amount of the repatriation tax.

Under an exemption system, the equation becomes $rf(1 - tf) = r_{US}(1 - t_{US})$, because $(1 - tr) = 0$. Notice however, that the equation for a worldwide system with deferral reduces to the same equation, because (1 - tr) appears on both sides of the equation. Therefore, an MNE operating under the exemption system and a mature MNE operating (*see* definition

equilibrium the allocation of capital between mature U.S. MNEs[71] and foreign MNEs will be the same under the current U.S. system and under an exemption system.

This occurs because the repatriation tax affects not only the initial decision to export capital, but also the decision to repatriate capital. Retained earnings are not immediately subject to the repatriation tax, whereas repatriated earnings are. Thus, the tax system creates incentives to retain earnings in the foreign subsidiary. By slowing down capital repatriation, more capital remains in the foreign jurisdiction. For mature subsidiaries, these two effects balance each other at equilibrium. Thus, a worldwide system that defers the tax on foreign source income until repatriation has the same effect on allocation of capital between U.S. MNEs and foreign MNEs as an exemption system.[72]

To illustrate, assume that under exemption system A, a U.S. MNE, would have invested $1500 in country X, a low-tax country. However, under the worldwide system, A would only have invested $1000, because under this system the income will eventually be subject to a repatriation tax.[73] Under the Hartman-Sinn analysis, in future years A will have an incentive to retain earnings within the foreign subsidiary, because as long as the earnings remain in country X they will not be subject to U.S. tax. The incentive to retain earnings in Country X is equal to the initial disincentive to invest in Country X, so that at equilibrium A will have $1,500 of capital invested in country X, which is the exact amount that would have been invested under the exemption system.[74]

The results of empirical studies agree with the predictions of this model.[75] In addition, a study by Joel Slemrod provided additional evidence for this model.[76]

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infra note 71) under a worldwide system with deferral will have the same investment behavior. *See* Hartman, *supra* note 24, at 112–13, 116–17.

71. The definition of "mature" enterprise is an enterprise that is no longer in need of additional capital infusions. It is able to generate sufficient capital through its own retained earnings. *See* CAVES, *supra* note 23, at 192.

72. Once capital has been exported, any income this capital earns will ultimately be subject to tr, the repatriation tax. Any reinvestment decision does not depend on whether this tax is large or small. As shown *supra* in note 70, the term representing this tax (tr) drops out of the repatriation equation. Therefore, at equilibrium, this will not affect the allocation of capital between low-tax jurisdictions and high-tax jurisdictions.

73. *See supra* note 70 and accompanying text.

74. For proof of this result, *see supra* note 70.

75. *See* Roseanne Altschuler et al., *Do Repatriation Taxes Matter? Evidence from the Tax Returns of U.S. Multinationals, in* THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS 253 (Martin Felstein et al. eds., 1995) (finding that the permanent amount of repatriation tax did not affect the repatriation rates; only the after-tax rate of return in the two countries controlled the rates). This is a key prediction of the Hartman-Sinn Model. *See also* Jason Cummins & R. Glen Hubbard, *The Tax Sensitivity of Foreign Direct Investment: Evidence from Firm-Level Panel Data, in* THE EFFECTS OF TAXATION ON MULTINATIONAL CORPORATIONS 123 (Martin Felstein et al. eds., 1995).

76. *See* Joel Slemrod, *Tax Effects of Foreign Direct Investment in the United States: Evidence from a Cross-Country Comparison, in* TAXATION IN THE GLOBAL ECONOMY 79 (Assaf Razin & Joel Slemrod eds., 1990).

That article found that the allocation of capital between high-tax and low-tax jurisdictions was not correlated with whether the parent corporation was a resident of an exemption system country or a worldwide system country.[77] Even though this study did not involve U.S. MNEs, it does demonstrate that in general worldwide systems with deferral generally lead to the same allocation of capital as exemption systems.[78]

The Hartman-Sinn analysis in connection with the empirical evidence shows that the "runaway plant" argument does not apply to U.S. MNEs because of the deferral element of the U.S. tax system; therefore, an exemption system will not cause a flight of investment away from the United States. For mature organizations, the allocation of capital by mature U.S. MNEs between foreign and U.S. investment is unlikely to be different under an exemption system than under the current U.S. system.

III. THE EXEMPTION SYSTEM WOULD IMPROVE ECONOMIC EFFICIENCY

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

A. The Worldwide System Discriminates Against Immature U.S. Firms

One of the Author's primary arguments in favor of the exemption system is that, unlike the current system, it would not discriminate against immature U.S. MNEs.[79] The U.S. tax system disadvantages U.S. MNEs in raising capital.[80] All

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77. *See id.*

78. *See id.*

79. For example, the NFTC, *see supra* note 5, at 56–62, as well as Hufbauer, *see supra* note 16, at 54–57, focus on the "competitiveness" of U.S.-based MNEs. Both give some examples of how the U.S. worldwide system hurts U.S. MNEs in their ability to compete with foreign MNEs. They point out that the U.S. system of taxing its multinationals is probably the most far reaching of all of the worldwide systems. *See* NFTC, *supra* note 5, at 56–62; HUFBAUER, *supra* note 16, at 54–57. That is, the U.S. system causes more income to be subject to U.S. rates at an earlier time than any other system.

80. *See* NFTC, *supra* note 5, at 63. These arguments only apply to U.S. MNEs that have a worldwide effective tax rate lower than the U.S. tax rate. These MNEs will have to pay additional U.S. tax on repatriation of dividends. For the U.S. MNEs that have a tax rate greater than the U.S. rate, the foreign tax credit will equal or exceed the U.S. tax on the dividend, and so no repatriation tax will be due. In this case, the MNE will in many ways be

other things being equal, U.S. MNEs pay more in income tax than MNEs from exemption countries do.[81] The higher worldwide tax burden decreases the after-tax return to investors. This lower return results in a higher cost of capital[82] for U.S. MNEs.[83] Therefore, U.S. MNEs will receive lower initial infusions of capital, and they will allocate a lower portion of their capital to the foreign operations in low-tax jurisdictions as compared with foreign MNEs.[84] This reduces worldwide efficiency by distorting the allocation of capital between U.S. MNEs and foreign MNEs.[85]

To illustrate, assume there are two MNEs (a U.S. MNE and a foreign MNE) competing in the same low-tax jurisdiction. They both have a pre-tax profit of $100. The U.S. MNE is taxed by the United States at a rate of 35% and the foreign MNE at a rate of 20%. Assuming that the shareholder level taxes are

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in the same position as if it were operating under an exemption system. (For one difference and the distortion it creates, see *infra* section III.C.)

81. It is possible for an exemption system MNE to pay more tax than a U.S. MNE if it earns more income in a high-tax country. Everything else being equal, however, the U.S. MNE will pay more worldwide tax than an exemption system MNE because the tax-burden on income earned in low-tax jurisdictions will be higher for the U.S. MNE. Empirical evidence for this is found in Michael P. Devereux & Harold Freeman, *The Impact of Tax on Foreign Direct Investment: Empirical Evidence and the Implications for Tax Integration Schemes*, 2 INT'L TAX AND PUBLIC FINANCE 85–106 (1995). That study analyzed the cost of capital for U.S. MNEs for outward foreign direct investment into France, Germany, Japan, Italy, the Netherlands, and the United Kingdom. It compared this with the cost of capital for MNEs from these countries operating in these countries. The study found that U.S. MNEs's cost of capital was consistently higher than that for all the MNEs from all of the other countries operating in each of these jurisdictions. This was confirmed by Julie Collins & Douglas Shakelford, *Corporate Domicile and Average Effective Tax Rates: The Cases of Canada, Japan, The United Kingdom, and the United States, in* THE TAXATION OF MULTINATIONAL CORPORATIONS 51, 71–72 (Joel Slemrod ed., 1996). The increased cost of capital may be due to other factors as well, such as the lack of corporate integration in the U.S. For a discussion of the effects of corporate integration on the cost of capital, see HARRIS, *supra* note 1, at 25–35.

82. The cost of capital is defined as the pre-tax rate of return necessary to cause investors to wish to invest. *See* Hans Werner Sinn, *Taxation and the Cost of Capital: The "Old" View, the "New" View, and Another View, in* 5 TAX POL'Y AND THE ECON. 25, 26 (David Bradford ed., 1991). If the tax rate is higher, the pre-tax rate of return must also be higher to have the same after-tax rate of return. *See id.*

83. *See* NFTC, *supra* note 5, at 57. After-tax return from its investments will be less than if that same MNE were based in a country that permitted an exemption. If investors will equalize the after-tax returns to equity, then, because the after-tax returns to equity invested in U.S. MNEs is less, less will be invested in them.

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

85. Because of the tax disadvantage, their cost of capital is higher. If we assume that MNEs have declining marginal returns to capital, then if cost of capital is higher, less capital will be allocated to U.S.-based MNEs. Under the fundamental theorem of welfare economics, if a tax system distorts behavior, it is likely to reduce worldwide output. *See supra* note 23 and accompanying text.

constant,[86] an outside investor would rather invest in the foreign MNE because it has a higher after-tax return ($80 versus $65). In order for the investor to be indifferent between the two investments, the pre-tax rate of return on the U.S. MNE operations would have to be 23.1% higher.[87] Therefore, the cost of capital will be higher for U.S. MNEs than for foreign MNEs.[88]

If the cost of capital is higher for U.S. MNEs, and if all other things are equal, the U.S. MNE is less efficient[89] and therefore less competitive. A potentially profitable business might now be unprofitable because of the U.S. system.[90] Thus, the tax system has altered the allocation of capital.

Under this model the higher cost of capital will result in the immature MNE initially under-capitalizing new foreign ventures.[91] However, as discussed before, the foreign subsidiary will retain its earnings at a higher rate than it otherwise would have until it reaches its equilibrium size.[92] This life-cycle model is sometimes referred to as the "nucleus" hypothesis.[93] The empirical evidence indicates that this is an accurate description of the investment behavior of MNEs when they are creating new subsidiaries.[94]

Under the Hartman/Sinn analysis, which shows that once the foreign subsidiary has reached equilibrium it will be the same size it would have been under an exemption system, the effects of the higher cost of capital may seem to be only temporary. However, if under-capitalization makes the business less competitive, it may not survive long enough to reach equilibrium.[95] If a mature

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86. That is, the shareholder level tax is the same no matter which investment is pursued.

87. $(1 - .2)/(1 - .35) = 1.231$. The American enterprise would therefore have to earn at least 23.1% more than a foreign enterprise to attract investors.

88. *See supra* note 63.

89. If less capital is used or it is more expensive, then either fewer units of other inputs such as labor will be used, or they will be less productive. In general, the greater the capital supplied to a business, the greater the productivity of the other elements of the business. *See* J.P. GOULD & C.E. FERGUSON, MICROECONOMIC THEORY 161–63 (1980).

90. Assumedly profits will decrease because they will already have chosen the optimal mix of capital and labor. This is a result of the rationality assumption and the profit maximization assumption. *See* GOULD & FERGUSON, *supra* note 89, at 381; DAVID FRIEDMAN, PRICE THEORY 2 (1990).

91. *See* Sinn, *supra* note 24, at 336–42.

92. Because retained earnings are a cheaper source of capital, the MNEs will be willing to let the capital remain in the subsidiary. *See supra* notes 70–72 and accompanying text.

93. *See* Sinn, *supra* note 24, at 337–41.

94. *See* James R. Hines, Jr., *The Case Against Deferral: A Deferential Reconsideration*, 52 NATIONAL TAX J. 385, 400–402 (1999).

95. There is evidence that sufficient capitalization is necessary for a business, and sufficient capitalization or lack thereof might have long-term effects. There is extensive literature in the business area that states the advantages to getting into new market niches as fast as possible. *See, e.g.*, THOMAS PETERS, THRIVING ON CHAOS: HANDBOOK FOR A MANAGEMENT REVOLUTION (1985).

U.S. MNE and an immature U.S. MNE are both equally efficient[96] at a new business activity, the mature MNE will be more efficient at exploiting the activity because it has a lower cost of capital. The immature firm may be effectively out-competed in that particular market. Therefore, because the U.S. tax system slows down the response time of immature U.S. MNEs to new business opportunities, as compared to mature U.S. MNEs and foreign MNEs, it affects competitiveness of global markets and resource allocation. This argument is not an argument about U.S. MNEs versus foreign MNEs as much as immature U.S. MNEs versus foreign MNEs and mature U.S. MNEs.

Even if every country in the world adopted the worldwide system, as long as countries have different tax rates, immature U.S. subsidiaries will be discriminated against. First, as discussed above, mature U.S. MNEs would have a lower cost of capital than immature U.S. MNEs. Second, MNEs based in a low tax country would always have an advantage, because they can retain the benefits of income earned in low-tax countries.[97] Only if all countries were to adopt the territorial system would firms be neutral as to where the parent corporation resides.[98]

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96. That is, given the same resources (capital, labor, etc.), they could both produce the same pre-tax income.

97. If the additional tax paid to the residence country results in additional benefits to the firm, it is possible that the incentives may not be quite as clear as presented here. It would depend on the value of those benefits. *See* discussion in Chorvat, *supra* note 2, at 249–52.

98. Dan Shaviro has pointed out that if capital export neutrality, i.e., the idea that the tax system should not affect the decision of whether to invest in the U.S. or abroad, *see supra* note 23, is viewed as the appropriate standard for economic efficiency, then I have overstated the case for efficiency here. This is because an exemption system would create a greater incentive for immature enterprises to invest in a low-tax country than the current system. *See supra* Part II.A. This would violate capital export neutrality.

There are at least three responses to this argument, two of which Dan was kind enough to point out. First, it is far from clear that capital export neutrality is the appropriate standard. In fact, many have recently argued it is not the appropriate standard. *See, e.g,* MICHAEL P. DEVEREUX & R. GLENN HUBBARD, TAXING MULTINATIONALS (National Bureau of Econ. Research Working Paper No. W7920, 2000).

Second, this effect is only temporary. As shown above, once the enterprise enters its mature phase, the incentives are the same as in an exemption system. On the other hand, the effects of an undercapitalized subsidiary may be permanent if it is kept out of the market.

Third, if capital export neutrality is viewed at the investor level rather than at the corporate level, then the exemption system promotes capital export neutrality. Under an exemption system, there would be no tax incentive for a U.S. investor to invest in a French MNE, which is permitted to retain the tax advantage of operating in a low-tax jurisdiction, as opposed to a U.S. MNE, which currently cannot retain the advantages permanently but could under an exemption system. Hence, the investor's decisions of whether to export capital or not would not be distorted under an exemption system, while they are to some extent so distorted under the current system.

B. The U.S. System Inefficiently Prevents U.S. MNEs from Acquiring Foreign Businesses

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

	Foreign MNE	U.S. MNE
Pre-Tax Income	$100	$100
Local Tax	10%	10%
Residence Country Tax		25%
After-Tax Value	$90	$65[99]

Because the foreign MNE would be willing to pay $90 for the target, whereas the U.S. MNE is only willing to pay $65, the foreign MNE will be able to outbid the U.S. MNE. Foreign MNEs will acquire businesses that, but for the U.S. tax system, the U.S. MNE would have acquired. Hence, the U.S. tax system affects resource allocation and efficiency.[100] Unlike the earlier cost of capital argument, this distortion applies both to mature and immature U.S. MNEs.

A similar argument, often made by exemption system proponents,[101] is that the U.S. system causes U.S. MNEs to become takeover targets.[102] If the

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

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

100. *See* WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS 690–700 (2000); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. OF POL. ECON. 110, 119–20 (1965).

101. *See* NFTC, *supra* note 5, at 12.

102. The NFTC report discusses Daimler-Chrysler and Amoco-BP mergers in which the foreign company emerged as the parent corporation. *See* NFTC, *supra* note 5, at 12.

acquiring parent corporation were not subject to the U.S. tax rules, the after-tax value of the firm would increase. Therefore, the firm is more valuable in the hands of the foreign parent than to the current shareholders. This would make the U.S. firm a take-over target. However, the nature of the U.S. tax rules is such that unless the foreign acquirer is willing to recognize an inherent gain in all of the foreign assets of the U.S. firm, the foreign income of the U.S. firm's assets will still be subject to the U.S. tax rules.[103] In fact, under the current system, a U.S. MNE can transform itself into a foreign MNE if it is willing to pay the tax on its inherent gain.[104] The insertion of a foreign acquirer is unnecessary. Therefore, it is unlikely that the current system makes U.S. MNEs takeover targets.

There is one advantage for a U.S. MNE in being acquired by a foreign corporation. If the firm ever wants to raise additional equity capital for non-U.S. operations, then this can be done more cheaply by the foreign parent.[105] Therefore, if a U.S. MNE and a foreign MNE are already likely to merge, they may decide that it is optimal to have the foreign, rather than the U.S., corporation as the parent because of this option.[106]

As with the analysis in the previous section, even if all the countries of the world adopted the worldwide system, as long as countries have different tax rates U.S. MNEs will have disadvantages in acquiring firms operating in low-tax countries. If the competing MNE is based in a low-tax country, it will always have an advantage, because it can retain the benefits of income earned in other low-tax countries. U.S. MNEs will always have a higher worldwide tax burden.[107]

C. The U.S. System Is More Complicated and Costly Than an Exemption System

The U.S. system of taxing international income is costly as a direct result of its complexity.[108] The U.S. rules dealing with the foreign tax credit, and in

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103. *See* I.R.C. § 367(a) (2000). This sections require recognizing all built-in gain in assets transferred to foreign corporations. This includes all goodwill and the net present discounted value of all future earnings of these subsidiaries.

104. *See* Lee A. Shepard, *News Analysis: The Tax Analogue of the Hotel California*, 75 TAX NOTES 167 (Apr. 14, 1997).

105. Here we are assuming, as is likely, the foreign parent has a lower cost of capital. *See* discussion in Parts II.B and C.

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

107. If the additional tax paid to the residence country results in additional benefits to the firm, it is possible that the incentives may not be quite as clear as presented here. It would depend on the value of those benefits. *See* discussion in Chorvat, *supra* note 2, at 249–52.

108. Complexity creates costs, both by requiring more training of those who practice it, and by requiring more of their time while practicing it. *See* Gordon Henderson,

particular the foreign tax credit limitation, are very complex.[109] To a large extent this is because they are designed to prevent abusive "cross-crediting." Cross-crediting occurs when an activity generates excess foreign tax credits,[110] which are then used to reduce the U.S. tax on another item of income.[111] For example, assume a foreign investment generates a pre-tax return of $100 that is taxed at a local rate of 50%. The taxpayer will then have $15 of excess credit.[112] If the same taxpayer also has another investment which earns $100 but is taxed at a 20% rate locally, the $15 of excess credit will offset the $15 that would be due on repatriation of the entire amount to the United States. Then the U.S. person would pay no U.S. tax on this foreign source income. To some extent, this behavior is desirable. Because most worldwide systems have a foreign tax credit limit, they often cannot fully achieve neutrality between investing in the United States and abroad.[113] However, if excess credits from one activity are permitted to offset U.S. tax paid on another foreign activity, the system draws closer to neutrality.[114]

Using credits generated in an active business to offset taxes that would be paid on passive income is viewed as an abuse of the system. Passive income[115] is highly mobile. If what otherwise would be U.S. source income can become foreign source income, the taxpayer can use excess credits to offset U.S. tax on income that is not in a real sense attributable to foreign activities.[116] In order to prevent this, the foreign tax credit system does not allow cross-crediting between active business income and passive income. It does this by creating separate categories of income (often called "baskets").[117] There are nine separate categories.[118] Cross-crediting is not permitted between separate categories.[119] Active and passive income are generally in separate categories.[120]

Controlling Hyperlexis—The Most Important "Law and...." 43 TAX LAWYER 177, 182 (1989).

109. *See* I.R.C. § 904 (2000).

110. Because the local tax rate is higher than the U.S. tax rate, the activity has generated excess credit. *See* discussion *supra* Part I.A.

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

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

113. *See supra* note 36 and accompanying text.

114. In the above example, because the taxpayer was able to cross-credit, the taxpayer had a worldwide tax rate of 35% and was neutral between investing in the U.S. and investing abroad.

115. For this purpose, "passive income" means the kinds of income treated as foreign personal holding company income under I.R.C. § 954(c). It includes items such as dividends, interest, royalties, and rents as well as gains generated from the sale of property which give rise to these kinds of income.

116. *See supra* Part I.B and accompanying text.

117. *See* I.R.C. § 904(d) (2000).

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

A person engaged in a foreign trade or business must allocate all foreign source income among these categories and calculate a separate foreign tax credit limitation for each category.[121] The rules for determining how much income is to be allocated to each basket are quite complex. Furthermore, the calculations are multiplied because the foreign tax credit limit is applied separately to each basket.[122]

With an exemption system, much of this complexity disappears. If active foreign source income is not taxed, it will not be eligible for a foreign tax credit, and no quarantine of credits is necessary.[123] There would simply be one category of income: taxed income.

An additional source of complexity is the incoherence of the residence system. The corporation itself is a fiction.[124] Basing a tax system on the residence of a fictional entity causes incoherence. Normally, income earned by French residents for activities conducted in France cannot be taxed by the United States. However, if the corporation that earned this income is a U.S. MNE, the United States will tax the French source income allocable to French shareholders of U.S. corporations. Therefore, under a worldwide system, the taxation of income is determined by arbitrary distinctions.

Because taxation is based on the residence of a fictional entity, there is a large incentive to move the parent corporation outside of the United States. Many companies have either moved their headquarters or are trying to move their headquarters out of the United States.[125] Consequently, there is also a large incentive on the part of the U.S. Treasury to prevent this movement.[126] However, the tension between trying to allow mergers and acquisitions that promote economic efficiency[127] and trying to prevent U.S. MNEs from escaping U.S. tax

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119. *See* I.R.C. § 904(d). Each limit is calculated separately, and no cross-crediting is generally allowed.

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

121. *See* AULT, *supra* note 5, at 389.

122. *See* I.R.C. § 904(d).

123. Because excess credits are generally the result of active income, it may be possible to eliminate the foreign tax credit. However, the U.S. may decide to keep it to give an incentive to foreign governments to keep their taxes lower. *See* Slemrod, *supra* note 1, at 17–20.

124. *See* CHOPER, CASES AND MATERIALS ON CORPORATIONS, 27–28 (1995); *see also* William Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1261–1262 (1982).

125. *See* Shepard, *supra*, note 104, at 116. Tax advisers generally advise new companies to incorporate in a foreign jurisdiction. *See* Herman Bouma, *The Tax Code and Reality: Improving the Connection*, 85 TAX NOTES 811, 813 (1999).

126. *See* I.R.C. § 367(a) and the treasury regulations promulgated under that section for rules to prevent the movement of U.S. corporations to foreign countries.

127. Mergers and acquisitions are generally efficiency improving. *See* Carney, *supra* note 100, at 42–54; Manne, *supra* note 100, at 119. The tax system should not create

provisions results in very complex rules governing international mergers and acquisitions.[128]

The incentives to engage in this behavior will exist as long as U.S. MNEs are taxed on their worldwide income. The U.S. government will have to continue to devote resources to prevent more companies from leaving the United States.[129] Furthermore, tax planners devote significant resources to trying to devise ways to circumvent the rules. Exempting active foreign source income would cause these problems to largely disappear. The residence of the parent corporation of the MNE as a resident would no longer matter.

Some have argued that the exemption system would not reduce the complexity of the system very much.[130] However, an empirical study by Slemrod and Blumenthal[131] compared the cost incurred complying with tax laws by European MNEs (most of which are residents of exemption countries) on their foreign source income with the compliance costs of U.S. MNEs on their foreign source income. That study showed that the U.S. system of taxing foreign source income increases the tax compliance burden on U.S. MNEs by about 20 percent.[132] The authors of that study suggest that if we adopt a system similar to that of other countries, we should be able to reduce the compliance burden on U.S. MNEs. This would help to bring U.S. MNEs compliance costs in line with those of MNEs from other countries.[133]

D. The Current System Often Encourages Locating Production Offshore

The basic justification for the worldwide tax system is that it causes firms to be neutral between investing in the United States and investing abroad.[134] And as stated before, one of the more commonly used arguments against the exemption system is that it may encourage U.S. MNEs to place assets outside of the United

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incentives or disincentives for foreign and U.S. MNEs to merge. *See supra* note 23 and accompanying text.

128. *See* Treas. Reg. § 1.367(a)-3 (2000).

129. *See* Reuven Avi-Yonah, *Globalization, Tax Competition and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (May 2000); Hines, *supra* note 94, at 401–02.

130. *See* Charles Kingson, *The Foreign Tax Credit and Its Critics*, 9 AM. J. TAX POL'Y 1, 12–13 (1991).

131. *See* Marsha Blumenthal & Joel B. Slemrod, *The Compliance Cost of Taxing Foreign Source Income: Its Magnitude, Determinants, and Policy Implications* 33, *in* THE TAXATION OF MULTINATIONAL CORPORATIONS (Joel Slemrod ed., 1995). The study found that foreign source income constituted 20% of the U.S. MNEs income, but it caused 40% of their compliance costs. *See id.* For European MNEs, the compliance costs for foreign source income were proportional to their percentage of overall income. *See id.*

132. *See id.*

133. This improves efficiency because this additional compliance cost applies only to U.S. MNEs, reducing their after tax-income, but not the after-tax income of MNEs from other countries.

134. *See supra* Part II.A.

States. However, the U.S. worldwide tax system paradoxically creates incentives for some taxpayers to place capital in foreign jurisdictions.

Under the U.S. foreign tax credit system, if an excess credit taxpayer can generate low or zero taxed foreign source income, that income may escape taxation all together.[135] For example, if a foreign subsidiary makes royalty and interest payments to its U.S. parent, these payments are generally deductible abroad.[136] When received by U.S. persons, they are foreign source income.[137] These payments increase the foreign tax credit limit of the U.S. MNE and allow any excess foreign tax credits to reduce or eliminate the U.S. tax on these payments. In this case, the income will not be subject to tax in the foreign jurisdiction,[138] nor will it be subject to tax in the United States. Therefore, for those taxpayers who are likely to be in an excess foreign tax credit position, the U.S. system provides an incentive to move income producing activities abroad, because any income earned from these activities and paid back in interest or royalties to the United States will not be taxed in either country.

This incentive would disappear if we exempt dividends from active business income, as well as active business income from foreign sources. In general, it is active business income which generates the excess credits.[139] If this income is exempt from U.S. taxation, there would be no excess credit taxpayers.[140] If the taxpayer does not have excess credits to use, these payments would be fully taxed in the United States.

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135. *See* Harry Grubert, *Taxes and the Division of Foreign Operating Income Among Royalties, Interest, Dividends, and Retained Earnings*, 68 J. PUB. ECON. 269, 273–75 (1998); *see generally* Rosanne Altshuler & Harry Grubert, *Balance Sheets, Multinational Financial Policy, and the Cost of Capital at Home and Abroad*, (National Bureau of Econ. Research (NBER) Working Paper No. 5810 (1996).

136. Interest and royalty payments are usually deductible from the payor's taxable income. *See* AULT, *supra* note 5, at 204.

137. Under I.R.C. § 862(a)(1), (2), (4), these payments are classified as foreign source income. Further it is likely to be put into the general or active basket because to determine the category of income for income received from a controlled foreign corporation by a U.S. shareholder, the U.S. person looks through the payment to the underlying income of the controlled foreign corporation. *See* I.R.C. § 904(d)(3).

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

139. *See* INTERNAL REVENUE SERVICE, STATISTICS OF INCOME BULLETIN 175 (Fall 1998).

140. If the income is exempt from U.S. tax, any taxes paid on this income would not be eligible for the foreign tax credit. *See* I.R.C. § 901(a) (2000).

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

The U.S. tax rules treat income earned by branches and income earned by subsidiaries differently.[141] The income from branches is taxed when it is earned by the U.S. owner whereas the tax on income of subsidiaries is deferred.[142] In general, operating as a branch in a low-tax jurisdiction is disfavored.[143] A firm cannot retain any of the tax advantages of operating in a low-tax jurisdiction if this business is conducted by a branch.

In certain circumstances, there is an incentive to use a branch. One such situation occurs if a foreign operation is likely to incur losses in the near future. In this case, these losses can initially offset U.S. income. This would not be true if the business is conducted through a foreign subsidiary. Even though the current rules require that in later years the taxpayer must either reduce its foreign tax credit limit or recognize additional income,[144] there is often a time value of money advantage.[145]

If the United States exempted all foreign source income and loss earned by an active foreign trade or businesses if operated as a branch, as well as all dividends from foreign subsidiaries paid out of active earnings and profits, this mismatch would largely disappear.[146] There would be no incentive or disincentive to operate as a branch or a subsidiary.

IV. ACTIVE FOREIGN SOURCE INCOME SHOULD BE EXEMPT; OTHER FORMS OF INCOME SHOULD BE TAXED

This Article proposes the United States end the worldwide taxation of active business income of U.S. persons, whether earned directly or indirectly.[147] However, the United States should continue to tax passive income earned by U.S.

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141. *See supra* note 65.

142. *See* Slemrod, *supra* note 1, at 13; *see also* I.R.C. § 61 (2000).

143. *See* Slemrod, *supra* note 1, at 32–34.

144. Under the overall foreign loss rules (I.R.C. § 904(f)) and the section 367(c) branch loss rules, any foreign loss used to offset U.S. tax will later reduce the taxpayer's foreign tax credit limit. If the taxpayer is an excess limitation taxpayer, this won't have much effect because the foreign tax credit limit does not affect the taxpayer's tax.

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

146. There could still be an incentive relating to the allocation of interest expense. Interest paid by a subsidiary is not allocated against U.S. income, whereas interest paid by a branch can be. *See* Treas. Reg. § 1.861-8-12T (2000).

147. Consequently, foreign taxes paid on this exempt income will no longer be credited against U.S. income tax.

persons, whether earned directly or indirectly.[148] For this purpose, "passive income" should not include dividends, interest, or royalties received by foreign subsidiaries of U.S. MNEs from affiliated corporations.

Even if the United States adopted an exemption system, certain portions of the U.S. international tax rules should be retained.[149] First, passive foreign source income received by U.S. persons should be subject to U.S. tax. Second, passive income earned by controlled foreign corporations should be subject to tax in the United States. Third, the foreign-base-company rules[150] should also be retained.

A. Passive Foreign Source Income Earned by U.S. Persons

The proposal exempts active business income directly earned by U.S. persons and dividends received from foreign affiliates.[151] However, income from passive investments should not be exempt. If there is a tax advantage to investing in a French corporation as opposed to a U.S. corporation, the system will distort investment decisions.[152]

In addition, interest and royalties paid by foreign affiliates could still be included in income of the U.S. parent. These payments are generally deductible against income earned by the foreign subsidiary.[153] Therefore, if they are not subject to tax in the United States, these payments would escape taxation. As long as the MNE did not operate in the United States, it would pay little or no taxes. This would cause a distortion in favor of foreign investment.

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148. Taxes paid on passive income, which is subject to tax in the U.S., will still be eligible for the foreign tax credit. The definition of passive income should include dividends that are received from companies where the shareholder owns less than 10% of the outstanding shares.

149. This Article will not discuss provisions such as either the Foreign Sales Corporation provisions (I.R.C. §§ 921–927) or the Domestic International Sales Corporation provisions (I.R.C. §§ 991–994) which are designed to encourage exports. These provisions are, therefore, beyond the scope of this Article.

150. Foreign-base-company income is defined in I.R.C. § 954 and is discussed in Part IV.C, *infra*.

151. Under the proposal, the U.S. recipient must own 10% or more of the stock of the foreign payor for the dividend to be exempt.

There are a number of provisions in the Code that are attempting to ensure that foreign source passive income earned by U.S. persons is taxed in the U.S. These include the Passive Foreign Investment Company rules, *see* I.R.C. §§ 1291, 1293–1298, and the Foreign Personal Holding Company Rules, *see* I.R.C. §§ 551–558. These rules should be retained. These rules generally do not apply to MNEs, but rather to passive investment companies, and so are not the focus of this Article.

152. The analysis in this Article assumes that shareholder level taxes were the same no matter which MNE was invested in. Furthermore, the proposal is attempting to eliminate such distinctions. These taxes would create misallocations of capital. *See supra* note 23 and accompanying text.

153. *See* Grubert, *supra* note 135, at 273–75.

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

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

If it did, almost all U.S. persons, both individuals and corporations, would set up foreign corporations, and all passive income would be earned in low-tax jurisdictions.[154] This would essentially repeal the taxation of passive income.

On the other hand, dividends, interest, royalties, etc., received by controlled foreign corporations from foreign affiliates should not be taxed in the United States. The exemption for dividends seems clear, because they would not be taxed if they were received by a U.S. person. Interest and royalties received by foreign subsidiaries from affiliates should also be exempt. First, they are generally taxable in the country of the recipient corporation.[155] Second, under an exemption system, the United States has no residual claim on active business income. These payments all ultimately derive from foreign active trade or business conducted by the MNE and so should not be taxed in the United States.

One might argue that taxing U.S. MNEs on their passive income, while other countries allow their MNEs to earn passive income without taxing it, would put U.S. MNEs at a disadvantage.[156] However, most other countries, even those with exemption systems, tax passive income earned by their MNEs.[157] Furthermore, even if some countries do not tax resident MNEs on their passive income, taxing U.S. MNEs on their passive income will not impair the ability of U.S. MNEs to raise capital for active business projects. Active business income will be taxed alike in both countries. The foreign MNE will only have an advantage in raising capital to the extent it is using that capital for passive investment. There seems little reason for the United States to encourage U.S. MNEs to become passive investors.[158] In addition, even if more capital flows to foreign MNEs to be placed in passive investments, this capital will eventually flow into real investments.[159] The foreign MNE will invest in those assets where the income has the highest after-tax return. On this basis, the U.S. MNE is an

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154. If the U.S. taxed individuals on this income, but not corporations, there would be an incentive to earn passive income through foreign corporations. They could retain earnings in the foreign corporations and never pay U.S. tax. Before the provisions discussed in this section were adopted, many wealthy individuals avoided taxation on their passive income by doing exactly this. *See* Kingson, *supra* note 61, at 452–53.

155. In both the Netherlands and France, the exemption for foreign source income from a foreign subsidiary only applies to dividends or capital gains on the sale of shares. It does not apply to interest or royalties. *See* AULT, *supra* note 5, at 403–05.

156. *See* discussion *infra* section II.

157. AULT, *supra* note 5, at 403–06.

158. As discussed *supra* in note 146 and accompanying text, this would create an incentive to invest in corporations, which would distort investment decisions.

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

equal competitor to the foreign MNEs. Hence, the U.S. MNE will receive the appropriate amount of capital. Therefore, taxing U.S. MNEs on their passive investments will not affect real investment or economic efficiency.[160]

C. Foreign-Base-Company Income Rules

Some of those who argue for an exemption system also argue that subpart F of subchapter N of the Internal Revenue Code, particularly the foreign-base-company rules,[161] should be repealed or altered significantly.[162] The foreign-base-company rules attempt to ensure that U.S. source income is taxed in the United States. Because this is consistent with the exemption system, these rules should be retained.[163] In fact, many countries that have exemption systems have adopted similar rules.[164]

There are two important types of foreign-base-company income: sales income and services income. Foreign-base-company sales income is income earned by a controlled foreign corporation from selling property that is either purchased from a related party[165] or sold to a related party and is not for ultimate use in the country in which the controlled foreign corporation is incorporated.[166] Foreign-base-company services income is income earned by a controlled foreign corporation when it performs services for a related party outside the country in which it is incorporated. These rules are designed to prevent a U.S. MNE from inserting a low-tax corporation into a transaction simply to lower taxes.[167]

To illustrate, assume that A, a U.S. MNE, will sell computers that were made in the United States to U.S. customers. A has its Cayman Islands subsidiary purchase the computers from A and sell them to one of A's U.S. subsidiaries. Even though in substance this is all U.S. source income, because of this arrangement, part of the profit from this transaction is now allocated to the Cayman Islands.[168] Because the Cayman Islands will not tax this income, the total

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160. Efficiency is concerned with resource allocation, not with ownership. Therefore, even though the capital is owned by the foreign MNE, it is used by the U.S. MNE.

161. *See* I.R.C. § 954 (2000).

162. *See* NFTC, *supra* note 5, at 1; *see also* Massey, *supra* note 106, at 13.

163. Certain modifications are required, however. The Organization for Economic Co-operation and Development ("OECD") recently called on all countries, both exemption systems as well as worldwide systems, to adopt rules similar to the U.S. controlled foreign corporation rules. *See* ORGANIZATION FOR ECON. CO-OPERATION AND DEV., CONTROLLED FOREIGN CORPORATION LEGISLATION 10–12 (1996).

164. For a discussion of the rules that France has adopted, see AULT, *supra* note 5, at 412–13.

165. A related party for this purpose means any affiliated corporation or significant owner of an affiliated corporation. *See* I.R.C. § 954(d)(3) (2000).

166. *See* I.R.C. § 954(d).

167. If the controlled foreign corporation is actually involved in the manufacture of the product, then these rules do not apply. *See* I.R.C. § 954(e)(2)(A) (2000).

168. Because the MNE can allocate all of the risk of the transaction to the Cayman Islands subsidiary, a significant portion of the income can also be allocated to

tax amount is lowered. The foreign-base-company income rules would operate in this scenario to cause all the income allocated to the Cayman Islands to be taxed immediately in the United States, thus negating any potential tax advantage from placing the low-tax subsidiary in the transaction.[169] The foreign-base-company rules help to ensure that U.S. source income is taxed in the United States. Rules like this are therefore essential to ensure that income is at least taxed in the source country.[170]

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

V. CONCLUSION

This Article has introduced some new analysis into the debate[171] over the exemption system. As this Article has shown, the exemption system would improve economic efficiency. The exemption system would not discriminate against new businesses. It would not discriminate against U.S. MNEs in their attempt to acquire foreign businesses. Furthermore, it does not set up arbitrary distinctions between the taxation of foreign subsidiaries and foreign branches. The exemption system would not create the same kinds of distortions to move production offshore that the worldwide system does. Therefore, it does not result in the kinds of economic distortions that a worldwide system must. Beyond this, the exemption system is by its nature simpler and cheaper. Finally, the main efficiency argument against the exemption system conflicts with both economic theory and empirical evidence.

On the other hand, we must still understand that there are potential abuses of the exemption system. Taxpayers may attempt to have U.S. source income characterized as foreign source income. Also, passive foreign source income of

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where it will not be taxed. *See* I.R.C. § 482; *see also* CAVES, *supra* note 23, at 192–93; CHARLES GUSTAFSON ET AL., TAXATION OF INTERNATIONAL TRANSACTIONS 499–501 (1997).

169. Under I.R.C. § 954(d), if any of the income is generated from activities occurring in the subsidiary, e.g., the goods are manufactured there, this income is permitted to be exempted from these rules. So if the subsidiary is not simply inserted in the transaction for tax reasons, this income will not be subject to tax in the U.S. until it is repatriated. *See id.*

170. The Foreign-Base Company ("FBC") rules also operate to create subpart F in situations where there is no possibility of U.S. source income. To illustrate, in the example given in the text, if the U.S. MNE made computers in Germany and sold them in France, but in between the Cayman Islands corporation acquired them from the German subsidiary and sold them to the French subsidiary, under the current rules the income of the Cayman subsidiary would be subpart F income. Under an exemption system, this would no longer be necessary. Therefore, the FBC rules should only apply when either the goods are acquired from a U.S.-related person or sold to a U.S.-related person, or the services are performed in the U.S.

171. For a sampling of this debate, see *supra* note 1.

U.S. persons must be subject to tax in the United States. Most other countries with exemption systems tax passive income earned by their residents and by their MNEs.[172]

Overall, it is clear that an exemption system which accounts for these potential abuses is clearly superior to the current credit system. Therefore, the United States should adopt an exemption system.

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172. *See* AULT, *supra* note 5, at 403–06.