Chapter 1
Introduction to International Tax

§ 1.01. Overview of International Tax

The international income tax rules of the United States determine the U.S. claims to tax revenue from income having a nexus with the United States and one or more foreign tax jurisdictions. These rules are the subject matter of this book. Income having a nexus with more than one country is referred to here as transnational income. Such income comprises a substantial and growing percentage of the income taxable under the Code.[1]

Transnational income may be taxable under the Code because of a nexus between the United States and the activities that generated the income. According to international usage, a jurisdictional claim based upon such a nexus is called "source jurisdiction." All countries imposing an income tax exercise source jurisdiction.

The Code also imposes a tax on transnational income because of a nexus between the United States and the person earning the income. A jurisdictional claim over income based on a nexus between the country making that claim and the person subject to tax is called "residence jurisdiction." A person subject to the residence jurisdiction of the United States is taxable on its worldwide income, without reference to the source of the income.

With a few exceptions, countries that exercise residence jurisdiction do so only with respect to the income of individuals and legal entities that they consider to be residents. Thus the term "residence jurisdiction." The United States is an exception to the general pattern. It asserts the right to impose its income tax not only on the worldwide income of its residents but also on the worldwide income of its citizens. Indeed, citizenship is the primary basis under the Code for exercising residence jurisdiction over individuals.[2] Like other countries, the United States also taxes the worldwide income of domestic corporations and other resident juridical persons. The persons subject to the residence jurisdiction of the United States are referred to in the Code as U.S. persons.[3]

A U.S. person is defined in Code section 7701(a)(30) to be a citizen or resident individual of the United States or a domestic corporation, partnership, trust, or estate.[4] Persons fitting this definition are subject to

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[1] All references in this book to the "Code," unless otherwise stated, are references to the Internal Revenue Code of 1986.

[2] Albania, Bulgaria, Mexico, and the Philippines are other countries that have exercised residence jurisdiction in the past over their citizens as well as their residents.

[3] U.S. tax is imposed on all individuals under IRC § 1 and on all corporations under IRC § 11, without regard for their citizenship, residence, place of incorporation, or any other nexus with the U.S. Under IRC § 61, gross income is defined to include all income, without regard for its geographical source. IRC § 872, however, limits the gross income of nonresident alien individuals to income derived from the United States. A similar rule in IRC § 882 limits U.S. tax jurisdiction over foreign corporations to income derived from the United States.

[4] The Code reference is to "United States person." As a shorthand, the abbreviated term "U.S. person" is used throughout this book in place of the official term.

the residence jurisdiction of the United States. A foreign person, as that term is used in this book, is a person other than a U.S. person. Foreign persons are subject only to the source jurisdiction of the United States.[5]

When a U.S. person earns transnational income, the claim of the United States to tax that income based on its residence jurisdiction may overlap the claim of a foreign country for tax revenue based on source jurisdiction. Similarly, the claims of foreign governments for tax revenue based on their residence jurisdiction may overlap U.S. jurisdictional claims to revenue based on source. Unless resolved satisfactorily, the competing claims for tax revenue based on residence and source would stifle international investment and commerce.[6] In addition, the tax burdens imposed on persons earning transnational income would be unfair under traditional concepts of tax equity.

To reduce the likelihood of double taxation of transnational income, the United States accedes primary tax jurisdiction to the country of source. The Code achieves this result by granting a foreign tax credit to U.S. persons for income taxes paid to foreign governments with respect to foreign source income. Most other countries make similar accommodations, either through their taxing statutes or through bilateral tax treaties.

Although persons earning transnational income face some risks of double taxation, they also have some possibilities for international tax avoidance. Those opportunities result from certain gaps in the jurisdictional reach of the United States and other countries. The undertaxation of transnational income is both inefficient and unfair. Undertaxation is inefficient because it induces taxpayers to engage in the undertaxed activities instead of taxable activities producing a higher before-tax rate of return. It is unfair because taxpayers earning equal amounts of income do not end up paying equal taxes.

Some foreign tax jurisdictions have increased the risks of undertaxation of transnational income by operating as a tax haven. In the typical case, a tax haven country has structured its tax rules so as to allow foreign persons to take advantage of the provisions of foreign law designed to prevent double taxation. Tax haven countries typically obtain some revenue from foreign taxpayers, but the amount is very small in comparison with the amount of tax revenue that other taxing jurisdictions lose on account of their conduct. The Code is replete with complex provisions designed to protect U.S. tax jurisdiction against the beggar-thy-neighbor policies of tax haven countries.[7]

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[5] Under some conditions, former U.S. citizens and certain former U.S. residents who give up their citizenship or their permanent residence status to avoid U.S. taxes would be subject to U.S. tax for a 10-year period on a quasi-residence basis.

[6] Countries may have competing claims to income based upon overlapping residence jurisdiction. For example, a U.S. citizen resident in France might be taxable on a residence basis by both France and the United States. Some efforts are made to prevent such overlaps through tax treaties. See U.S. Model Treaty (2006), Art. 4 (Residence), providing tie-breaker rules so that a person who qualified as a resident of both Contracting States under their domestic tax legislation would be treated as a resident in only one of the Contracting States. Some recent U.S. treaties provide for mandatory arbitration to resolve disputes. See, e.g., Article 25, para. 5-6, of U.S.-Germany treaty, as revised 2008 (providing, *inter alia*, for mandatory arbitration if disputes under Article 4 (Residence) are not resolved by mutual agreement).

[7] The Organization for Economic Cooperation and Development (OECD), of which the United States is a prominent member, has attempted to induce cooperation among countries to mitigate beggar-thy-neighbor tax policies. See OECD Committee on Fiscal Affairs, *Harmful Tax Competition: an Emerging Global Issue*, Paris (1998). For an earlier assessment of the harmful effects of unbridled tax competition on national tax policies, see Michael J. McIntyre, "Taxing Income from Moveable Capital in the EEC After 1992," 2 *Tax Notes Int'l* (May 1990) 461-463; Michael J. McIntyre, "The Design of Tax Rules for the North American Free Trade Alliance," 49 *Tax Law Review* 769-793 (1994).

§ 1.02. The International Tax Advisor

***International Tax Primer* (2002)**

By Brian J. Arnold and Michael J. McIntyre

The tax adviser's role with respect to international transactions is similar to his or her role with respect to domestic transactions. Probably the tax adviser's most important obligation is to ensure that the client does not fall into any traps or anomalies that result in levels of taxation beyond what might reasonably be expected. Such defensive tax planning may put the tax adviser on the same side of an issue as the tax policymaker, who should also be seeking to impose appropriate tax burdens on taxpayers. Domestic and international tax advisers are also expected to be acquainted with international tax schemes that might be used to minimize taxes. These schemes often involve the use of tax havens or special low-tax regimes of countries that generally levy high taxes.

International tax advisers are likely to spend much more of their time engaging in defensive tax planning than their domestic counterparts. The reason is that taxpayers engaged in international transactions frequently confront serious risks of having to pay excessive levels of tax. These risks typically arise when two or more countries claim the right to impose tax on the same items of income. Many of the most important international tax rules are designed to mitigate or eliminate such double taxation. The common measures used to relieve double taxation are discussed [elsewhere in this *Primer*].

Although visible and fashionable, the offensive tax planning activities of most international tax advisers occupy a modest part of their practice. These activities, however, are very important and have generated a great deal of complex anti-avoidance legislation. The most important of the rules designed to combat international tax avoidance are discussed [elsewhere in this *Primer*]. These rules have not driven the tax havens out of business. Opportunities for international tax avoidance are still widely available to many individual investors and to the multinational enterprises of many countries.

The role of the tax adviser depends on whether the transaction involved is an outward-bound investment or an inward-bound investment. In the case of an outward-bound investment, the tax adviser often has an ongoing relationship with the client and is familiar with the client's total affairs. Consequently, the client usually looks primarily to his or her domestic tax adviser for advice concerning both the domestic and foreign tax consequences of the transaction. Although the domestic tax adviser is not generally qualified to provide advice concerning foreign tax law, the client often expects the tax adviser to act as a cipher or filter with respect to foreign tax advice. It is not unusual for foreign tax advisers to deal with the domestic tax adviser rather than with the client directly. In contrast, when the tax adviser is providing advice concerning an inward-bound investment by a nonresident, the role is often more restricted. Usually, the advice is limited to the tax consequences in the adviser's particular country, and the tax adviser is not likely to be involved in the overall tax planning for the nonresident on an ongoing basis. Also, as indicated earlier, in this situation the tax adviser may deal with the foreign tax advisers rather than directly with the client.

Whether an inward-bound or an outward-bound investment is involved, tax advisers consulting on an international transaction will almost invariably deal with foreign lawyers, accountants, or business persons. The role of tax advisers in this regard may often be difficult because of differences between the basic legal concepts, tax laws and accounting practices of the countries involved. These differences may be exacerbated by language and cultural differences.

Although a tax adviser may not be legally qualified to provide advice concerning foreign tax law, he or she should have as much knowledge concerning foreign tax systems as possible. This knowledge enables an adviser to deal more effectively with foreign tax advisers and to suggest alternative methods for structuring transactions that provide desirable tax results under the laws of both countries.

From the taxpayer's viewpoint, the foreign tax consequences of any investment or transaction are often as important as, or even more important than, the domestic tax consequences. Consider, for example, an individual, T, who is resident in one country and who plans to make a portfolio investment in another country. T obviously is concerned about how her country of residence will tax the foreign-source income and what provisions it makes for relieving double taxation. T is also concerned, however, about the level of the foreign tax. If her residence country relieves double taxation by exempting foreign-source income, the foreign tax is the only tax on the income.

If T's country of residence provides a foreign tax credit, the situation is more complex, for reasons explained in some detail [elsewhere in this *Primer*]. In brief, countries granting a credit for foreign taxes typically limit the credit to the amount of the domestic tax imposed on the foreign income — they do not allow a refund of any excess foreign tax. If T can expect to obtain a credit for foreign taxes imposed on her foreign income, then she is concerned with the foreign tax only if it exceeds the domestic tax, in which case T will be subject to an effective rate of tax equal to the foreign tax rate.

To take a more complicated example of the importance of foreign tax law to the tax planner, suppose that a multinational corporation desires for business reasons to reorganize its multinational group of corporations. In the absence of special relief provisions, such a reorganization typically will result in significant adverse tax consequences under the tax laws of most countries. Many countries, however, provide for certain corporate reorganizations to occur on a tax-free (or, more accurately, tax-deferred) basis. In deciding whether the reorganization should go forward, therefore, the multinational corporation will look to its tax advisers for advice on the tax consequences of the reorganization under the tax laws of the country in which the parent corporation is resident and also under the tax laws of the foreign countries in which the foreign subsidiaries of the parent corporation are located. Providing this advice is no easy matter because the tax rules governing corporate reorganizations vary widely and often interrelate in complex ways.

This intersection of domestic tax law and foreign tax law is one of the most challenging features of the study and practice of international tax. Although tax advisers are usually qualified to give advice only on their domestic tax law, they must be sufficiently familiar with foreign tax laws to be able to recognize potential problems and to deal efficiently with foreign tax advisers. Further, the intersection of foreign and domestic law extends beyond tax. Tax consequences generally attach to particular legal results. For example, the tax consequences may differ if income is earned by an individual, a trust, a partnership, or a corporation. Consequently, a tax adviser may be required to determine in particular situations whether an entity is a trust, a partnership, a corporation, or something else. The problem of determining tax consequences on the basis of the underlying legal situation is exacerbated in the foreign context because the domestic tax consequences often must be determined on the basis of foreign legal concepts. For example, if a resident of one country holds an interest in a *limitada* or limited liability company (which is in essence an entity that provides limited liability for its investors and flow-through treatment for income tax purposes), should the ownership rights be characterized as an interest in a partnership or as shares in a corporation?

Tax is not usually a major factor in the initial decision of an enterprise to make a direct investment abroad. Other factors, such as return on investment, political stability, labor costs, and access to foreign markets, are much more important as far as the original investment is concerned. The tax "tail" should not wag the commercial "dog." Once the decision to invest has been made, however, tax is an important factor in determining the way in which the investment should be structured. Further, tax is important in determining whether to reinvest or repatriate the profits from the investment, or if the investment proves to be unprofitable, how to utilize the losses. Tax advisers are expected to provide advice concerning the tax consequences of the various ways in which the profits of a foreign enterprise might be repatriated to the domestic corporation. Similarly, they are expected to provide advice concerning the tax consequences of providing the foreign enterprise with additional capital.

One important point about tax planning in general which must be kept in mind is that the client's organization must be able to live with the operational implications of the tax plan. If the tax plan is too complex from an operating viewpoint, any tax savings may be offset by additional administrative costs. Moreover, if the business is unable to operate, in fact, in accordance with the tax plan, the effectiveness of the plan for tax purposes may be jeopardized. For example, a tax plan might involve the establishment of a foreign subsidiary in a tax haven to purchase goods from the domestic parent corporation and resell them to customers abroad. Such a tax plan might be conditional on the delivery of the goods to the tax haven subsidiary. Therefore, if the goods are shipped by the parent corporation directly to the ultimate customers because that is the sensible thing to do from a non-tax perspective, the success of the tax plan may be jeopardized, and indeed, significant penalties may be imposed on the taxpayer.

There are many different ways of structuring foreign investments. A manufacturing enterprise might sell its goods in a foreign country in one of several ways. For example, it might:

- sell its manufactured goods directly to customers in the foreign country;
- sell its goods to an arm's length foreign distributor for resale to customers;
- establish a branch in the foreign country with a warehouse and sales employees or agents to sell its goods there;
- establish a foreign sales subsidiary in the foreign country;
- establish a foreign holding company which can incorporate a foreign sales subsidiary in the country; and
- license an unrelated foreign corporation to manufacture and sell its goods in the foreign country.

The tax consequences of these various alternatives may vary considerably under the tax laws of a particular country (and from country to country).

One of the fundamental choices in structuring a foreign investment is between a foreign branch and a foreign subsidiary. The essential difference between a branch and a subsidiary is that the latter is a separate legal and taxable entity, whereas the former is a part or division of the domestic parent corporation. As a result, when a domestic corporation sells its products through a foreign branch, the domestic corporation is taxed on the profits of the branch because the branch is not a legal entity. Further, for general law purposes, it is the domestic corporation that is responsible for any legal obligations arising out of its foreign sales activities. In contrast, if the foreign sales are made by a foreign subsidiary corporation, the foreign subsidiary, as a separate legal entity, is taxable on its profits and is responsible for its own legal obligations. There are, of course, exceptions to this general rule.

In summary, a tax adviser is expected to perform two functions with respect to tax planning for international transactions. First, tax advisers must quantify the tax cost, within a reasonable range, of carrying out transactions. Second, tax advisers are expected to provide advice for minimizing the amount of tax payable. Often, this tax minimization aspect of international tax planning involves identifying various methods of structuring a transaction and recommending one method over others in light of the tax consequences and the compatibility of the transaction with the overall operating structure of the enterprise.

Although tax planning for international transactions must be tailored to each client's particular situation, certain common types of tax planning can be identified. Below we describe three types of international tax planning to give some flavor of the nature of the exercise. The following examples have been simplified drastically.

Double dip leases. Some cross-border transactions are structured to exploit differences in the tax treatment of the transactions by two countries. Cross-border leasing provides an example of this type of international tax planning.

Assume that an airline company in Country A wishes to acquire, on credit, some new aircraft for use in its business. It can take out a commercial loan and purchase the aircraft directly, or it can acquire the aircraft by utilizing a so-called financial lease. In general, a financial lease is a financing arrangement under which the lessee acquires substantially all ownership rights to the leased property. In effect, the lessor sells its ownership rights in the property and finances the acquisition of the property by the lessee. Instead of receiving interest and repayments of principal as a conventional lender would, the lessor receives "rental" payments which reflect both the sale price of the property and the financing aspect of the transaction.

Under the tax laws of Country A, a financial lease is treated as a sale. Accordingly, if the airline company leases the aircraft, it would be treated as if it borrowed funds and purchased the aircraft. As a result, it would be entitled to deduct depreciation on the aircraft and the interest element of the lease payments. The depreciation deductions may be very large, as many countries provide accelerated depreciation deductions as a tax incentive for investment. The airline company also would be permitted to claim any investment credits that Country A provides for purchases of aircraft.

If the lessor is a resident of Country A, it will be treated as having sold the aircraft, with the appropriate gain or loss recognized on the sale and as having loaned funds to the airline, with the interest element of the lease payment included in its income. Assume, however, that the lessor is a resident of Country B and that Country B treats financial leases for tax purposes as genuine leases. Under these facts, the lessor will be treated as the owner of the aircraft and will be entitled to take depreciation deductions and to claim any tax credits offered by Country B to owners of aircraft. It will be taxable in Country B on the receipt of rent payments. Country A, however, typically will treat a major portion of the payments as nontaxable installment payments of the sale price of the aircraft rather than as taxable rent. The remaining portion will be characterized as interest.

This type of structure is often referred to as a "double dip" lease because the tax benefits of ownership of the aircraft are claimed in both countries as a result of the inconsistent characterization of the transaction by the two countries.

Tax haven companies. Much international tax planning focuses on the use of countries that levy little or no tax. Such tax havens can be used in a wide variety of ways to reduce taxes of residents of high-tax countries. One common way is to establish a controlled foreign corporation in a tax haven.

For example, assume that ACo is resident in and manufactures goods in Country A, which levies corporate tax at a rate of 40 percent. ACo sells its manufactured goods not only in Country A but also in several other countries. ACo is taxable in Country A on its worldwide profits. ACo incorporates a wholly-owned subsidiary, THCo, in Country TH, which does not impose any income taxes. THCo purchases manufactured goods from ACo at their arm's length price and resells them to clients outside Country A. As a result, the sales profits attributable to sales outside Country A will be earned by THCo, not by ACo. Because THCo is a separate legal entity and because the tax advisers will ensure that it is not resident in Country A, the sales profits derived by THCo are not taxable either by Country A or by Country TH. Thus, assuming that the sales profits are 2 million, this transaction will reduce the taxes payable to Country A by 800,000 (40 percent × 2 million).

If THCo does not have any employees and does not ever take delivery of the goods, Country A may consider the sales profits to be derived by ACo. Even if THCo actually performs the sales function, some countries have rules to attribute the income derived by THCo to ACo. These "controlled foreign corporation" rules are discussed [elsewhere in this *Primer*] dealing with international tax avoidance.

Treaty shopping. Another type of international tax planning involves the use of tax treaties to reduce tax. One common example involves the establishment by a resident of one country of a "conduit" company in another country in order to take advantage of that country's tax treaty network.

Assume that ACo, resident in Country A, has developed valuable intangible property and intends to license the use of the property by manufacturers in several other countries. Country A does not have treaties with some of the countries in which the potential licensees are resident, and the treaties with the other countries provide for withholding taxes on royalties of 15 percent. Country A provides an exemption for dividends received from foreign corporations in which corporations resident in Country A have a substantial participation. ACo transfers its intangible property to a wholly-owned subsidiary, BCo, established in Country B. Country B has tax treaties with all of the countries in which the potential licensees are resident, and those treaties provide for no withholding taxes on royalties. The result is that no tax will be imposed on the royalties by the countries in which the royalties arise. Country B may not tax the royalties derived by BCo, either because it is a tax haven or because it provides generous write-offs for intangible property. When BCo distributes dividends to ACo, Country A will not tax the dividends because of its exemption for dividends. Even if Country A taxes the gain on the transfer of the intangible property by ACo to BCo, Country A may have significant difficulty in taxing the appropriate amount of gain because of the problem of establishing the fair market value of the property with accuracy.

This example illustrates the problem of treaty shopping. In effect, ACo has taken advantage of Country B's treaty network by the simple expedient of establishing a corporation in Country B. BCo functions as a conduit to flow through the royalties as tax-exempt dividends to ACo. The overall effect is that the withholding taxes of the countries in which the royalties arise are avoided. The problem of treaty shopping is dealt with [elsewhere in this *Primer*]. "

§ 1.03. Goals of International Tax Rules

A primary goal of the U.S. income tax system is to raise revenue to finance government spending programs. Raising revenue, however, is the goal of any tax system. That goal, therefore, does not explain why a personal income tax is preferred over other tax mechanisms, such as a sales tax, nor does it explain very much about the design of particular features of an income tax system.

The three goals specific to the U.S. income tax system, as it applies to U.S. citizens and resident aliens, are fairness, efficiency, and administrative economy. Fairness is the primary goal. That goal has two traditional components: horizontal equity and vertical equity. Horizontal equity is generally understood to mean that individuals in comparable economic circumstances, as measured by their income, should pay equal amounts of tax. Vertical equity means, in general, that the poor should be exempt from tax and that the rich should pay a higher proportion of their income in taxes than members of the middle classes.

Economic efficiency and administrative economy are secondary goals of the U.S. income tax in that they do not justify the basic decision to employ an income tax rather than some other tax mechanism. Many specific Code provisions, however, were designed to achieve efficiency and administrative economy. This is especially true of the international features of the U.S. income tax system.[8]

§ 1.03.1. Revenue Goal

Despite its general lack of explanatory power, the revenue goal does explain some of the rules applicable to foreign persons. The United States is in competition with foreign governments for tax revenue from transnational income. That competition is regulated by a general agreement of countries to defer, in the case of a conflict between residence jurisdiction and source jurisdiction, to the country of source. To implement that general agreement, many countries have entered into tax treaties with the United States that require them to give their residents a credit in many circumstances for the U.S. income taxes that they have paid with respect to income derived from the United States.[9]

A foreign tax credit regime utilized by a foreign government sometimes causes the burden of the U.S. tax to be borne by that government rather than by the foreign person paying the tax. In such circumstances, the U.S. policy makers are likely to be more concerned with the revenue goal than with fairness and efficiency goals.

Assume, for example, that T is a resident of Country K. T is earning investment income of $1,000 in the United States. T is taxable on that income in Country K at a rate of 35 percent. Country K also gives T a credit for withholding taxes paid to the United States as long as the U.S. tax does not exceed a rate of 35 percent. Assume that the United States government is deciding whether it wants to tax investment income of foreigners at a rate of 10 percent or 20 percent. On revenue grounds, it obviously should tax T at a rate of 20 percent. Fairness and economic efficiency arguments for or against that rate would not be relevant because the burden of the U.S. tax will fall on Country K and not on T.

In taxing foreign persons, the United States is committed under its tax treaties and certain other treaties to refrain from imposing discriminatory taxes.[10] It is also required by treaty to limit the withholding tax rate applicable to certain types of investment income payable to residents of the treaty country. The U.S. government is not free, therefore, to make revenue maximization its only goal in designing its tax rules applicable to foreign persons.

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[8] For a more detailed discussion of the goals of international tax regimes, see Michael J. McIntyre, "The Design of Tax Rules for the North American Free Trade Alliance," 49 *Tax Law Review* 769, 771-782 (1994).

[9] Some countries seek to prevent double taxation by exempting their nationals from tax on their foreign source income. The exemption may not extend to income earned through a tax haven jurisdiction. For general discussion of exemption regimes, see Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, 2d Ed. (2002), ch. 3.

[10] See, e.g., U.S. Model Treaty (2006), Art. 24 (Non-Discrimination).

§ 1.03.2. Fairness Goal

Fairness in taxation is often discussed in terms of the twin goals of horizontal equity and vertical equity. For domestic individuals deriving all of their income from U.S. sources, the goal of horizontal equity would be achieved by subjecting all income from whatever source derived to uniform rates of tax. To achieve vertical equity, those uniform rates would be graduated. A zero tax bracket—or some functional equivalent, such as a low-income deduction—would be provided to keep the poor off the tax rolls. Whether vertical equity requires some additional graduation of rates is an issue of debate in the tax literature. In the political arena, that debate has been resolved for now in favor of some additional graduation.

The model tax system described above incorporates an implicit assumption that all of the income of the taxpayer is subject to tax without reference to its geographical source. That simple model must be modified to take account of domestic and foreign taxpayers earning transnational income.

§ 1.03.2.1. Fairness to Resident Individuals

For resident individuals, the modified model would be designed to achieve the distribution of burdens that would have been achieved in the simple model if those taxpayers had derived their income wholly within the United States. Adjustments in the simple model must be made for taxes imposed by foreign governments with respect to income derived within their borders. Those adjustments would require some distinction in the treatment of U.S. source income and foreign source income. In substantial measure, those adjustments are made through the foreign tax credit mechanism.

Adjustments in the simple model also must be made to prevent domestic persons from avoiding U.S. taxes through the use of foreign entities. Those adjustments are accomplished through the rules regulating transfer prices to related parties, through the rules taxing U.S. shareholders on the income of certain foreign corporations under their control and through a variety of other anti-avoidance provisions.

§ 1.03.2.2. Fairness to Foreigners

Fundamental adjustments in the simple model described above must be made in the design of tax rules applicable to foreign taxpayers. The basic premise of the simple model is that the entire income of the taxpayer, from whatever geographical source derived, is subject to taxation. That premise is inappropriate for a model designed to govern the taxation of foreigners because the United States is not prepared to tax foreigners on income unless the income has some nexus with the United States.

Absent treaty limitations and possible constitutional limitations, the United States could impose its income tax on foreign taxpayers with respect to their worldwide income. To the extent that such a tax could be collected, it would provide the United States with a politically attractive source of revenue. In practice, however, the exercise of such jurisdiction would be unthinkable. To induce other sovereign states to accept limits on their exercise of tax jurisdiction, the United States must accept some reasonable restrictions on its own tax jurisdiction.

All international income tax agreements that limit the taxing powers of sovereign states rest on the following three pillars. First, a country can exercise residence jurisdiction only over its own residents and nationals. Second, a country can tax income under its source jurisdiction only if that income has some nexus with that country. Third, the country of residence must yield primary jurisdiction to tax to the country of source.

The United States is generally not in a position to ensure that the burdens ultimately imposed on foreign taxpayers are fair. Its fairness goal, therefore, must be modest. The United States can insist that foreign taxpayers pay some taxes, and it can assist foreign governments in achieving their legitimate fairness goals. By exercising some restraint in taxing income derived from economic activity within its borders, the United States supports the fairness goals of foreign countries. It also supports those goals through Code provisions that prevent it from being a tax haven for taxpayers from certain foreign countries.

§ 1.03.2.3. Fairness to Corporations

The goals of the U.S. corporate income tax are unsettled. One apparent goal is to collect current tax on income earned by individuals and tax-exempt entities through their ownership of corporate stock. Putting a tax on corporations probably adds some progressivity to the federal tax system because wealthy individuals own a disproportionate percentage of corporate stock.

The concept of fairness, as understood in the context of a personal income tax, is not directly applicable to the design of a tax on corporations. Individual human beings are thought to have certain inalienable rights, including the right to equal treatment under the law. A corporation is merely a legal structure. Its fairness claims are derivative claims, based on the claims to fairness of their shareholders and of other individuals affected by the corporate tax.

In practice, the Code has applied to corporations the basic rules defining taxable income that are applicable to individuals. The special rules developed to govern corporate distributions, reorganizations, and the like are not explainable by reference to criteria applicable to the taxation of individuals. Even these rules, however, have been influenced by analogies to the tax treatment of individuals.

§ 1.03.3. Economic Efficiency Goal

Tax analysts should care about economic efficiency in the sense that they should prefer a tax system that is efficient to one that is inefficient. When economists discuss efficiency, they typically are referring to what is called "Pareto efficiency." A tax measure achieves Pareto efficiency when it causes the welfare of at least one person to increase without a diminution in the welfare of any other person.

In the international tax context, tax analysts should care less about Pareto efficiency than they do in other contexts. Despite the attention that analysts have been giving to international tax issues in the last few years, they frequently are unable to offer reliable estimates of the Pareto-efficiency consequences of alternative international tax regimes. Given the current state of the economic art, any economic model that purports to measure the efficiency of alternative international tax regimes is going to be hopelessly flawed and subject to manipulation by its designers or sponsors.

In theory, efficiency deserves some weight and perhaps even controlling weight in some circumstances. The problem is that analysts often do not know when efficiency costs of particular international tax rules are high enough to be given significant weight, nor do they know how much weight to give efficiency concerns in particular circumstances. An efficiency principle obviously provides little guidance on the design of international tax rules when analysts do not have a sound basis for deciding when the principle should be applied or what weight to give it.

§ 1.03.3.1. Efficient Taxation of Residents

Commentators have often suggested that the efficient taxation of resident taxpayers (including citizens and domestic corporations) would be advanced by implementing the principle of "capital export neutrality." According to this principle, a country should design its tax laws so that they are neutral as to whether investment is made domestically or abroad. The underlying logic of this principle is that in a market economy, investors will tend to maximize the social rate of return on their capital if they are free to make their investments without respect to tax consequences.

Investors that maximize the social rate of return on their capital tend to maximize world welfare, although they may not maximize domestic welfare. Assume, for example, that PCo, a U.S. company, has \$1,000 to invest. If it invests in Canada, it can expect to earn annual income before taxes of \$100, whereas it can expect to earn only \$90 annually if it invests in the United States. Assume that all of the benefits of PCo's after-tax profits enure to the benefit of the U.S. economy[11]and that PCo is subject to a tax on its profits in Canada at a rate of 35 percent. All else being equal, PCo would maximize worldwide welfare (and its own welfare) by investing in Canada. If it invests in the United States, however, it would increase domestic welfare by \$90 (U.S. tax of 35% of \$90 = \$31.50 plus after-tax profit of \$58.50), whereas the investment abroad would increase domestic welfare by only \$65 (\$100 profit minus \$35 Canadian tax).

The example above assumed implicitly that the only cost to the United States from pursuing the goal of capital export neutrality was the lost tax revenue. In the real world, a country may suffer additional costs when its residents decide to invest abroad. For example, jobs might be exported along with the investment capital. If a country is more concerned—as most countries are—with maximizing domestic welfare than with maximizing worldwide welfare, it is difficult to understand why it would embrace the principle of capital export neutrality.

Although some bias in favor of domestic investment over foreign investment is rational, an unlimited bias is not. To illustrate, assume that PCo in the above example could earn \$400 annually from its Canadian investment, for an after-tax return of \$260 to it and to the United States. The domestic investment, however, would yield only \$90 of benefits to the United States. All else being equal, therefore, the United States would benefit much more from the foreign investment than from the domestic investment.

In the real world, a country probably cannot follow a policy of favoring domestic investment over foreign investment in an aggressive manner without provoking a tax policy response from foreign countries. In some cases, the response would be sanctioned by treaties to which the United States is a signatory.

Assume, for example, that QCo is a Canadian company that has \$1,000 to invest. It can earn a before-tax annual income of \$100 by investing in the United States and a before-tax income of \$90 by investing in Canada. Assuming that the United States and Canada have a 35 percent tax rate, the Canadian government would prefer that QCo invest in Canada for the same reason that the U.S. government wanted PCo, in the above example, to invest in the United States. If the United States takes measures to guarantee that PCo invests in the United States, Canada can be expected to take retaliatory action to guarantee that QCo invests in Canada. The result would be a loss of domestic welfare for both the United States and Canada and a loss in worldwide welfare.

The examples above assumed that countries could readily take effective action to favor domestic investment over foreign investment. That assumption is unrealistic. Few if any countries have demonstrable success in using tax measures to foster domestic investment in an efficient manner. Virtually all tax incentive programs have ended up serving political objectives rather than economic objectives. Thus the principle of capital export neutrality may be a worthy goal in practice notwithstanding its weak theoretical underpinning.

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[11] Politics aside, U.S. policy makers should not care whether U.S.-based multinationals enjoy greater success than their foreign competitors unless they believe that the U.S. economy benefits in some special way from that success.

Most proponents of capital export neutrality have viewed that principle as an injunction against tax preferences for foreign investment. Whether that principle adds to the case against such preferences is unclear. What is clear is that those preferences are unjustified on efficiency grounds. They clearly reduce worldwide welfare, all else being equal, and they clearly tend to reduce domestic welfare. The prevalence of those preferences in the Code is due almost entirely to the political power of the multinational companies that enjoy the benefits.

Commentators who favor tax preferences for foreign investment have asserted that "capital import neutrality" rather than capital export neutrality is the proper goal of U.S. international tax policy. In their view, residence-based taxation, which is a requirement of capital export neutrality, makes U.S.-based multinationals uncompetitive in foreign markets. This assertion is remarkable, given the overwhelming evidence that U.S.-based multinationals are extremely competitive in foreign markets. In addition, capital import neutrality cannot claim any support from economic theory. This ersatz principle amounts to little more than an assertion that business enterprises should be taxable exclusively in the country of source.

§ 1.03.3.2. Efficient Taxation of Foreigners

To achieve the goal of economic efficiency in taxing foreign persons, the U.S. government should seek to obtain some reasonable degree of tax parity between U.S. persons and foreign persons. Efficiency would suffer if the burdens on foreigners were too high because such burdens would discourage foreign persons from engaging in productive economic activity within the United States. Too low a burden on foreigners would give them an unwarranted competitive advantage over domestic taxpayers. Of course, full tax parity between foreign and domestic taxpayers is impossible to achieve because foreign taxpayers are not taxable by the United States on their income derived from foreign operations.

§ 1.03.4. Administrative Economy Goal

The U.S. international tax regime is so complex that outside observers might be led to conclude that administrative economy has played little role in the design of that regime. In fact, however, many of the major features of that regime have been driven by a desire to minimize compliance problems for the tax authorities and affected taxpayers. That is, administrative economy has been a goal of policy makers, notwithstanding the frequent failures in achieving that goal.

Of course, administrative issues have rarely gotten the attention they deserve. In most political battles over tax policy, the participants are usually willing to give up the goal of administrative economy before surrendering their core objective of lower or high taxes. Under the time pressures of a political battle, moreover, the participants often do not have the time needed to give administrative issues their due.

The withholding rules applicable to nonresident taxpayers are the most obvious example of international rules developed primarily to achieve administrative economy. Withholding at source is the most effective administrative technique yet developed for assessing and collecting income taxes. To facilitate assessment and collection of the tax on the investment income of foreign persons at the source, the United States generally imposes a flat-rate tax of 30 percent on gross investment income, without allowance for deductions properly allocable to such income. Obviously this regime is inconsistent with traditional fairness criteria and is not mandated by economic efficiency concerns.

§ 1.04. Scope and Organization of Book

The international tax rules addressed in this book determine the U.S. income tax consequences to foreign persons from engaging in investment or business activities in the United States. They also determine the U.S. income tax consequences to U.S. persons from engaging in similar activities abroad. Issues relating to the activities of individuals are addressed frequently in this book. The focus, however, is on the activities of corporations. International aspects of the taxation of partnerships, trusts, and estates receive only limited attention. Taxes other than income taxes are not discussed at all.

Chapter 2 of this part deals with the taxation of U.S. citizens. Chapter 3 deals with the taxation of individuals resident in the United States. The tax jurisdiction rules applicable to legal entities are addressed in chapter 4. Some planning problems are presented in Chapter 5.

Part 2 of this book describes the rules employed by the United States for taxing foreign corporations, nonresident alien individuals, and other foreign persons on income derived from economic activity conducted in whole or in part within the United States. Under the Code, the investment income and business income of foreign persons are subject to different tax regimes. In general, investment income is taxed at a 30-percent rate, with no allowance for costs of earning such income. Business income is not taxed unless the foreign person has established some minimum contacts with the U.S. economy. Foreigners having such contacts are taxed on a net basis under the tax rate schedules applicable to U.S. persons.

The rules developed by the United States for determining the source of income are presented in Part 3. Source rules are important to foreign persons primarily because foreign persons are subject to U.S. tax jurisdiction with respect to their U.S. source income. Those rules are important to U.S. persons earning transnational income primarily because the amount of the credit for foreign taxes that they can claim depends in part on the amount of their foreign source income. The general rule is that U.S. persons and foreign persons employ the same source rules. There is a growing list of exceptions, however, to the general rule.

The results reached under the Code for taxing foreign persons may be modified for persons residing in a country having a tax treaty with the United States. Tax treaty issues are addressed in Part 4. In general, foreign persons engaged in business in the United States are not taxable by the United States unless they have a fixed place of business or other permanent establishment located within the United States. In addition, only income attributable to that permanent establishment is subject to U.S. tax. Foreign persons earning investment income in the United States are often provided with a substantial reduction in the 30-percent withholding tax rate if they are resident in a treaty country.

The foreign tax credit is the subject matter of Part 5. In general, a U.S. person may claim as a credit against U.S. tax the amount of foreign income taxes that it has paid. U.S. corporations also may claim a credit for taxes paid by their a foreign affiliates. Complex limitation provisions apply to prevent perceived abuses of the credit. The limitation provisions were modified substantially by the 1986 tax act through the introduction of the so-called "separate basket" rules. These rules, in general, limit opportunities for taxpayers having excess foreign tax credits from obtaining additional foreign tax credits by shifting U.S. source income to foreign sources.

Part 6 presents the rules that the United States employs to limit the ability of taxpayers to minimize taxes by manipulating the prices charged to related parties on intercompany transfers. These rules apply to foreign persons and to U.S. persons. Under Code section 482, taxpayers are required to set their transfer prices equal to the amount that they would have charged in an arm's length transaction with an unrelated party. Practical and theoretical problems arise in determining an appropriate arm's length price for transactions having no clear market analog. Transfer pricing issues have been much discussed over the past decade and a half. The Treasury Department issued regulations under section 482 in 1994 that replace the much less detailed regulations adopted in 1968. Perhaps stimulated by the U.S. initiatives, many other countries have refined their transfer pricing rules in recent years. The Organization for Economic Cooperation and Development ("OECD") issued a report in 1995 that provides substantial guidance to countries in refining their transfer pricing rules.

Many U.S. persons engaged in international commerce have sought to avoid the residence jurisdiction of the United States through the use of controlled foreign corporations (CFCs) organized in tax haven countries. The measures adopted by the United States to block such tax avoidance attempts are explained in part 7. Many of those measures are found in subpart F of the Code. Under the subpart F provisions, foreign corporations controlled by U.S. interests are deemed to have distributed to their U.S. shareholders the portion of their net profits deemed to have been deflected to a tax haven corporation. The subpart F provisions are supported by other anti-avoidance rules, such as, for example, the rules applicable to foreign passive investment companies (PFICs).