Guidelines for Taxing International Capital Flows: The Legal Perspective

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The celebrated complexity of the international income tax rules of the United States is symptomatic of fundamental design problems. The principles of taxation that apparently inform the current U.S. rules are not well developed and are not fully compatible with each other. In addition, the factual premises that underlie those principles are not in accord with current realities. The same may be said of the tax regimes of U.S. trading partners. Indeed, the U.S. rules are, in most respects, the best of a bad lot.

In this paper, I set forth and discuss some guidelines that could inform the design of a coherent international tax regime. A U.S. tax regime designed according to these guidelines would advance long-term U.S. national interests and would promote fair and efficient taxation worldwide. The focus of the paper is on the taxation of income from moveable capital. The design of rules governing the taxation of capital income, however, cannot be divorced from the rules for taxing business income. Poorly designed business taxation rules will undermine good capital income rules, and the converse is also true. Thus the guidelines suggested here are ones that have general applicability.

Statement of the Guidelines

Guideline #1: Worldwide taxation. To promote the traditional fairness goals of an income tax, the citizens and residents of a country should be taxable currently on their worldwide income, including their income from moveable capital. See guidelines #5 and #6.

Guideline #2: Source taxation. To mitigate competitive pressures that would undermine its income tax and to raise revenue, a country should tax foreign persons on income, including income from moveable capital, that is derived from business or investment activities conducted within that country. Taxes on capital income should be collected through withholding so as to facilitate administration of the tax. The withholding rates should be moderately low so as to mitigate problems of capital flight and the problems of taxing financial intermediaries. Capital flows derived through novel financial instruments should be subject to a withholding tax at the rate applicable to the least favored form of capital income.

Guideline #3: Foreign tax credit (or functional equivalent). To promote investment activities within its borders, a country should arrange, through bilateral or multinational tax treaties, for foreign persons subject to source-based income taxes to receive appropriate relief from double taxation in their country of residence. To promote international tax comity, a country should give its citizens and residents unilateral relief from double taxation, but the relief should be limited to genuine income taxes paid with respect to currently taxable income.

Guideline #4: Tax harmonization. To reduce economic pressures that might undermine its domestic income tax, a country should work toward the harmonization of worldwide tax rates and should undermine the viability of tax havens through all appropriate means.

Guideline #5: Accrual taxation of foreign funds. To avoid creating a tax incentive for holding moveable capital offshore, a country should tax its citizens and residents on income derived from foreign funds (including foreign trusts and other investment vehicles) as the income accrues.

Guideline #6: Formulary apportionment. To simplify the taxation of multinational enterprises and to promote a fair distribution of tax revenues among the countries in which they operate, a country should work toward an internationally sanctioned formulary apportionment system.

Commentary on the Guidelines

Each of the guidelines (and subguidelines) set forth above has sufficient content that it can be supported or rejected based on its likely effects. I briefly state my arguments for the guidelines and indicate some of their policy implications.

Worldwide Taxation

The rules governing the taxation of international capital flows should be an organic part of a country's income tax system. A discussion of the merits of an income tax relative to other forms of direct taxation is outside the scope of this paper. I simply note that the income tax is currently the clear winner in the political arena.[2]

An income tax based on Haig/Simons principles is inherently global. An exemption for foreign source income is precisely the type of source distinction that Henry Simons inveighed against. Thus arguments against worldwide taxation should be understood for what they are — an attack on the income tax itself. Such attacks are surely appropriate in some contexts, but not in the context of designing rules to govern the taxation of capital income under an income tax.

Guideline #1 implicitly approves taxation of income earned by citizens and nationals through legal entities, including legal entities organized in foreign jurisdictions. In the long run, I would favor the taxation of business income through a formulary apportionment system (see guideline #6). Investment income generally should be taxable as it accrues (see guideline #5).

Source Taxation

Commentators generally agree in principle that a country should exercise tax jurisdiction over income arising from business and investment activities conducted within its borders. The exceptions that are made in practice to the exercise of source jurisdiction, however, are extensive.

Transnational business income is often lightly taxed or exempted from tax entirely, largely due to provisions in tax treaties that were designed for a world in which international messages were carried by steamer. The United States collects little income from foreign importers (including in many cases importers controlled by American companies). The amounts of revenue collected from other foreign corporations and their controlled U.S. subsidiaries are also very low, notwithstanding the very substantial activities they conduct within the United States.[3] This situation will not be changed until the United States revises the permanent establishment clause in its tax treaties and eliminates the treaty exemption currently provided to foreign persons operating in the United States through a domestic subsidiary.

Most countries also do a poor job of exercising source jurisdiction over the returns on moveable capital. For example, most countries, including the United States, exempt the interest income of nonresidents from taxation, by statute, by treaty, or by both. Many countries, including the United States, allow rental income to be deflected to a tax exempt entity through its tax leasing rules. Royalty income is typically exempt by treaty or is subjected to a very low rate. In contrast, income distributed as a dividend often does get taxed, sometimes twice.

If the countries of the world are going to tax income from capital — and such taxation is essential to the survival of the income tax as a coherent policy tool — they must impose at least some of that tax at the source. Taxpayers seeking to confuse the tax collector by funnelling capital income through a maze of corporate shells should be subject to cascading withholding taxes at each juncture in the maze.

Income from newly minted financial instruments often avoids withholding taxes, due to uncertainty about its taxable status. Indeed, the point of creating those instruments is typically to outfox the tax collector. The proper governmental response is to subject the capital income derived from hybrid financial instruments to withholding taxes at the rate applicable to the least favored form of capital income (typically the dividend rate). A more favorable rate might be allowed prospectively by statute in appropriate cases.

All countries feel themselves under substantial economic pressure to exempt investment income, and especially interest income, from taxation. Without international cooperation, a small country that imposes a withholding tax on interest payments made to foreigners should expect that most of the tax will be borne not by the foreign lender but by the domestic borrower. Even the United States, the world's largest economy, should anticipate significant shifting of withholding tax burdens from the foreign lender to the U.S. borrower.

The shifting problem described above would be mitigated, even solved completely, if the major industrial countries of the world would harmonize their withholding taxes at some positive rate. The United States could take an important first step toward such harmonization by imposing a low-rate withholding tax (e.g. two percent) on all interest payments. If this initiative is successful, other countries are likely to follow, thereby opening up the possibility of higher withholding rates.

Most U.S. tax treaties provide for low rates of tax on interest and royalties. These treaty obligations must be honored, although negotiations should commence to modify those treaties. To reduce tax avoidance and evasion in the interim, foreign taxpayers entitled to relief under a tax treaty should be subjected to withholding and then offered a prompt refund of the tax after they have establishing their right to treaty relief.

Foreign Tax Credit

Under every U.S. tax treaty, the treaty partner promises to grant its residents and citizens some form of relief from double taxation with respect to U.S. source taxes. The usual form of relief is a credit. Guideline #3 suggests no change in current policy.

The guideline puts emphasis on the credit granted to the treaty country to its own citizens and residents. The usual focus of the U.S. Treasury Department in treaty negotiations, however, has been on obtaining some reduction in the foreign taxes paid by U.S. persons. For example, Treasury officials have publicly acknowledged that they used some of their leverage in their recent treaty negotiations with Mexico to get the Mexican withholding rate on interest income below five percent. It is unlikely that U.S. national interests were served by that negotiating approach.

When U.S. tax rates were high by world standards, the policy goal of obtaining reductions in the foreign taxes imposed on U.S. persons had some surface justification. By getting the otherwise high foreign taxes below the U.S. rate, the United States put itself in position to pick up some tax revenue. In fact, however, U.S. companies paid little residual U.S. tax on their foreign source income even in the days of relatively high U..S. tax rates.[4]

Under current conditions, the United States typically cannot gain tax revenue from negotiating lower rates for U.S. persons. Although some U.S. taxpayers benefit, the benefit to the U.S. economy may be negligible. The benefits might be negative if the lower foreign taxes induce U.S. persons to move their operations from the United States to the foreign country.

The United States has provided a foreign tax credit by statute since 1918. By giving the credit unilaterally rather through the tax treaty process, the United States reduces somewhat its leverage in treaty negotiations. The loss of leverage, however, is probably not great; in many cases, it may be negligible.

The benefits from granting a unilateral credit are probably impossible to document. I strongly suspect, however, that the United States has had a very positive impact on the international tax practices of its trading partners by granting the credit unilaterally. That action may have contributed to the development of an international consensus in favor of providing relief from double taxation, through tax treaties or otherwise. It may also have reduced the emphasis in treaty negotiations on the expected tax revenue gains and losses of the negotiating partners. Countries ought to care about revenue, but they should care about other matters as well. As long as countries negotiate treaties on a bilateral basis, they will forgo desirable agreements if they insist that each agreement be revenue-neutral.

Although a unilateral credit is probably desirable, the U.S. unilateral credit rules are far too generous and are out of line with international norms. To protect the integrity of the income tax, the unilateral credit should be given only for taxes that are unambiguously income taxes. Cross crediting of high foreign taxes against foreign income subject to low foreign taxes should not be permitted. The separate basket limitations adopted by the United States in 1986 represent a step in the right direction. They should be tighten, however, and simplified.

Most importantly, the unilateral credit should be limited to genuine income taxes paid with respect to currently taxable income. The U.S. credit for in-lieu taxes should be eliminated and the definition of a creditable tax should be tightened.

In addition, taxpayers that elect to defer income earned through a foreign corporation should permanently lose the right to a unilateral foreign credit. Assume, for example, that P, a U.S. corporation P, earns $100 in year 1 through F, a foreign subsidiary. F pays a foreign income tax of $10 in that year. P could only get the credit for that $10 under the unilateral credit rules only if P is taxable by the United States in year 1 on a real or deemed distribution from F. To avoid hardship and to prevent U.S. taxpayers from needlessly incurring foreign withholding taxes, the U.S. tax code should allow taxpayers to elect to be taxable currently on undistributed income derived through a foreign corporation.[5] Note that under Guidelines #5 and #6, all foreign source income of domestic taxpayers would be subject to current taxation.

Tax Harmonization

Tax harmonization, like tax simplification, is one of those goals that everyone favors and no one is willing to give up very much to achieve. Its support is very broad and very thin. As the economies of most countries are becoming more and more global, however, the potential benefits from tax harmonization increase markedly.

Without substantial harmonization of tax rates, countries will face increasing market pressures to avoid origin-based taxes such as the income tax. The alternative, destination-based taxes, may also be put under pressure. For example, Canada has encountered competitive problems as a result of its recently enacted General Sales Tax (GST) due to the opportunities available to many Canadian residents to shop in the United States. In any event, destination taxes are typically steeply regressive and are not an acceptable substitute for an income.

Within an economic community, such as the EC or NAFTA, the need for harmonization increases. Fortunately, the possibility of achieving it also increases. The experience of the European Community suggests that harmonization is difficult, even among relatively homogeneous countries. the goal, however, is attainable.

Accrual Taxation of Foreign Funds

A country cannot expect to impose an effective tax on the domestic gains from moveable capital earned by its citizens and residents unless it is prepared to tax comparable gains earned abroad.[6] Thus some foreign fund rule is an essential complement to a domestic tax on capital income. The fund rules should be very strict — all income should be subject to current tax even at the risk of discouraging foreign investment and eliminating foreign funds as viable investment vehicles for domestic taxpayers.

The down side of strict rules applicable to foreign funds is small. Taxpayers treated harshly under the fund rules will respond by investing domestically, which is probably a desirable outcome, or investing abroad through a domestic investment vehicle, which may also be desirable.

To work well, a fund rule must be tight — that is, all vehicles for foreign portfolio investment must be covered by the fund rules. In addition to traditional funds, the rules should cover trusts, partnerships, annuity contracts, certain insurance contracts, and the like.

Formulary Apportionment

A formulary apportionment regime would eliminate most of the difficult transfer pricing problems, the deferral problems, and the source rule problems that plague the U.S. tax system and the systems of other countries. It would introduce, of course, some problems of its own. Those problems are not intractable ones, however, as long as some reasonable level of cooperation can be achieved among the major industrial countries of the world.[7]

A good formulary apportionment system would eliminate the benefits to be derived from tax havens because the apportionment formula would not attribute any income to tax haven states. Once a critical mass of participating countries is achieved, the apportionment formula could be set so as to attribute no business income to states that refused to participate in the system.

An appropriate starting point in developing a formulary apportionment system would be among members of an economic community, such as the EC or NAFTA.[8] Starting with NAFTA is more promising, partly because the subnational governments of the United States and Canada have had favorable experience with unitary taxation, and partly because of the current hostility of the Europeans to unitary taxation.

Unhelpful Traditional Principles

None of the guidelines presented above rely on the so-called principles of capital export neutrality or capital import neutrality, notwithstanding the usual prominence of those principles in discussions of international tax regimes. In my view, capital export neutrality is a secondary goal. Neutral treatment of capital flows cannot be achieved fully without subversion of the income tax through an exemption for capital income. Capital import neutrality is a lobbying position, not a coherent tax policy goal.

Capital Export Neutrality

In virtually every country of the world, capital inflows generally are considered desirable and are encouraged, through tax and other economic policies. Capital outflows are thought to diminish national wealth and are discouraged, at least to some degree. Prudent policy makers exercise some caution in discouraging outflows, partly in deference to powerful political factions and partly out of an understanding that limitations on capital outflows may discourage capital inflows. But they unquestionably reject capital export neutrality as an overarching goal of income tax policy.

Policy makers are right to give little weight to capital export neutrality in the design of international tax rules applicable to income from moveable capital. Although often invoked, that principle has never been properly defended. To make a proper defense, analysts must demonstrate that a country's welfare is generally improved by allowing a free flow of capital across its national borders, and they must show that the projected welfare gains are substantial enough to justify the many costs associated with the free flow of capital.

Some worldwide economic benefits might be expected to arise from the flow of investment capital to the place where its utilization would yield the highest gain. If the investment of $100 in a factory in Thailand would produce profits of $10, and the same investment in a factory in Singapore would produce profits of only $8, then it can be assumed in general that investment in Thailand rather than Singapore would improve worldwide welfare.

Although a free flow of investment capital to its most productive use may tend to enhance worldwide welfare, it does not necessarily tend to enhance national welfare, as many commentators have noted. Worldwide welfare is desirable, but national welfare is the more appropriate goal of a national tax policy.

A less obvious flaw in the argument for free capital flows is that those flows are only tangentially related to investment in factories and farms and other engines of production. Most of what the world characterizes as capital investment is investment in paper assets, such as bonds and shares of stock. The linkage between the yield on paper assets and productivity is often difficult to establish. Whether a flow of capital from low-yield paper to high-yield paper will enhance world welfare is often uncertain. Whether it would enhance national welfare is virtually unknowable.

The principle of capital export neutrality is sufficiently flexible that it can be invoked to support most of the guidelines presented in this paper. It might also be invoked to oppose many of those guidelines. For example, current taxation of foreign investment funds, by eliminating a bias in favor of domestic investment, can be defended on capital export neutrality grounds. The tough, discriminatory rules against foreign funds, however, may be seen as violating capital export neutrality. A tax principle that is so flexible has limited explanatory power.

Capital Import Neutrality

According to the so-called principle of capital import neutrality, a country should avoid international tax rules that might cause its multinational companies to bear a higher effective tax burden in foreign markets than the multinational companies of other countries. It effect, it is a plea for residence countries to adopt an exemption system. It is best understood as a spending principle, not a tax principle. That is, it calls for special treatment of income earned by domestic-based multinational companies on the ground that such treatment will enhance the competitive position of domestic-based multinational companies.[9]

The fundamental weaknesses in the general case for capital import neutrality should be well understood.[10] In any event, the case for an exemption system on competitive grounds has little or no relevance to the design of tax rules applicable to the taxation of interest, portfolio dividends, rents, royalties and other income derived from moveable capital. An exemption system, as applied to income from moveable capital, would result in most capital income being earned through tax haven corporations.

Concluding Note

Some of these guidelines set forth above are ones that the United States could follow unilaterally. Others require close cooperation with its major trading partners. All embody explicit value judgments that analysts can accept or reject. I have briefly stated my reasons for embracing them.

Notes

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2. See M. McIntyre, Book Review: *World Tax Reform* (M. Boskin & C. McLure, eds.), 38 *Canadian Tax Journal* 767-772 (1990).

3. For discussion of the need to revitalize U.S. source jurisdiction, see M. McIntyre, "The Demise of U.S. Source Jurisdiction," 1 *Tax Notes Int'l* 371-373 (October 1989).

4. Because of weaknesses in the credit limitation rules, U.S. corporations frequently were able to cross credit high foreign taxes inposed on foreign business against the U.S. tax otherwise imposed on foreign portfolio income. In addition, many U.S. corportions took advantage of loopholes in the subpart f rules to defer tax on their foreign source portfolio income.

5. See *Statement of Michael J. McIntyre on H.R. 5270, The Foreign Income Tax Rationalization and Simplification Bill of 1992*, before the House Ways and Means Committee, July 21, 1992.

6. For discussion, see M. McIntyre, "Australian Measures to Curb Tax Haven Abuses: A United States Perspective," 5 *Australian Tax Forum* 419-449 (1988).

7. For a discussion of the benefits and drawbacks of a formulary apportionment system, see M. McIntyre, "Design of a National Formulary Apportionment Tax System," 1991 *NTA-TIA Proceedings* 118-124 (1991).

8. A proposal for using NAFTA to launch formulary apportionment in the international arena is set forth in R. McIntyre & M. McIntyre, "Using NAFTA to Introduce Formulary Apportionment," 6 *Tax Notes Int'l* 851-856 (April 5, 1993) (based on testimony before the Senate Committee on Governmental Affairs, March 25, 1993).

9. The United States should be concerned primarily with increasing the welfare of its citizens and residents. That welfare may be enhanced by measures that increase the competitve position of the U.S. economy. The competive position of U.S.-based multinationals should be an objective of the U.S. government only to the extent that such competiveness contributes to the welfare of U.S. citizens and residents. For discussion, see M. McIntyre, "Understanding Competitiveness Arguments," 1 *Tax Notes Int'l* 497-499 (November 1989). See also Staff of the Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, Washington, D.C.: U.S. Gov't Printing Office (1991); J. Slemrod, "What Makes a Nation Prosperous, What Makes It Competitive, and

Which Goal Should We Strive For?" 9 *Australian Tax Forum* 373-385 (1992).

10. See M. McIntyre, *The International Income Tax Rules of the United States*, Boston: Butterworths Legal Publishers (1989 with current updates) at 6/A (explaining that an end to deferral might raise the cost of equity capital under some circumstances but otherwise would not create competitiveness problems).