House Ways and Means Committee Luncheon Meeting
Issues in International Taxation
U.S. House of Representatives
107th Congress, Second Session
April 25, 2002

Statement of Michael J. McIntyre
Professor of Law
Wayne State University

Options for Major Reform of the U.S. International Income Tax Rules

My name is Michael J. McIntyre. I teach international tax and various other tax courses at Wayne State University Law School in Detroit, Michigan. I have been writing on international tax matters since the early 1970s, when I began teaching at the International Tax Program at Harvard Law School. Over the past 30 years, I have worked with many foreign governments in the design and reform of their international tax rules and have been involved in policy discussions about the U.S. international tax rules in many forums. I thank the committee for inviting me to participate in this discussion on major reform of the U.S. international tax rules.

Summary

For reasons discussed in detail below, I believe that Congress should not adopt a "source-based" or "territorial" tax system but instead should focus its energies on reform of the current system. I set forth below an agenda for reform of the current international tax rules of the United States. I also explain why a source-based system would not serve the best interests of the American people and the American economy.

Section 1, below, sets forth some major reforms that would be useful to improve the fairness, efficiency, and administrative economy of the current system. In my view, the current system has some serious flaws that require the immediate attention of Congress. Fortunately, many of the flaws are rather easily fixed, given the political commitment to do so.

Section 2 examines what some commentators refer to as a "territorial" system. Actually, there are a variety of territorial systems, some reasonable, some not so reasonable. The territorial system being proposed as a replacement for the U.S. corporate tax falls into the latter category. It is best described as a "source-based" tax system. It may be distinguished from various forms of sales taxes, which are inherently territorial in that the sales tax is imposed with respect to transactions occurring within a particular geographical area. It may also be distinguished from a worldwide formulary

apportionment system, which taxes income from whatever source derived but assigns jurisdiction to tax that worldwide income by an apportionment formula.

The source-based tax system examined in section 2 would exempt U.S. corporations on income earned through foreign affiliates and on some or all of their foreign source income. The details of the various source-based systems vary somewhat, depending on the sophistication and political leanings of the proponents. The details, however, are relatively unimportant because all of the systems are badly flawed. As explained in detail below, a source-based system is undesirable for the United States or any other country and has only been adopted by tax-haven countries. It would make the U.S. tax system substantially less fair, it would create major inefficiencies that would undermine the competitiveness of the U.S. economy, and it would present nearly hopeless problems of administration. It should be viewed as an umbrella concept describing a package of new tax preferences targeted at U.S.-based multinationals rather than as a serious alternative tax model.

1. Reform of the Current International Tax Rules

The United States currently taxes U.S. corporations on their worldwide income and allows a foreign tax credit for foreign income taxes and foreign "in lieu" taxes paid by those corporations. It generally does not tax U.S. corporations on their income earned through foreign affiliates unless the foreign affiliate earns certain types of income easily shifted to a tax haven. Such "tainted" income is taxable to the U.S. parent corporation under subpart F of the Code (and related provisions) when it is earned. A U.S. parent corporation is allowed a foreign tax credit for the foreign income taxes paid by their foreign affiliates when the foreign affiliates distribute their profits to the U.S. parent as a dividend or when those profits are taxable under subpart F and related provisions.

The decision to tax U.S. corporations on their worldwide income promotes the traditional three tax policy goals of fairness, efficiency, and administrative economy. Some aspects of the current system, however, are in need of reform. The current system permits a high degree of tax avoidance and evasion, creates some inefficiencies that discourage productive investment in the United States, imposes heavy administrative burdens on the Internal Revenue Service, and encourages taxpayers to engage in various tax strategies that lead to high compliance costs. The following changes would improve the current system significantly.

a. Eliminate Deferral

Much of the unfairness, inefficiency, and complexity of the current system comes from the failure of the United States to tax U.S. corporations on income earned through foreign affiliates. When the corporate income tax was adopted over 90 years ago, very few U.S. corporations operated abroad through separately-incorporated affiliates. The question of how income earned through a foreign affiliate should be taxed was not really addressed in any detail. It was simply assumed that a foreign affiliate would be treated as distinct from its parent corporation in the same way that the individual shareholders of a corporation were treated as distinct from the corporation. Few people today would assume that members of a corporate family are distinct taxpayers in any substantive way. In this check-the-box era, the formal organization of a corporate group is understood to be a matter of minor significance. It is foolish, therefore, to make the taxation of the income of a parent corporation turn on its choice of organizational form. If a U.S. corporation has earned income, it should be taxable on that income, whether that income was earned through a branch, an affiliate, or some partnership arrangement.

One of the foolish inconsistencies in the Code is to treat a foreign affiliate of a U.S. corporation as a branch in allowing the U.S. corporation to claim a credit for the taxes paid by the affiliate but to treat the affiliate as a separate entity in allowing deferral of its income — unless the taxpayer checks the box to have the affiliate treated as a branch. The correct solution to this inconsistency is to allow the credit and tax the income earned through the affiliate currently.

In taxing a U.S. corporation, the general rule should be that all of its income is taxable, without regard to the source or the form in which it is earned. That rule is simple, fair, and efficient. It would mean that a U.S. corporation and, indirectly, its shareholders, could not obtain an unfair tax advantage over other U.S. corporations by earning income abroad rather than in the United States. It would mean that U.S. corporations would not have a tax incentive to invest abroad when they could earn as much or more, prior to tax, from investing in the United States. It would mean that the costs of administering the tax system, for the taxpayer and the government, would be cut drastically because U.S. corporations would have far less opportunity to avoid tax through the complex avoidance schemes developed by their tax advisors.

Some transitional relief would be appropriate if the United States ended deferral entirely. Otherwise all of the income currently being held abroad in foreign affiliates would become taxable immediately. The simplest and most efficient way to provide relief would be to assess the appropriate tax in the year the reform goes into effect but to allow payment of the tax over some extended period, such as five or ten years. This catch-up tax would act like a lump-sum levy — the gold standard for an efficient tax. Assessing the tax in full in the transition year would also promote simplification because taxpayers generally would be free to restructure their overseas operations to achieve their business goals without concern for tax consequences.

Full taxation of U.S. corporations on their foreign earnings will undoubtedly provoke sharp resistence from those now enjoying the benefits of tax deferral. Such opposition is to be expected. Indeed, its absence would suggest that those claiming that full taxation of foreign source income would promote fairness and efficiency had made some mistake in their analysis.

b. Fix the Subpart F Rules

In 1962, the Kennedy administration proposed the full taxation of U.S. corporations on their foreign source income earned directly or through a controlled foreign corporation (CFC). That proposal met with fierce resistance from the tax avoidance community and was not adopted by Congress. Instead, Congress adopted the subpart F provisions that imposed current tax on various types of investment income and on many types of active business income that are easily shifted to a tax haven. The subpart F rules are quite complicated, and tax professionals were able to find some loopholes in those rules. The rules were reformed and rationalized in 1986, again to a chorus of complaints from the usual suspects.

Over the past decade, the subpart F rules have again developed major leaks. The problems have arisen from many causes, including inaction by Congress and the IRS in the face of clear abuses, some bad decisions by the IRS and the Courts, and the highly aggressive and perhaps unethical conduct of some tax planners. We know from the Enron debacle that at least one of the major accounting firms has been playing fast and loose with the tax system. As suggested above, the best response to the problems of subpart F is to tax U.S. corporations on all of their foreign source income, including the income earned through foreign affiliates. If that reform is not currently on the table, Congress can restore the integrity of the subpart F rules by adopting all of the following reforms.

(1) *Anti-Inversion Rule*. The Code should treat foreign corporations owned by U.S. persons as controlled foreign corporations, without regard for the percentage of the voting stock owned by those U.S. persons. Currently, a U.S. person must own at least 10 percent of the voting stock of a foreign corporation to be counted in determining whether the foreign corporation is owned by U.S. interests. The elimination of the 10-percent ownership requirement would prevent companies like Stanley Tools from avoiding U.S. taxes by reincorporating themselves in the Bahamas or some other tax haven. It would also prevent a wide host of other devices currently used to avoid U.S. taxes. This common-sense rule is part of the anti-tax haven legislation of a number of foreign countries, including Germany, Japan, and the United Kingdom.

(2) *New Branch Rules*. The subpart F branch rules should be expanded and rationalized to take account of new opportunities for tax avoidance arising under the so-called check-the-box regulations issued in 1996. Various techniques are available to achieve the proper result. The most effective would be to allow the IRS to treat any legal entity or branch as a separate corporation for purposes of determining the subpart F income of a controlled foreign corporation. For example, if FCo is treated as a branch of

PCo under check-the-box and FCo pays a royalty to PCo, the royalty would be treated as a payment from a related person, subject to tax under the subpart F rules. This is the proper subpart F result and the result produced prior to the adoption of check-the-box. The expanded branch rule would also permit the IRS to elect to treat a hybrid entity as a partnership, branch, trust, or corporation if necessary to prevent the avoidance of the subpart F rules.

(3) *Contract Manufacturing Fix.* The branch rules contained in the Code and Regulations should be modified to correct the tax-avoidance problem created by the decision in *Ashland Oil*, which allowed a CFC using a contract manufacturer to avoid subpart F. In particular, if a CFC uses another entity to conduct manufacturing activities on its behalf, it should be treated as having a branch in the country where those activities are conducted. As a result, any transfer from the deemed branch to the CFC would be treated as a purchase from a related party for purposes of the subpart F rules. Under this rule, sales income deflected to a tax haven would be subject to current taxation notwithstanding the exception provided under subpart F for corporations that manufacture the goods they sell.

(4) *Financial-Services Income.* Congress should repeal and not extend the temporary provision allowing taxpayers to avoid current U.S. taxes on financial services income. That provision is being used, *inter alia*, to shift income derived in the United States to tax-haven jurisdictions through leasing transactions and similar devices. It is also being used to avoid U.S. taxes on income derived abroad. Contrary to the claims of its supporters, this measure is costing American jobs. If it should become permanent, U.S. firms engaging in what they characterize as active financial business activities in the United States will shift much of their profits to tax havens. It is widely assumed, for example, that the U.S. auto companies intend to move their financing subsidiaries offshore. The purpose of the subpart F rules is to impose taxes currently on income that is easily shifted to a tax haven. Those rules apply to many types of active business income, including shipping and aircraft income, offshore mining income, oil income, sales income, and insurance income. An exception for financial services income simply makes no sense, given the policies underlying subpart F.

(5) *Strong Anti-Avoidance Rule.* To protect against creative new ways of avoiding the subpart F rules, a general anti-avoidance provision should be added to subpart F. Under the anti-avoidance rule, the IRS would be authorized to treat any income as subpart F income, taxable currently by the United States, if a reasonable person would conclude that the income was derived through a transaction that was structured, in whole or on part, to avoid subpart F. This rule could be invoked, for example, if FCo, a CFC, sold goods to an unrelated person and that person resold the goods to GCo, a corporation related to FCo.

(6) *Fraud Penalties.* To protect against fraud, serious tax fraud penalties, computed as a percentage of the taxes that the taxpayer has attempted to evade, should be imposed on U.S. taxpayers that establish foreign entities to evade U.S. taxes when they do not have a reasonable legal basis to support their claim of exemption from U.S. taxes.

c. Other Important Reforms

Many other changes in the current international tax system are needed to achieve the goals of fairness, efficiency, and administrative economy. Set forth below are some important changes that could be adopted without great technical difficulty.

(1) *Foreign Tax Credit.* Various changes should be made in the foreign tax credit rules to prevent abuses and to coordinate credit policies with tax treaty policies. One important change is to prevent taxpayers from avoiding or mitigating U.S. taxes on income that escapes foreign income taxes under a U.S. tax treaty. Under the typical bilateral tax treaty, each country forgoes full source taxation of interest, dividends, royalties, and most capital gains, with the expectation that the income exempted in the source country will be taxable in the residence country. This trade-off of source taxation for residence taxation is thought to promote efficiency and fairness because the residence country is better situated to compute the proper amount of the tax and to prevent the tax from acting as an excise tax on some income flow rather than as an income tax. The tradeoff does not work properly, however, if the residence country fails to tax the income in full. Under current law, the U.S. frequently does not tax the income of U.S. corporations that escapes tax in the source country because of flaws in the credit limitation rules. The limitation rules should be reformed to prevent avoidance of the residence tax. For example, assume that PCo, a U.S. corporation, earns royalties in Country A of $1 million and those royalties are exempt from source taxation by treaty. Those royalties should be fully taxed by the United States, without mitigation by any excess foreign tax credits that PCo may have accumulated. Only withholding taxes imposed directly on the treaty income should be creditable against the U.S. tax otherwise imposed on the treaty income.

Another important reform is to reduce the period that excess foreign tax credits may be carried over. The current rule is that the credits may be carried back two years and forward five. The five-years-forward rule is unreasonably long. With such a long period, taxpayers will plan their affairs to make use of the credit by reducing their U.S. source income and increasing their foreign source income. It obviously does not advance the interests of the U.S. economy or the American people for Congress to provide a tax incentive for moving U.S. source income abroad. The only legitimate purpose of the carryover rule is to allow for differences in the way income is computed under U.S. and foreign tax rules. A short period is fully adequate to satisfy that purpose. Indeed, if a two-year forward and two-year back period is not adequate to adjust for differences in accounting rules, it is highly likely that the foreign government has intentionally created those differences as an investment incentive. The United States has no reason to make a foreign tax incentive more effective in drawing investment capital out of the United States.

One more useful reform of the credit would be to extend broadly the anti-avoidance rule of Code section 901(k), which is designed to prevent the transfer of credits from tax-exempt entities to taxable entities. Although that rule is a useful one, it does not block a wide array of abuses of the credit. In general, the anti-abuse rule should not allow a credit if it is reasonable to infer that the economic incidence of the tax did not fall on the person claiming the credit.

(2) *Breakup of "Accounting" Firms.* One of the major lessons of the Enron debacle is that the so-called accounting firms cannot be trusted to audit the books of U.S. companies when they are simultaneously selling them aggressive tax-avoidance schemes and lobbying on their behalf in Congress against necessary anti-avoidance legislation. The big-five "accounting" firms are no longer accounting firms. They are full-service tax avoidance firms. Leaving aside the firm now in bankruptcy proceedings, each of these firms has resources at its disposal that exceed by a very large amount the resources available to the IRS for monitoring compliance with the international tax rules of the United States. According to newspaper accounts, Arthur Anderson will become an accounting firm again if it should emerge successfully from bankruptcy. Reform through bankruptcy proceedings, however, is not the way to fix the problem. Congress should adopt reasonable rules that preclude companies engaged in the accounting practice from also engaging in major tax planning operations or in the marketing of tax-avoidance schemes. In addition, it should prevent the accounting firms from engaging in the practice of law.

(3) *Transfer Pricing Problems.* In 1986, Congress amended Code section 482 to provide that the transfer price on the sale of intangible property should be "commensurate with the income attributable to the intangible." This legislation provoked a reexamination by the IRS of the regulations under section 482. New regulations were issued in 1994, with important additions in 1996. In 1995, the OECD issued transfer pricing guidelines based in part on the U.S. regulations, and it has expanded those guidelines in later years. The IRS has also developed the Advanced Pricing Agreement system, which allows taxpayers to negotiate in secret with the IRS on the pricing method to be used in particular circumstances. Despite all of this activity, however, the transfer pricing problems have not been solved. Indeed, those problems are probably more acute today than they were in 1986. The energy expended in revising the regulations was not wasted. Tax analysts now have a much better understanding of the nature of transfer pricing problems than they did before that reform process began. What is needed is a statutory and regulatory structure that reflects that greater understanding. Instead, we have guidelines that operate more as an invitation to negotiate than as rules of law.

(4) *Full Taxation of U.S. Source Income.* The most important objective of the U.S. international tax rules is to collect tax on income derived from business and investment activities conducted within the United States. Full taxation of foreign source income is important in and of itself, but its primary importance is in ensuring full taxation of income having nexus with the United States and in eliminating the incentive for moving income outside the United States. For a variety of reasons, nevertheless, the United States has given up the right to tax many important categories of income having a U.S. nexus. The single most important exception to U.S. taxation is the exemption for so-called "portfolio interest." That provision, adopted in 1984, has attracted investment by foreign persons seeking to evade taxes in their home country. This "hot" money was used to finance the large deficits that the federal government ran up during the Reagan administration. This measure has done great harm to the United States and to its friends abroad, and it is inconsistent with American ideals and aspirations. It should be repealed forthwith. In addition, various other tax concessions designed to make the United States a tax haven should be repealed or revised substantially.

(5) *General Anti-Avoidance Legislation.* Anti-avoidance schemes are freshly minted daily. No set of tax rules can be drafted that takes account of all opportunities for improper tax avoidance. To maintain the integrity of the tax system against the onslaughts from the tax avoidance community, Congress needs to delegate the power to the IRS to block tax avoidance schemes that a reasonable person would conclude were designed in significant part to avoid U.S. taxes.

(6) *Coordinated Action with Trading Partners.* The United States engages in extensive consultation with its trading partners on tariff issues. It has sponsored, for example, the creation of World Trade Organization and actively participates in its operation. Coordination on direct tax matters is far less extensive. The United States does work in a coordinated way through the OECD on tax treaty issues. It has not done nearly enough, however, to cooperate with other countries in the design and implementation of anti-tax haven rules. The United States acted unilaterally in 1962 when it adopted the subpart F rules. Since then, over 20 other countries have adopted similar legislation. Now is the time for a coordinated approach. By joining with other countries to combat tax avoidance and evasion, the United States could help promote uniform and effective rules that would give no special advantage to U.S.-based or foreign-based companies. The result would be a level playing field for all companies, with a marked improvement in the fairness, efficiency, and administrative economy of the U.S. tax system and the tax systems of its foreign partners.

(7) *Properly Fund IRS International Compliance Activities.* It is a cliche to say that the IRS is "outgunned" by the private sector in dealing with international tax matters. Obviously the IRS budget for international compliance work needs to be increased dramatically for it to do the job that Congress has assigned it. As a starting point in setting the IRS budget, Congress should make some reasonable estimate of the budget

that U.S.-based and foreign-based companies are devoting to the avoidance of the U.S. international tax rules. The IRS budget should be increased so that it represents around 20 percent of the aggregate private budget.

2. Adoption of a "Source-Based" System

Various commentators have been arguing for some form of "territorial" or "source-based" tax system to replace the imperfect worldwide income tax system that the United States and many of its trading partners are attempting to enforce. This source-based system would modify the current income tax system by providing an exemption for income earned through foreign corporations and for most or all foreign-source income. No one seems to have a coherent theory that would justify the adoption of such a system. The typical claim is that it would improve the competitiveness of U.S.-based multinationals. How it would do this is unclear, aside from the obvious fact that it would be helpful to U.S.-based multinational companies in increasing their after-tax profits. An exemption, however, for domestic source income also would improve their bottom line, so the "bottom-line" explanation is inadequate to explain an exemption for foreign source income. It would appear that the rationale is purely political — that the advocates of tax preferences for U.S.-based multinationals believe that Congress would be more inclined to exempt them on foreign source income than on other types of income.

In principle, an income tax is an origin-based tax that imposes burdens with respect to income from whatever source derived. The United States has taken that position when it adopted the corporate income tax in 1909 and again when it adopted the personal income tax in 1913. Source distinctions are anathema to an income tax. They make the tax less fair, less efficient, and more difficult to administer. Adoption of a source-based system also would result in a revenue hemorrhage. Set forth below is a summary of some of the important ways that an exemption for foreign source income would reduce the fairness, efficiency, and administrative economy of the current income tax. The revenue aspects are not discussed, other than to note here that some major substitute tax would be required for the proposed tax change to be revenue neutral.

a. Fairness

The following points suggest that the cost in fairness from adopting a source-based income tax would be high.

(1) *Tax Avoidance by Individuals.* If foreign income is not taxed, then U.S. citizens and residents earning only U.S. source income would pay higher income taxes than otherwise similarly-situated U.S. citizens and residents who earn foreign source income through a corporation or other legal entity. Some promoters of a territorial system, in recognition of this point, have suggested that some type of anti-avoidance rules, similar to the current subpart F rules, would need to be retained to prevent individuals from using

corporations to avoid U.S. tax on foreign income. To be effective, however, these new anti-avoidance rules would need to be at least as extensive as the current subpart F rules, modified to repair the current loopholes. In addition, U.S. citizens and residents would need to be made taxable on distributions from corporations and other entities to the extent that those entities earned their income from foreign sources. The resulting system would be similar in many respect to the current system, except that it would be more complex, less coherent, and less well understood than the current system. That is, a territorial system that excludes foreign source income earned through a corporation becomes untenable once it is conceded that fairness to U.S. individuals requires taxation of their foreign source income.

(2) *Tilted Playing Field for Small Businesses.* Small businesses and even large businesses that earn most or all of their income from the United States should not be forced to compete against businesses that are enjoying a tax preference on their income earned abroad. U.S.-based multinationals already enjoy major competitive advantages over small businesses. Giving them an additional advantage by exempting them on their foreign source income is obviously unfair to U.S. businesses that are required to pay their fair share of the U.S. tax burden.

b. Efficiency

In the typical case, a tax system that treats all forms of income the same is likely to be much more efficient than one that provides preferences for one kind of income rather than another. Determining the efficiency of a tax provision, however, is sometimes a complex matter. It is possible, for example, that a narrow-based tax on salt and other essentials for life might be more efficient than a general sales tax because the tax on essentials is less likely to affect consumption choices. Of course the efficiency gains would be dwarfed by the costs in fairness from such a brutal system. In any event, no one has yet advanced a coherent argument for the efficiency of an income tax preference for foreign source income. Set forth below are some important reasons for rejecting a source-based income tax on efficiency grounds.

(1) *Incentive for Foreign Investment.* A source-based territorial system would make foreign investment more attractive, on an after-tax basis, to U.S.-based multinationals than otherwise equivalent domestic investment. As a result, a source-based system would encourage an outflow of investment and jobs from the United States, reducing the competitive position of the U.S. economy in world markets. Those who promote source-based taxation on efficiency grounds seem to have convinced themselves that what is good for U.S.-based multinationals is always good for the United States. If that is actually their position, they are clearly wrong.

No one can plausibly argue that the national interests of a country are advanced by favoring foreign investment over domestic investment. Indeed, the conventional wisdom has been that if a country wants to promote domestic investment and domestic job creation, it should tax income from foreign investment at a *higher* effective rate than income from domestic investment. The conventional wisdom is correct, up to a point. It is certainly correct in not wanting any preference for foreign investment. In my view, however, neutrality between domestic and foreign investment is the preferred policy because a preference for domestic investment is likely to trigger retaliatory measures by foreign countries seeking to preserve their own domestic investment. The tax reform measures proposed in section 1 would promote neutrality between domestic and foreign investment. They also would promote other, perhaps more fundamental, goals of taxation.

(2) *Shifting of Tax Burden to U.S. Income Factors.* A global income tax, in its pure form, is similar in some respect to a joint venture between a business and the government, with the government acting as the silent partner. The business makes its decisions to maximize the profits of the firm and then the "silent partner" takes its cut of those profits through the corporate tax. A source-based tax, however, would not operate like a tax on profits. Instead, there would be a strong tendency for the tax to operate as an oddly designed tax on the factors of production. Commentators have noted that state corporate taxes, when evaluated in isolation from the corporate taxes imposed by other states, can operate more like excise taxes on the factors of production than like a true income tax. The same point applies to a source-based income tax imposed by a national government.

To illustrate the point, assume that PCo is a U.S.-based company that makes loans to U.S. and foreign customers. Assume also that the United States has adopted a source-based system, so that foreign source interest income is not taxable. PCo is asked to make a loan of $1 million to QCo, a U.S. corporation. The market rate of interest, without reference to taxes, is 10 percent. If PCo makes the loan to QCo at a 10 percent rate, it will earn income of $100,000 and pay U.S. corporate taxes of $35,000, for net income after taxes of $65,000. If it makes the loan to a foreign person, however, it will earn the full $100,000 without diminution by taxes. Under these circumstances, PCo would make the loan to QCo only if QCo agreed to pay interest in excess of 10 percent. Indeed, QCo would have to agree to pay interest at a rate in excess of 15 percent before it could convince PCo to make the loan. The result would be that a tax intended to act as an income tax on PCo would become an unfair and inefficient excise tax on QCo.

The unhappy result illustrated above would not occur when a country taxes interest income on a residence basis. In the above example, if the United States taxed PCo on its worldwide income, it would earn after-tax income of $65,000 on its loan whether the loan was made to QCo or some foreign person. As a result, PCo would not be able to charge QCo more than the market rate of 10 percent, and the burden of the tax would fall, as intended, on PCo.

(3) *Competitiveness with Foreign-based Multinationals.* U.S.-based multinationals often assert that they cannot compete effectively abroad because they are taxable by the United States on their foreign earnings whereas their competitors enjoy an exemption from tax. This claim is false in three respects. First, U.S.-based multinationals have been enormously successful operating abroad. The market tends to measure competitiveness by profits, and U.S.-based multinationals have earned huge profits from their foreign operations. In many, many cases, these companies are more competitive abroad then they are in the United States. That is, they frequently earn higher rates of return on investment abroad than on domestic investment. Some U.S.-based multinationals may be nostalgic for the days when their European and Asian competitors were devastated by the destruction of World War II and unable to compete. Fortunately, the economies of our allies and former opponents in that war have recovered, and their companies are again competitive in world markets. The fact that U.S.-based companies face competition, however, is not evidence that they are not able to compete. Anyone who doubts that American companies are competitive in world markets should compare the share prices of U.S.-based multinational companies in 1990 to the share prices today and should look at the reported foreign profits of these companies over the past decade.

Second, the claim that the foreign competitors of U.S.-based companies do not face significant foreign income taxes is incorrect. Many of our major trading partners, including, for example, Japan, have corporate income tax regimes similar to our own. Some countries, such as Canada, have adopted some features of a territorial system for administrative reasons. Canada, however, attempts to limit its exemption for foreign source income to income derived in countries that impose taxes at rates roughly comparable to the Canadian rate. In general, the low-tax claims made about foreign tax systems are often flat-out wrong or wildly overstated. The implication of these claims is that Congress should not impose fair and efficient taxes on U.S. corporations because some foreign tax systems have major flaws. The existence of some flawed foreign systems is really an argument for international cooperation on income tax matters. Most of our major trading partners would welcome the cooperation of the United States in developing international anti-avoidance rules that created a level playing field for business from all countries. Those few countries that would not be willing to cooperate could be isolated so that their beggar-thy-neighbor tactics would be ineffective.

Third, the claim that higher U.S. income taxes, when they actually exist, have a major impact on competitiveness is incorrect. In general, the U.S. corporate income tax is unlikely to have much impact on the prices charged by U.S.-based multinationals in foreign markets. In principle, the effect of a profits tax is to reduce profits, not to raise prices. Although there is some uncertainty about the incidence of the corporate tax in general, there is little doubt that the tax cannot be passed on in higher prices by a taxpayer when the taxpayer's competitors are not paying that tax. For example, assume that PCo, a U.S. company, makes electronic toys at a cost of $100 and generally sells them at a price of $200, resulting in a before-tax profit of $100 and a U.S. tentative tax (subject to allowable foreign tax credits) of $35. PCo is competing in Country A with ACo, which also produces electronic toys at a cost of $100. ACo pays no income taxes to any country. If ACo sells the toys for $200, PCo cannot increase its price to pass on the U.S. income tax of $35 to customers in Country A. It must pay the tax out of its profits, just as it must pay the tax out of its profits when it sells the electronic toys in the United States.

Some commentators seem to believe that the efficiency of the U.S. economy is advanced through export subsidies. They also seem to believe that a source-based system would encourage exports. They are wrong on both counts. Standard free-trade theory, accepted for over two centuries, holds that export subsidies and import barriers make a country poorer not richer. In addition, a source-based system would not stimulate exports. The idea that a source-based system would stimulate exports is apparently based on the assumption that the U.S. tax on foreign profits is passed on to foreign consumers in the form of higher prices. As illustrated in the example of the electronic toys above, that assumption is fallacious.

c. Administrative Considerations

Some proponents of a source-based corporate tax assert that it would be less complex to administer than the current tax. That claim is difficult to support. In any event, the proper comparison is between the proposed source-based system and a reformed system that eliminated the obvious flaws in the current system. There is no doubt that a reformed worldwide system would be much easier to administer than a source-based system. Set forth below are some of the new complexities introduced by a source-based system.

(1) *Defining the Tax Base*. A first step in specifying the features of a source-based income tax is to provide practical and theoretically sound rules for separating income assigned to a particular territory from income assigned to other territories. A global income tax has two rules of that type. The first are source rules and the second are transfer pricing rules. In an ideal global income tax system, these rules do not play a major role in determining the worldwide tax burdens on taxpayers. Their primary function is to determine, through the tax credit limitation and otherwise, how tax revenues obtained under the tax are to be shared among countries with overlapping claims to those revenues. The subpart F rules operate as a backstop to the transfer pricing rules and the source rules by taking away most of the obvious opportunities for U.S. corporations to abuse those rules to avoid U.S. taxes. In a source-based system, however, the source rules and the transfer-pricing rules bear the burden of actually defining the tax base. These rules cannot sustain that burden.

As the tax literature makes clear, both the transfer pricing rules and the source rules are not grounded on any sound theory. On the contrary, the theoretical arguments sometimes given to justify those rules are deeply flawed. Those rules do not in any serious way locate income in the place where it actually arose.

The source rules are constructed on the false assumption that gross income and the associated deductions typically have a specific geographical locus. In fact, income is a number, determined by adding and subtracting other numbers. Like any number, it has no geographical place. The source of income is typically determined by assigning a place to it by reference to the place where certain income-producing activities occurred. The assignment is not controversial when all of the activities relating to the earning of the income occurred in one location. When those activities occurred in more than one country, however, the assignment tends to be arbitrary. Interest income derived from a cross-border loan, for example, is typically assigned exclusively to the country where the borrower is located. In reality, however, the income would not have arisen without the lender's participation. In many cases, the interest income would not have arisen if the borrower had not made use of the loan proceeds to earn income from some other types of activities.

The transfer pricing rules are constructed on the false assumption that a multinational corporate group typically earns the same amount of income from its interrelated activities as a group of unrelated corporations engaging at arm's length in similar or identical activities. The multinational companies, however, have come to dominate world markets precisely because they earn more income from operating in a coordinated way that unrelated corporations would earn from operating in an uncoordinated way. The failure of the arm's length method to account for all of the income earned by multinational enterprises does not discredit that method. The point is that whatever assignment of income is made under the arm's length method is arbitrary to at least some degree.

Given the weak conceptual foundation for source rules and transfer pricing rules, it is inevitable that they will be complex and difficult to administer. Residence taxation, along with the quasi-residence jurisdiction exercised under subpart F, prevents the weaknesses of the source rules and the transfer pricing rules from destroying the income tax. Without the residence backstop, the administrative problems become overwhelming.

One need not make wild guesses about the administrative problems that the United States would confront in attempting to operate a source-based system because the United States is operating such a system in its efforts at taxing foreign corporations engaging in income-producing activities within the United States. The results are not pretty. In the typical year, foreign corporations will report total gross receipts from U.S. activities of $75 billion or more and total deductions somewhat in excess of those gross receives, with total taxes paid to the U.S. Treasury of less than a billion dollars. These numbers speak for themselves.

(2) *Hard-to-Tax Income.* The United States has addressed many problems in taxing certain types of income on a source basis by taxing it on a residence basis. For example, the United States currently determines the source of capital gains by reference to the residence of the earner. The basic idea is that the country of residence is better able to determine the net income from capital gains than the country where the gains arose. Similar rules are used in taxing certain currency gains, gains from the sale of inventory through a U.S. office, income derived from activities conducted on the high seas, and so forth. That approach is inconsistent with a source-based system.

An important topic of international discussion is the proper treatment of income derived from e-commerce. The United States has been arguing, with the support of U.S.-based multinationals, that only the country of residence should tax such income. This approach makes little sense in a world in which the United States does not exercise residence jurisdiction. Some commentators do not favor exclusive taxation of e-commerce in the residence state, favoring instead some reasonable sharing of revenues between the source and residence countries. This sharing approach, however, requires some taxation in the residence country to be effective.

E-commerce is just one of the emerging areas where exclusive source jurisdiction would make a farce of the tax system. Another problem area is income derived from various derivative financial products. Most commentators have concluded that such income cannot be taxed effectively in the source country without imposing excessive compliance burdens on taxpayers using those products for legitimate hedging purposes. Some low level of withholding taxation in the source country probably might be workable, but a true tax on net income in the source country would not be feasible. A third and somewhat related area is income from global trading. The favored solution to taxation of that income is worldwide formulary apportionment — an approach that is also inconsistent with a source-based system.

(3) *Income Exempt by Treaty.* Following World War II, the United States began the development of a worldwide network of bilateral income tax treaties. That network continues to grow. Under U.S. tax treaties, various categories of income are exempt from tax in the source county or are subject to a relatively low withholding rate. These items of income may be viewed as a special case of hard-to-tax income in that the principal reason for the exemption is the difficulty of taxing them at source on a net basis.

One example of a hard-to-tax category of income that enjoys favorable treatment under U.S. tax treaties is royalty income. When royalties are taxed by a residence country, the proper result is achieved, relatively easily, by including the full amount of the royalty in income and allowing a deduction for the attributable expenses. When a royalty is taxed at source, however, the tax is typically collected through withholding. The withholding agent is unlikely to know the amount of the relevant expenses associated with the income. As a result, the withholding tax is imposed on a gross basis, usually at a rate somewhat below the anticipated rate that would apply if the interest had been taxed on a net basis. Similar problems can arise in taxing capital gains, interest, and various other categories of income on a source basis.

The solution that the United States and its trading partners have developed for taxing these hard-to-tax items is for each country to relinquish some or all of its claim to tax on a source basis through bilateral tax treaties. For example, the United States and Canada have agreed to limit their withholding tax on interest to 10 percent and reduce their tax on most royalties to zero. Thus if PCo, a U.S. corporation, earns interest income of $1 million in Canada, it would pay a Canadian withholding tax of $100,000 and pay tax in the United States on its net interest income. If the cost of earning that income was $400,000, PCo would have U.S. income of $600,000 and would pay a tentative U.S. tax, before the foreign tax credit, of $210,000 (35% of $600,000) and take a foreign tax credit (ignoring limitation issues) of $100,000, for net U.S. tax of $110,000. If PCo had earned $1 million of royalty income in Canada, it would have paid no tax in Canada. If its costs of earning that income were $400,000, it would pay a tentative and final U.S. tax of $210,000 (35% of $600,000).

At first blush, this system might seem unfair to the source country. But it is not unfair if there is a reasonable balance of investment flows among all of the countries having bilateral tax treaties with the United States. Assume, for example, that CCo, a Canadian corporation, earns interest income of $1 million in the United States, incurring attributable expenses of $400,000. In that case, the United States would reduce its withholding rate on interest to 10 percent, and Canada would get to collect tax of $110,000 from CCo, after allowing a credit for the U.S. tax. If CCo had earned a royalty of $1 million in the United States and had incurred attributable expenses of $400,000, Canada would get to keep the full tax of $210,000.

The system illustrated above would not work in a source-based system because the revenue lost from reducing or eliminating a U.S. withholding tax would not be recouped by taxing U.S. corporations on their foreign source income. Any revenue given up would just be lost. To maintain its revenue and to properly implement the source principle, the United States would need to impose tax on foreign investors on their U.S. source interest, dividend, royalty, and capital gains income, and various other types of income now exempt by treaty. As a practical matter, it would be difficult to impose the tax properly because the withholding agent would not know the amount of the deductions properly attributable to the income. Some arbitrary withholding rate would have to be set, and the taxpayer might then be given an election to file a tax return and pay the tax on a net basis. Auditing the taxpayer to verify its claimed deductions would put a significant burden on the tax department.

Introduction of source-based taxation on foreign investors would not be popular. Some investors would respond to the new system by taking their investment funds elsewhere. The new regime also would be unpopular with U.S.-based multinationals because all U.S. treaty partners would respond to the new U.S. system by imposing a similar source-based tax on U.S. taxpayers earning income in their country. The entire tax treaty network that the United States has built up over the past five decades would unravel.

The promoters of a source-based system might try to repair this nearly fatal defect by proposing that foreign source income receiving preferential treatment under a U.S. tax treaty would continue to be taxable by the United States, and U.S. source income of treaty residents would continue to receive favorable treatment. This "solution" would create a strong bias in favor of U.S.-based multinationals earning their foreign investment in countries that do not have a tax treaty with the United States. This result is obviously at odds with longstanding U.S. treaty policy. To the extent that the income was shifted to non-treaty countries, the basic problem would remain — the U.S. government would be giving up revenue under its treaties and would not be receiving any compensating revenue from taxing its taxpayers with respect to their foreign source income. A more radical repair would be for the U.S. government to tax all foreign income of a type that receives preferential treatment under its treaties. The treaty classifications of income, however, are not firmly rooted in economic realities. To prevent conversions of income to an exempt category, the United States probably would need to define the treaty categories broadly and buttress the definitions with anti-avoidance rules. The result would be a system with no redeeming features that would be far more complex and difficult to administer than the current system.

It should be noted that ease of administration is only one of the reasons for exempting certain categories of income from source taxation. Another reason, discussed above, is that the incidence of the tax may be shifted when the tax is imposed on a source basis. For example, a tax on interest imposed by the country of residence is likely to be paid by the person earning the income (the lender), whereas the same tax imposed by the source country is likely to be shifted to the person making the payment (the borrower).

3. Conclusion

Congress has four options for dealing with what most commentators acknowledge to be serious problems with the U.S. international tax rules. One option is to do nothing. This is not the worst option, but a do-nothing result certainly would be a disappointment to those who promote fair and efficient taxation. Another option, which I obviously endorse, is to fix the current rules, adopting reform measures of the type discussed in section 1, above. A third option, which would make the current system even worse, would be to adopt a source-based system of the type described and criticized in section 2. The fourth option would be to adopt a new type of tax. There is substantial risk that the fourth option would simply be a smoke screen for the first option.

In the long term, a more radical change in the current system might be worthy of consideration. One long-term option sometimes discussed is to replace the corporate income tax with a sales tax. One form of sales tax that has been suggested is the business component of the flat tax. Some years ago, a tax of that type, popularly referred to as the Armey/Shelby flat tax, circulated around Congress without any action being taken. The international aspects of that tax are sufficiently horrific that it cannot be considered as a solution to the problems of international taxation now under discussion.

Another sales tax proposal that received limited congressional attention some years ago was the Nunn/Dominici U.S.A. tax system. The proposal would replace the personal and corporate income tax with two consumption taxes, a graduated tax on personal consumption and a tradition European-style VAT. The authors of that proposal correctly concluded that Congress cannot simply repeal the corporate tax without hopelessly undermining the personal income tax. Because the Nunn/Dominici proposal goes far beyond international tax reform or even corporate tax reform, it cannot be viewed as a reasonable response to the problems arising under the international tax rules of the United States.

The best long-term solution to U.S. international tax problems would be the adoption of a worldwide income tax that used some type of formulary apportionment to determine each country's jurisdiction to tax. This system would be "territorial" in that each country would be authorized to tax only the income attributed to it under the apportionment formula. One advantage of this system is that it would largely eliminate tax haven abuses. Another related advantage is that it would reduce reliance on the two weakest links of the current system — source rules and transfer pricing rules.

A few years ago, formulary apportionment was routinely criticized by a wide segment of the business community and even by many members of the academic community. It is now considered a serious option in many quarters. Some academics, myself included, have suggested that it might be used within the NAFTA community for allocating income. The European Union is actively examining various options for adopting a formulary apportionment system, with considerable support from the European business community. The OECD and the IRS have endorsed the use of formulary apportionment for taxing income from global trading.

Notwithstanding the emerging international interest in formulary apportionment and its successful use by California and some other states for several decades, it does not offer a short-term solution to the current international tax problems facing Congress. By its very nature, formulary apportionment requires a high degree of cooperation from participating tax jurisdictions. To introduce it at the national level, the United States would need to develop within the world community an unprecedented level of cooperation and coordination on income tax matters. That form of taxation should be studied, and experiments in the EU and NAFTA would certainly be useful. If those experiments are successful, they might improve the chances for international acceptance of some form of formulary apportionment.

If Congress wants to improve the U.S. international tax rules in the short run, its only practical option is to reform the current system. The reform that would provide the greatest benefits in terms of fairness, efficiency, and administrative economy would be to tax currently all income earned by U.S. corporations from whatever source derived, including income earned through a foreign affiliate. Congress could improve the U.S. international tax rules substantially, however, by revitalizing the subpart F rules while retaining some deferral benefits for U.S.-based multinationals. Adoption of a source-based system would not be reform at all. On the contrary, it would provide an open invitation to U.S.-based multinationals to engage in international and domestic tax avoidance.