Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income

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Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*

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I. INTRODUCTION

The ability-to-pay fairness concept[1] is a key factor underlying the historic U.S. policy of relying principally on the income tax to finance federal

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1. The meaning of ability-to-pay can be controversial at the margins. For example, commentators often refine the ability-to-pay fairness concept by subdividing it into a horizontal equity component (taxpayers with equal incomes should pay equal amounts of tax) and a vertical equity component (taxpayers with unequal incomes should pay amounts of tax which are sufficiently unequal to fairly reflect the differences in their incomes). See David F. Bradford, Untangling the Income Tax 150-53 (1986); Joseph M. Dodge, The Logic of Tax 88 (1989); Michael J. Graetz & Deborah H. Schenk, Federal Income Taxation: Principles and Policies 31 (3d ed. 1995); William A. Klein, Policy Analysis of the Federal Income Tax 7 (1976); Joel Slemrod & Jon Bakija, Taxing Ourselves, 49-50, 52-54, 73-74 (1996); Eric M. Zolt, The Uneasy Case for Uniform Taxation, 16 Va. Tax Rev. 39, 86-98 (1996).

Other commentators have criticized these refinements by asserting that horizontal equity has no significance as a tax policy norm separate from vertical equity or that neither horizontal nor vertical equity has any content that is independent of more general notions regarding fundamental fairness. See generally Paul R. McDaniel & James R. Repetti, Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange, 1 Fla. Tax Rev. 607 (1993); Louis Kaplow, A Note on Horizontal Equity, 1 Fla. Tax Rev. 191 (1992); Richard A. Musgrave, Horizontal Equity: A Further Note, 1 Fla. Tax Rev. 354 (1993); Louis Kaplow, Horizontal Equity: Measures in Search of a Principle, 42 Nat'l Tax J. 139 (1989); Richard A. Musgrave, Horizontal Equity, Once More, 43 Nat'l Tax J. 113 (1990).

There has also been disagreement regarding nuances of the ability-to-pay concept, such as the proper handling of psychic income, leisure and underachievement. See Staff of Joint Comm. on Taxation, Impact on Individuals and Families of Replacing the Federal Income Tax (JCS-8-97), at § IV.B.3 (Comm. Print 1997); Zolt, supra, at 89-101; see also Barbara H. Fried, The Puzzling Case for Proportionate Taxation, 2 Chapman L. Rev. 157, 182-83 (1999).

Nevertheless, administrability considerations have led to a U.S. tax policy consensus that presumptive fairness within an income tax regime requires taxpayers with larger net incomes in a given year to generally pay more tax than those who have smaller net incomes in the same year. This consensus also holds that when comparing net incomes for ability-to-pay purposes, items that cannot be feasibly measured (e.g., leisure and forgone opportunities) are omitted. See U.S. Treas. Dep't, Blueprints for Basic Tax Reform 3, 159-62 (1977) [hereinafter U.S. Treas. Dep't, Blueprints]; 1 U.S. Treas. Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth, 14-15, 37-42 (1984) [hereinafter U.S. Treas. Dep't, Tax Reform]; Walter J. Blum & Harry Kalven, Jr., The Uneasy Case for Progressive Taxation 64 (1953); Bradford, supra, at 16-19, 155-56; Graetz & Schenk, supra, at 31; William A. Klein, Joseph Bankman & Daniel Shaviro, Federal Income Taxation 7-9 (12th ed. 2000); Vada Waters Lindsey, The Widening Gap Under the Internal Revenue Code: The Need for Renewed Progressivity, 5 Fla. Tax Rev. 1, 3, 7-8, 39-40 (2001); Herbert A. Stein, What's Wrong with the Federal Tax System, in 1 House Comm. on Ways and Means, Tax Revision Compendium 107, 110-14 (Comm. Print 1959) [hereinafter House Comm. Compendium].

We have made the theoretical disagreements over vertical equity, horizontal equity and other refinements and nuances of the ability-to-pay concept irrelevant to this article by adopting the preceding consensus ability-to-pay concept. Our analytical approach also uncouples the ability-to-pay concept from the issues of whether the federal income tax should employ progressive rates and if so, how progressive they should be. See infra note 27.

government expenditures.[2] Indeed a major justification for this reliance, as opposed to significant dependence on consumption levies, is that the income tax is a system for spreading the costs of government in a way that advances fairness by giving substantial deference to comparative ability-to-pay.[3]

Consequently, one would expect tax policy analysts to routinely examine the equity implications of international income tax rules by applying the fairness criterion with the same rigor as in the domestic context. But surprisingly, there has been relatively little discussion in the literature regarding the role of the ability-to-pay concept in analyzing international tax policy issues.[4] This may be because the composition of international investment historically has been dominated by the direct foreign investments of multinational corporations, which pose perplexing issues in evaluating fairness concerns.[5] Even if true, however, this is an inadequate reason to forego analysis of fairness considerations when scrutinizing the important international dimension of a modern income tax.[6] In this article, we examine the role that

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2. As stated by one commentator:

> In the United States, consumption taxes account for only about 17 percent of total federal, state and local revenues–compared to an average of 30 percent for OECD member countries–and the U.S. federal government's share of that is quite small. Less than 5 percent of federal revenues come from excise taxes on specific kinds of consumption, and the federal government has no broad-based tax on consumption.

Michael J. Graetz, The U.S. Income Tax: What It Is, How It Got That Way, and Where We Go from Here 201 (1999); see also U.S. Dep't of Commerce, Statistical Abstract of the United States 847 (1999); Slemrod & Bakija, supra note 1, at 19-21.

3. See Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 6-7 (Comm. Print 1987); U.S. Treas. Dep't, Blueprints, supra note 1, at 1, 24; Joseph M. Dodge, J. Clifton Fleming, Jr. & Deborah A. Geier, Federal Income Tax: Doctrine, Structure and Policy 19, 21-22 (2d ed. 1999); Graetz & Schenk, supra note 1, at 43; Peter Andrew Harris, Corporate/Shareholder Income Taxation and Allocating Taxing Rights Between Countries 452-53 (1996); Slemrod & Bakija, supra note 1, at 135-36; Lindsey, supra note 1, at 34-40.

4. Professor Michael Graetz recently challenged "[t]he focus in the international income tax literature on economic efficiency to the exclusion of all other values" as a criterion for U.S. international tax policy and asserted that "deciding to tax income reflects a decision to place issues of fairness at the heart of tax policy debates. That commitment cannot be ignored simply because income traverses national borders." Michael J. Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies, 54 Tax L. Rev. 261, 294, 307 (2001). For an article that focuses on fairness considerations in international taxation, see Nancy H. Kaufman, Fairness and the Taxation of International Income, 29 Law & Pol'y Int'l Bus. 145 (1998).

5. See infra Part IV.

6. Moreover, since the 1990s, cross-border U.S. portfolio investment has exceeded U.S. multinationals' cross-border direct investment in volume. See National Foreign Trade Council, International Tax Policy for the 21st Century: A Reconsideration of Subpart F 5-6 to 5-7 (1999); Graetz, supra note 4, at 263-67. In the decade just past, cross-border direct investment increasingly was engaged in by private equity partnerships that amassed $1 billion or more from individuals and tax-exempt institutional investors.

fairness concerns, embedded in the ability-to-pay concept, play in justifying the U.S. policy of taxing U.S. residents on their worldwide incomes.

From almost the commencement of the modern income tax, the United States has taxed the worldwide income (i.e., both foreign-source and domestic-source income) of its residents and ameliorated international double taxation resulting from this approach by allowing a U.S. income tax credit for foreign tax imposed on foreign-source income.[7] Thus, if the foreign tax is less than the U.S. tax on a resident's foreign-source income, the United States receives a residual tax equal to the difference. Although there has been relatively little disagreement with worldwide taxation of the income of U.S. resident individuals,[8] many in the U.S. multinational business community, and some academic commentators, argue that considerations of fairness, simplification, competitiveness and/or efficiency support abandonment of the residual U.S. tax on the foreign-source active business income of U.S. resident corporations. They would favor adopting a territorial, or exemption, system under which such foreign-source income is excluded from the gross income of corporate residents.[9]

We have previously questioned the efficiency claims in favor of an exemption system and argued that taxation of foreign-source income at the time it is earned is necessary to avoid creating an inefficient and unjustified tax

7. See U.S. Treas. Dep't, The Deferral of Income Earned Through U.S. Controlled Foreign Corporations 2 (2000) [hereinafter U.S. Treas. Dep't, Deferral]; Harris, supra note 3, at 295-96; Sol Picciotto, International Business Taxation 12-13 (1992); Michael J. Graetz & Michael M. O'Hear, The "Original Intent" of U.S. International Taxation, 46 Duke L.J. 1021, 1041-47 (1997). The decision of the United States to grant its residents a foreign tax credit is consistent with the international norm which assigns to residence countries the primary obligation of mitigating international double taxation. See Charles H. Gustafson, Robert J. Peroni & Richard Crawford Pugh, Taxation of International Transactions 18-19 (2d ed. 2001); Harris, supra note 3, at 313; Robin Woellner, Stephen Barkoczy & Shirley Murphy, 2000 Australian Taxation Law 1303-04, 1336 (1999).

8. See Herman B. Bouma, Further Support for Territorial Taxation, Letters to the Editor, 87 Tax Notes 580 (2000). The decision to treat expatriate citizens as quasi-U.S. residents for this purpose is more controversial. See infra note 18.

9. See National Foreign Trade Council, supra note 6, at 6-29; Herman B. Bouma, The Tax Code and Reality: Improving the Connection, 85 Tax Notes 811, 813 (1999); Terrence R. Chorvat, Ending the Taxation of Foreign Business Income, 42 Ariz. L. Rev. 835 (2000); Graetz, supra note 4, at 330-31; Klaus Vogel, World-wide vs. Source Taxation of Income–A Review and Reevaluation of Arguments, in Influence of Tax Differentials on International Competitiveness 117 (1990); Transcript from the Symposium: Globalization and the Taxation of Foreign Investments, 21 Tax Notes Int'l 1268, 1272-73 (2000); see also Daniel J. Mitchell, OECD Tax Competition Proposal: Higher Taxes and Less Privacy, 89 Tax Notes 801, 821 (2000).

incentive for U.S. residents to invest abroad in low-tax countries.[10] We now

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10. See Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income, 52 SMU L. Rev. 455 (1999); J. Clifton Fleming, Jr., Robert J. Peroni & Stephen E. Shay, Deferral: Consider Ending It Instead of Expanding It, 86 Tax Notes 837 (2000).

There seems to be general recognition that an exemption system provides an incentive for U.S. residents to invest their directly-owned funds in low-tax foreign countries instead of at home or in other countries with effective tax rates equal to or greater than the U.S. resident's U.S. tax on the same category of foreign income. See, e.g., Staff of Joint Comm. on Taxation, 106th Cong., 1st Sess., Description and Analysis of Present-Law Rules Relating to International Taxation, at 75 (Comm. Print 1999) [hereinafter Joint Comm., Description]; Peggy Brewer Richman, Taxation of Foreign Investment Income: An Economic Analysis 51 (1963). There is also recognition of the fact that an exemption system encourages residents of high tax/high government benefit countries to engage in the strategic behavior of enjoying the costly perquisites of their residence country while earning their income in low tax/low government benefit countries. See Julie Roin, Competition and Evasion: Another Perspective on International Tax Competition, 89 Geo. L.J. 543, 588-89, 591 (2001). A degree of confusion has existed, however, regarding the incentive effect produced by the present U.S. system's deferred taxation of foreign-source income earned in low-tax countries by foreign subsidiaries of U.S. corporations.

This confusion has its roots in an article by economist David G. Hartman. The article asserts that two seemingly contradictory propositions are both true. The first proposition holds that because U.S. tax on the foreign-source income of a foreign subsidiary is deferred until the subsidiary pays dividends to its U.S. parent, the U.S. tax on the dividends is irrelevant in deciding whether a "mature" foreign subsidiary (i.e., one that does not require additional capital from its parent) will reinvest its earnings in its low-taxed foreign operations or pay dividends to its U.S. parent. The second Hartman proposition holds that because U.S. tax on the foreign-source income of a foreign subsidiary is deferred until the subsidiary pays dividends to its U.S. parent, a U.S. parent is encouraged to have the foreign subsidiary retain and reinvest its earnings instead of transferring them to the parent as dividends. See David G. Hartman, Tax Policy and Foreign Direct Investment, 26 J. Pub. Econ. 107, 110-11, 116, 119 (1985). Hartman's explanation of why these apparently conflicting assertions are, in fact, harmonious relies heavily on algebraic equations that may bewilder many lawyers. See id. at 112-113, 116-117. Other writers have attempted verbal explanations with mixed success. See Rosanne Altshuler, Recent Developments in the Debate on Deferral, 20 Tax Notes Int'l 1579, 1590 (2000); Reuven S. Avi-Yonah, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, 113 Harv. L. Rev. 1573, 1593 n.70 (2000); Chorvat, supra note 9, at 843-44; Harry Grubert & John Mutti, Taxing International Business Income: Dividend Exemption Versus the Current System 8 (The AEI Press 2001) [hereinafter Grubert & Mutti, Dividend Exemption].

We now try our hands at clarifying the matter by analyzing the following example:

> USCo, a U.S. resident C corporation, owns 100% of the shares of ForCo, a foreign C corporation resident in, and doing business exclusively in, Country X, which imposes a 15% corporate income tax and no dividend withholding tax. USCo is subject to a 35% U.S. tax on its worldwide income. In year 1, ForCo earns $117.65, pays a 15% X Country tax ($17.65) and has $100 left. If ForCo pays the $100 to USCo at the close of year 1 as a dividend, USCo's calculation of year 1 U.S. tax on the dividend will be:
>
> ($117.65 (see IRC § 78) x .35) - $17.65 foreign tax credit = $23.53 U.S. tax
>
> If USCo then invests $76.47 ($100 - $23.53) at 10% for one year, receives $7.65 of earnings at the end of year 2 and pays a $2.68 tax thereon, USCo will finish

with $81.44 ($76.47 + [$7.65 - $2.68]) at the end of year 2.

If, however, ForCo defers the U.S. dividend tax by retaining its $100 of year 1 after-tax earnings and if ForCo also invests this sum for one year at 10%, ForCo will have $10 of investment earnings at the end of year 2 on which it will pay a 15% Country X tax ($1.50), leaving $8.50. Assuming that ForCo immediately distributes $108.50 ($100 + $8.50) to USCo, the year 2 U.S. dividend tax calculation for USCo will be:

([$117.65 + $10 (see § 78)] x .35) - ($17.65 + $1.50) foreign tax credit = $25.53 U.S. tax at the end of year 2.

Assuming that the correct discount rate is the 8.5% after-tax rate of return that ForCo earned in Country X (.10 x [1 - .15] = .085), the $127.65 grossed-up dividend amount used in the second scenario U.S. tax calculation ($117.65 + $10 = $127.65) has a year 1 present value of $117.65 ($127.65 ÷ 1.085 = $117.65), which equals the grossed-up dividend amount used in the year 1 U.S. tax calculation of the first scenario. Consequently, there is no surprise in discovering that the $25.53 U.S. tax which USCo pays on the ForCo dividend at the end of year 2 in the second scenario has a present value at the end of year 1 of $23.53 ($25.53 ÷ 1.085), which is the same as the $23.53 U.S. tax that USCo incurred at the end of year 1 on the ForCo dividend in the first scenario. Thus, the U.S. tax on the ForCo dividend has the same present value ($23.53) in both the first scenario (immediate repatriation) and the second scenario (reinvestment by ForCo for one year). In that limited sense, the U.S. tax on dividends received by USCo from ForCo does not affect the decision of whether to have ForCo accumulate or distribute its earnings. This is apparently what Hartman meant by his first proposition.

But note that USCo finishes the second scenario with $108.50 (year 2 dividend from ForCo) - $25.53 (U.S. tax on ForCo dividend) = $82.97 at end of year 2. This is $1.53 more than the $81.44 USCo had at the end of year 2 in the first scenario. This inequality results from the facts that in the second scenario, deferral gives ForCo $23.53 more to invest during year 2 than USCo has in the first scenario ($100 - $76.47 = $23.53) and that the after-tax rate of return available to ForCo on its investments is no worse than USCo's after-tax rate of return. In other words, in spite of the truth of Hartman's first proposition, deferral encourages USCo to cause ForCo to reinvest its earnings in its low-tax homeland instead of repatriating them for investment by USCo in the United States.

With respect to empirical evidence regarding the effect of low foreign tax rates on the investment location decisions of U.S. multinational corporations under the present U.S. system, which approximates an exemption system for active business income, see Avi-Yonah, supra, at 1588-91; James Bandler & Mark Maremont, How a Xerox Plan to Reduce Taxes and Boost Profit Backfired, Wall St. J., Apr. 17, 2001, at C1; Harry Grubert & John Mutti, Do Taxes Influence Where U.S. Corporations Invest?, 53 Nat'l Tax J. 825 (2000) [hereinafter Grubert & Mutti, Where U.S. Corporations Invest] (suggesting that almost one out of every five dollars invested abroad by U.S. corporations is drawn to its investment location because of low host country taxes); Donald J. Rousslang, Deferral and Optimal Taxation of International Investment Income, 53 Nat'l Tax J. 589, 596 (2000).

Regarding taxpayer response to the partial U.S. exemption regime contained in the Foreign Sales Corporation (FSC) provisions, see Congressional Research Service, The Foreign Sales Corporation (FSC) Tax Benefit for Exporting and the WTO (RS20571, Sept. 22, 2000); Stephen A. Cohen, Will the WTO's FSC Ruling Be the Demise of the Guam Foreign Sales Corporation? 20 Tax Notes Int'l 1627 (2000); Jose Oyola, Foreign Sales Corporations Beneficiaries: A Profile, 88 Tax Notes 933 (2000); Jose Oyola, News Analysis: A Fresh Look at FSC Beneficiaries, 23 Tax Notes Int'l 71 (2001); Marjorie Rawls Roberts, WTO's FSC Ruling consider whether fairness considerations embedded in the ability-to-pay concept, as well as concerns regarding efficiency, favor worldwide taxation over an exemption system (or a deferral regime that functions as an exemption system). As we will discuss at greater length below, there are limits on our ability to apply the fairness criterion in the taxing of international (and domestic) income, such as the problems presented by our classical system of taxing corporate earnings. Nonetheless, we submit that fairness considerations are at the heart of the U.S. policy to tax the worldwide income of U.S. residents.

II. ABILITY-TO-PAY

A. *The Deference Accorded to Ability-to-Pay*

Ultimately, taxes that support the U.S. government and its direct expenditure programs are borne by individuals.[11] In that regard, the U.S. socio-economic consensus recognizes that one of the most important criteria for spreading the income tax burden among individual taxpayers is the proposition that this onus should be allocated on the basis of comparative economic well-being,[12] often referred to as ability-to-pay.[13] There are, of course, many

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Could Prove Detrimental to the USVI's Economy, 20 Tax Notes Int'l 1626 (2000). The FSC provisions have been replaced by IRC §§ 114, 941-43, which were contained in the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, Pub. L. No. 106-519, and were generally effective October 1, 2000. It remains to be seen whether this new regime will survive the challenge brought by the European Union in the World Trade Organization's dispute resolution body. See Chuck Gnaedinger & Robert Goulder, WTO Finds Successor to FSC Regime Also Violates Trade Rules, 92 Tax Notes 15 (2001); Richard A. Westin & Stephen Vasek, The Extraterritorial Income Exclusion: Where Do Matters Stand Following the WTO Panel Report?, 23 Tax Notes Int'l 337 (2001).

11. See U.S. Treas. Dep't, Distributional Analysis Methodology, OTA Paper No. 85, § 1 (1999) [hereinafter U.S. Treas. Dep't, Distributional Analysis]; Bradford, supra note 1, at 133-34, 148-49; Slemrod & Bakija, supra note 1, at 62-69; George K. Yin, The Future Taxation of Private Business Firms, 4 Fla. Tax Rev. 141, 153-54 (1999).

12. There is currently a sharp debate over whether economic well-being should be measured by reference to income that is both saved and consumed or only by reference to consumption. See, e.g., U.S. Treas. Dep't, Blueprints, supra note 1, at 38-42; U.S. Treas. Dep't, Tax Reform, supra note 1, at 199-200; Dodge, Fleming & Geier, supra note 3, at 472-81; William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113 (1974); Joseph Bankman & Barbara H. Fried, Winners and Losers in the Shift to a Consumption Tax, 86 Geo. L.J. 539 (1998); Bruce Bartlett, The End of Tax Expenditures As We Know Them?, 92 Tax Notes 413, 420-22 (2001); John K. McNulty, Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform, 88 Cal. L. Rev. 2095 (2000); Alvin C. Warren, Jr., Would a Consumption Tax Be Fairer Than an Income Tax?, 89 Yale L.J. 1081 (1980). Moreover, the present income tax is generally recognized as being a hybrid system that is substantially based on both of these approaches. See, e.g., U.S. Treas. Dep't, Blueprints, supra note 1, at 33-35; Bradford, supra note 1, at 8, 28-29;

Edward J. McCaffery, Tax Policy Under a Hybrid Income-Consumption Tax, 70 Tex. L. Rev. 1145, 1152-55 (1992). The current hybrid nature of the income tax does not, however, affect the analysis in this article because the U.S. income tax has important features that involve the taxation of both income that is consumed and income that is saved and the analysis herein is consistent with such a tax. This article is premised on the assumption that the United States will not in the foreseeable future adopt a value added-type consumption tax or otherwise rely principally on consumption taxes for federal revenue.

13. See Report on Double Taxation, League of Nations Doc. E.F.S. 73.F.19, at 18 (1923), in 4 Staff of Joint Comm. on Taxation, Legislative History of United States Tax Conventions 4003, 4022 (1962); U.S. Treas. Dep't, Blueprints, supra note 1, at 1, 24; Graetz & Schenk, supra note 1, at 31, 38-43; Klein, Bankman & Shaviro, supra note 1, at 7-9; Richard A. Musgrave & Peggy B. Musgrave, Public Finance in Theory and Practice 232-240 (4th ed. 1984); Slemrod & Bakija, supra note 1, at 49-55, 59-62, 73-74; Stephen G. Utz, Tax Policy 31-32, 41 (1993); Graetz, supra note 4, at 295; Robert A. Green, The Future of Source-Based Taxation of the Income of Multinational Enterprises, 79 Cornell L. Rev. 18, 29 (1993); Lindsey, supra note 1, at 3, 8, 34-40; Martin J. McMahon, Jr. & Alice G. Abreu, Winner-Take-All Markets: Easing the Case for Progressive Taxation, 4 Fla. Tax Rev. 1, 66-71 (1998); Robert L. Palmer, Toward Unilateral Coherence in Determining Jurisdiction to Tax Income, 30 Harv. Int'l L.J. 1, 9-10 (1989); Joseph T. Sneed, The Criteria of Federal Income Tax Policy, 17 Stan. L. Rev. 567, 574-80 (1965); see also U.S. Treas. Dep't, Distributional Analysis, supra note 11, at § 5. For a discussion of the use of fairness considerations in defining income, see Victor Thuronyi, The Concept of Income, 46 Tax L. Rev. 45 (1990).

Indeed, the familiar Schanz-Haig-Simons definition of income, see Henry Simons, Personal Income Taxation 50 (1938), is principally based on the ability-to-pay concept. See U.S. Treas. Dep't, Blueprints, supra note 1, at 31; U.S. Treas. Dep't, Distributional Analysis, supra note 11, at § 5.1; Dodge, Fleming, & Geier, supra note 3, at 31-32; see also Joseph M. Dodge, What's Wrong with Carryover Basis Under H.R.8, 91 Tax Notes 961, 971 (2001) (suggesting that the assignment of income doctrine, a core principle in the U.S. federal income tax, may be based on the ability-to-pay concept).

Ability-to-pay is a foundational principle in the income tax systems of many countries in addition to the United States. See Woellner, Barkoczy & Murphy, supra note 7, at 43-45; Frans Vanistendael, Legal Framework for Taxation, in 1 Tax Law Design and Drafting 15, 22-23 (Victor Thuronyi ed., 1996). The ability-to-pay principle has even been made a constitutional limitation on the power to tax income in Italy, Spain and Germany. See Vanistendael, supra.

For a discussion of the practical difficulty of translating the general concept of ability-to-pay into a specific rate structure, see Dodge, Fleming & Geier, supra note 3, at 24-25, 265-71.

An important exception to ability-to-pay taxation is the U.S. tax regime that applies to the U.S.-source income of nonresidents. See IRC §§ 871, 881, 882. Many other countries also impose similar source-based taxes. Because such a regime usually reaches less than the taxpayer's entire net income, it cannot be grounded on ability-to-pay. Instead, it is often rationalized as a benefit-based charge imposed by the source country. See American Law Institute, Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons 18-19, 29, 34, 37-38 (1987); Harris, supra note 3, at 483, 485; Graetz, supra note 4, at 298; Lawrence Lokken, The Sources of Income from International Uses and Dispositions of Intellectual Property, 36 Tax L. Rev. 235, 239-40 (1981). The gross-basis, source-based tax on foreign persons is also often justified on administrative grounds because it would be difficult, if not impossible, to impose any other type of tax on foreign persons who are beyond the practical reach of the Internal Revenue Service (IRS). See, e.g., Gustafson, Peroni & Pugh, supra note 7, at 196; Julie Roin, Rethinking Tax Treaties in a Strategic World with Disparate Tax Systems, 81 Va. L. Rev. 1753, 1762 n.28 (1995). But see Avi-Yonah, supra note 10, at 1649-50 (suggesting that the prevailing practice of giving priority to source-based taxes on international income, so occasions when ability-to-pay must yield to other considerations,[14] but it is usually given great weight in the domestic tax policy process.[15] There is no reason why it should not receive equal deference when international tax provisions are being scrutinized.

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that residence countries are limited to a residual tax, arose partly out of a recognition that source countries were generally poorer than residence countries in the 1920s when the current structure of international taxation was created); Hugh J. Ault & David F. Bradford, Taxing International Income: An Analysis of the U.S. System and Its Economic Premises, in Taxation in the Global Economy 11, 31-32 (Assaf Razin & Joel Slemrod eds., 1990) (suggesting that source-based taxes are imposed because source governments have the power to get away with it); Green, supra, at 31 (same); Roin, supra note 10, at 581-84 (suggesting that foreign persons are overtaxed by source countries, in relationship to benefits received, because they are generally unable to defend themselves through participation in the source country political process).

14. See 1 House Comm. Compendium, supra note 1, at ix; Zolt, supra note 1, at 99-101. These other considerations include economic efficiency, simplicity and administrability. See U.S. Treas. Dep't, Blueprints, supra note 1, at 1-2; U.S. Treas. Dep't, International Tax Reform: An Interim Report, ch I, §§ A, B (1993); 1 U.S. Treas. Dep't, Tax Reform, supra note 1, at 13-20; Sneed, supra note 13, at 567.

At present, there is considerable conflict at both the theoretical and empirical levels regarding whether a system of worldwide taxation is, or is not, more economically efficient than an exemption system. Indeed, the Staff of the Joint Committee on Taxation of the U.S. Congress recently stated that "[t]he literature on the theory of international taxation provides no clear direction" with respect to this dispute. Staff of Joint Comm. on Taxation, 106th Cong., 1st Sess., Overview of Present-Law Rules and Economic Issues in International Taxation, at § IV.D. (Comm. Print 1999) [hereinafter Joint Comm., Overview]; see also Altshuler, supra note 10; James R. Hines, Jr., The Case Against Deferral: A Deferential Reconsideration, 52 Nat'l Tax J. 385 (1999); Rousslang, supra note 10, at 595-96. By contrast, an earlier Joint Committee Staff publication took a considerably more certain position by stating that "[e]conomic analysis can demonstrate that for any capital import–neutral [i.e., exemption system] policy, there is almost always a superior revenue–neutral capital export–neutral [i.e., worldwide system] policy." Staff of Joint Comm. on Taxation, 102d Cong., 1st Sess., Factors Affecting International Competitiveness of the United States, at 5 (Comm. Print 1991) [hereinafter Joint Comm., International Competitiveness]. For similar conclusions regarding the endorsement of capital-export neutrality by the economics literature, see U.S. Treas. Dep't, Deferral, supra note 7, at 97; Avi-Yonah, supra note 10, at 1604-11; Alvin C. Warren, Jr., Income Tax Discrimination Against International Commerce, 54 Tax L. Rev. 131, 136, 159-60, 162-63 (2001). This controversy, however, centers primarily on the issue of which of the two approaches–an exemption system or a system of worldwide taxation–will maximize aggregate worldwide income. See generally Altshuler, supra; Graetz, supra note 4, at 282-94; Rousslang, supra. Thus, it has little relevance to the subject matter of this article, which is an inquiry into how fairness considerations affect the selection of a method for taxing foreign-source income.

With respect to whether there would be a substantial simplification gain from the United States replacing its current worldwide taxation system with an exemption system, see Graetz, supra note 4, at 330-31; Charles I. Kingson, The Foreign Tax Credit and Its Critics, 9 Am. J. Tax Pol'y 1, 52-55 (1991); Peter R. Merrill, International Tax and Competitiveness Aspects of Fundamental Tax Reform, in Borderline Case 87, 103 (James M. Poterba ed., 1997); David R. Tillinghast, International Tax Simplification, 8 Am. J. Tax Pol'y 187, 209-12 (1990).

15. See, e.g., 1 U.S. Treas. Dep't, Tax Reform, supra note 1, at 25-26; Sneed, supra note 13, at 579-80, 601-02; see also McMahon & Abreu, supra note 13, at 65-71.

One may, of course, dissent from this consensus and contend that the tax burden should be allocated on some basis other than ability-to-pay. Nevertheless, since ability-to-pay is the prevailing fairness dogma under our current income tax system, its implications regarding the issue of worldwide versus territorial taxation should be analyzed even if one might prefer a different doctrinal approach.

B. *Whose Ability-to-Pay?*

But whose ability-to-pay is relevant in an international context? Which individuals should be included in the group that bears the portion of government cost funded by the individual income tax? Certainly, individuals should be taken into account if their connection with U.S. society is so substantial that fundamental fairness requires their net incomes to be compared with the net incomes of other U.S. residents for purposes of making an equitable allocation of the tax burden under an ability-to-pay system.[16]

Those who continuously live year-round in the United States easily satisfy this standard but there is less clarity when the connection with the United States is less extensive. Congress has drawn lines to deal with this issue[17] and one can debate whether the lines have been properly positioned.[18]

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16. See generally Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 463-65 (Comm. Print 1984); Report on Double Taxation, League of Nations Doc. E.F.S. 73.F.19, at 18-20 (1923), in 4 Staff of Joint Comm. on Taxation, Legislative History of United States Tax Conventions 4003, 4022-24 (1962); Brian J. Arnold & Michael J. McIntyre, International Tax Primer 21 (1995); Hugh J. Ault, Comparative Income Taxation: A Structural Analysis 368 (1997); Harris, supra note 3, at 11-12, 478.

17. See IRC § 7701(a)(4), (b).

18. For example, one can entertain good faith doubts about whether an individual who is present in the United States for 183 days in one year, but is never in the United States during any other year and has no ongoing U.S. ties, is properly treated by IRC § 7701(b)(3) as a U.S. tax resident for the single year during which she was physically present in the United States. Objections can also be raised to treating U.S. citizens as residents when they have not recently lived in the United States. See Pamela B. Gann, The Concept of an Independent Treaty Foreign Tax Credit, 38 Tax L. Rev. 1, 58-69 (1982); see also Harris, supra note 3, at 478. The right of return to the United States that inheres in a long-term expatriate's retained U.S. citizenship is, however, a valuable privilege, see, e.g., Cook v. Tait, 265 U.S. 45, 56 (1924), and an expatriate's decision not to renounce U.S. citizenship can be seen as evidence that the benefits of citizenship are worth facing an annual U.S. tax on worldwide income. See generally Alice G. Abreu, Taxing Exits, 29 U.C. Davis L. Rev. 1087 (1996) (arguing against proposals for mark-to-market taxation of those who renounce U.S. citizenship on fairness, economic rationality and complexity grounds as well as on considerations of personal autonomy and the fact that citizenship does matter); Alice G. Abreu, The Difference Between Expatriates and Mrs. Gregory: Citizenship Can Matter, 67 Tax Notes 692, 695 (1995). But see Jeffrey M. Colon, Changing U.S. Tax Jurisdiction: Expatriates, Immigrants, and the Need for a Coherent Tax Policy, 34 San Diego L. Rev. 1 (1996) (arguing that a mark-to-market taxing regime for persons and property that enter or leave U.S. residence

That dispute, however, is outside the scope of this article and it leaves unaffected the basic principle that individuals substantially connected to the United States should have their net incomes taken into account in determining how the income tax will allocate the fiscal burden of the U.S. government. And, if an individual has such a connection, it seems clear that her entire net income[19] must be considered regardless of whether it is derived from U.S. or foreign sources.

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taxation or U.S. trade or business taxation would better reflect the ability-to-pay norm because it includes all changes in a citizen's net wealth in the income tax base). Such questions of whether the U.S. residency rules are overly aggressive at the margins should not, however, obscure the fact that most individual taxpayers who are treated as U.S. tax residents have sufficient U.S. connections so that the U.S. tax treatment of their total incomes must be compared to that of other U.S. residents for purposes of applying the ability-to-pay concept. With respect to the residence of corporations, see Joseph L. Andrus, Determining the Source of Income in a Changing World, 75 Taxes 839, 848 (1997) and infra Part IV.D.

19. Fairness considerations arguably are satisfied by allowance of a deduction, as opposed to a credit, for foreign taxes. See Kaufman, supra note 4, at 177-78 (arguing that both the foreign tax credit and exemption approaches to mitigating international double taxation should be viewed as tax expenditures that are inconsistent with the ability-to-pay principle); see also David Gliksberg, The Effect of the Statist-Political Approach to International Jurisdiction of the Income Tax Regime-The Israeli Case, 15 Mich. J. Int'l L. 459, 469 (1994). Nonetheless, as discussed further in Part V below, we believe that the efficiency and diplomatic gains that result from allowance of a foreign tax credit to mitigate double taxation properly supercede application of the fairness criterion in addressing the double taxation issue. To the extent that the U.S. resident's foreign taxes exceed the U.S. foreign tax credit limitation, the excess is disregarded in calculating the U.S. resident's net U.S. income tax liability so as to prevent the foreign tax credit from offsetting U.S. tax liability on U.S.-source income. (The foreign taxes in excess of the applicable limitation are not deductible but are carried back to the two prior years and carried forward to the five subsequent years under IRC § 904(c).) In such a case of excess foreign tax credits, the need to protect the U.S. income tax base from erosion by high foreign taxes is a consideration that outweighs the ability-to-pay criterion. See infra Part V.B. If a U.S. resident elects to deduct, rather than credit, foreign taxes the resident's foreign tax payments do reduce net income and such reduction is, of course, consistent with the ability-to-pay principle.

C. *Ability-to-Pay and Source of Income*

The source of net income is simply irrelevant to ability-to-pay.[20] The U.S. system of taxing the worldwide income of resident individuals is consistent with this conclusion;[21] an exemption or territorial system, under which foreign-source income is excluded from the tax base, is fundamentally inconsistent.

To illustrate this point, consider hypothetical individuals A and B who live year-round in the United States. A always earns $8,000 of U.S.-source net income per year as a full-time convenience store clerk while B wholly owns a

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20. See U.S. Treas. Dep't, Blueprints, supra note 1, at 98-99; Arnold & McIntyre, supra note 16, at 5-6; Bradford, supra note 1, at 16; Ault & Bradford, supra note 13, at 11, 27, 31, 41; Roy Blough, Taxation of Income from Foreign Sources, in 3 House Comm. Compendium, supra note 1, at 2145; Walter J. Blum, Tax Policy and Preferential Provisions in the Income Tax Base, in 1 House Comm. Compendium, supra note 1, at 83-84; Gliksberg, supra note 4, at 468-69, 473; Green, supra note 13, at 29; Lokken, supra note 13, at 239; Peggy B. Musgrave, Consumption Tax Proposals in an International Setting, 54 Tax L. Rev. 77, 80 (2000) [hereinafter Musgrave, Consumption Tax Proposals]; Peggy B. Musgrave, "Substituting Consumption-Based Direct Taxation for Income Taxes as the International Norm": A Comment, 45 Nat'l Tax J. 179, 181-82 (1992); Robert J. Peroni, Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules, 51 U. Miami L. Rev. 975, 981-82 (1997); see also Harris, supra note 3, at 318, 461. For a view that an ability-to-pay "comprehensive income tax base is, at least theoretically, susceptible to division by source," see Kaufman, supra note 4, at 174-75.

One commentator, Klaus Vogel, offers a dissenting view on this point. See Vogel, supra note 9, at 157. He argues that foreign-source income should not be taxed by a residence country until it is remitted thereto because before then, it is not enjoyed in the residence country and it remains subject to investment risks in the foreign country. This argument overlooks three critical facts. First, foreign-source income reinvested offshore has an immediate wealth increase effect that enhances the taxpayer's ability-to-pay out of residence country resources. Second, where significant currency controls or other foreign law restrictions prevent the all-events test from being satisfied with respect to foreign-source income of accrual method taxpayers, or prevent the receipt requirement from being satisfied with respect to foreign-source income of cash method taxpayers, the taxpayers will be relieved from recognizing the affected income by the ordinary operation of the U.S. tax system. See, e.g., Regs. § 1.451-1(a). If this is not regarded as an adequate remedy for the problem of foreign legal barriers to income repatriation, consideration could be given to a narrowly focused provision that defers inclusion of the income for as long as it is subject to such restrictions. See IRC § 964(b). Third, the investment risk objection is relevant to ability-to-pay only if the risk resolves adversely and a loss actually occurs. If this happens, the proper response by the tax system is to allow the taxpayer a deduction when the loss is sustained, provided that the loss represents income that was previously included in gross income under the taxpayer's accounting method.

The exercise of taxing jurisdiction over the foreign-source income of residents is clearly acceptable under international norms. See, e.g., American Law Institute, Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons 4-6 (1986); Restatement (Third) of Foreign Relations Law of the United States § 412(1)(a) (1987); Ault, supra note 16, at 367; Gustafson, Peroni & Pugh, supra note 7, at 14.

21. See Peroni, supra note 20, at 981-82. The U.S. view is expressed in IRC § 61(a), which defines gross income as "all income from whatever source derived."

U.S. limited liability company (in a jurisdiction permitting single-member LLCs) which always earns $8,000 per year of U.S.-source net income and $10 million per year of net income sourced to active branch operations in low-tax Country X.[22] Under a pure territorial system, only A's and B's $8,000 of U.S.-source income would be taken into account for income tax purposes.[23] Stated differently, a territorial system would allocate the fiscal burden of the U.S. government between A and B as if they had equal abilities-to-pay and both would remit the same amount of tax.

This is clearly the wrong answer.[24] There is nothing about foreign-source income that excuses it from being taken into account in allocating the tax burden between A and B under a tax system based on the ability-to-pay concept. A's and B's comparative abilities to pay can be properly measured only by including B's foreign-source net income in the calculus.[25] Current law accomplishes this result by ignoring the LLC for tax purposes, treating the

22. A might also receive government transfer payments, including an earned income tax credit, that should be taken into account for purposes of determining whether the allocation of the tax burden between A and B properly reflects their comparative abilities-to-pay. See U.S. Treas. Dep't, Distributional Analysis, supra note 11, at § 5.1; Harris, supra note 3, at 16; J. Clifton Fleming, Jr., Renewing Progressive Taxation by Relying More on Spending, Letters to the Editor, 60 Tax Notes 802 (1993); Fried, supra note 1, at 182-83. Transfer payments would, however, have little effect on the differences between A's and B's ability-to-pay and they are left out of the analysis to simplify it.

23. See Gustafson, Peroni & Pugh, supra note 7, at 18; see also Palmer, supra note 13, at 15 ("a home country's exemption of income earned through a foreign economic relationship presents greater problems in effectuating the fairness doctrine than does a properly designed foreign tax credit regime").

24. Because B's income is vastly larger than A's, the consensus-ability-to-pay fairness concept (see supra text accompanying note 1) clearly would be violated by a U.S. territorial system that imposed identical tax liabilities on A and B. This conclusion is sufficient for our purposes; there is no need to analyze the A-B example in terms of vertical and horizontal equity. See supra text accompanying note 1. However, if other observers would prefer to describe equal taxation of A and B in this example as a violation of the principle of vertical equity, we have no quarrel with their doing so. See, e.g, Avi-Yonah, supra note 10, at 1616.

25. See authorities cited in supra note 20. Although this conclusion is sometimes justified as necessary to prevent avoidance of the individual income tax's progressive rate structure, see U.S. Treas. Dep't, Blueprints, supra note 1, at 99; Vito Tanzi, Taxation in an Integrating World 77-78 (1995); Reuven S. Avi-Yonah, The Structure of International Taxation: A Proposal for Simplification, 74 Tex. L. Rev. 1301, 1311-12 (1996); Lee Burns & Richard Krever, Individual Income Tax, in 2 Tax Law Design and Drafting 495, 496-97 (Victor Thuronyi ed., 1998); Graetz, supra note 4, at 333; Green, supra note 13, at 29; Roin, supra note 13, at 1761; Introduction, in 2 Tax Law Design and Drafting xxi, xxii-xxiii (Victor Thuronyi ed., 1998), the conclusion is fully applicable to a single-rate income tax, see Blum & Kalven, supra note 1, at xvii; see also infra note 27. Many of those who prefer to subdivide the ability-to-pay concept into horizontal and vertical equity components would argue that including B's foreign-source income in the tax base is necessary to satisfy both components irrespective of concerns about progressivity.

LLC's entire net income as taxable to B[26] and imposing a much larger tax on B than on A.[27]

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26. See Regs. § 301.7701-3(a), (b)(1)(ii). There are narrow exceptions to this general approach of imposing worldwide taxation on U.S. residents. See, e.g., IRC §§ 911 (exclusion of a limited amount of foreign earned income and certain qualified housing amounts); 114, 941-43 (new exclusion for narrowly defined extraterritorial income).

27. See generally IRC § 1.

The current Internal Revenue Code imposes progressive rates on the incomes of individuals (and on corporations as well, see IRC § 11). Although we are supporters of this approach (at least with respect to individuals) we have chosen to defer our advocacy in behalf of progression. Thus, in this article when we assert that B's $10 million of foreign-source net income should be included in her U.S. taxable income and that she should pay a larger tax than A, we are saying nothing about what the rate of tax should be on A's $8,000 of net income or whether any part of B's income should be taxed at a rate higher than the rate applicable to A's net income. Stated differently, in this article, we do not, and need not, enter the debate over whether tax rates are too low or too high, or the debate regarding whether the income tax should be progressive and if so, how progressive.

Instead, we limit ourselves to arguing that because B's income is 1,251 times larger than A's, B should pay a tax that is at least 1,251 times larger than the amount paid by A. We seem to have general support for this position from persons who are not usually counted as friends of rigorous income taxation. For example, even former President Ronald Reagan said:

> Proportionate taxation we should gladly accept on the theory that those better able to pay should remove some of the burden from those least able to pay. The Bible explains this in its instruction on tithing. We are told that we should give the Lord one tenth and if the Lord prospers us ten times as much, we should give ten times as much.

Ronald Reagan, Encroaching Control: Keep Government Poor and Remain Free, 27 Vital Speeches of the Day 677 (1961), quoted in Marvin A. Chirelstein, Federal Income Taxation 5-6 n.4 (rev. 8th ed. 1999). Also, William Safire, the conservative New York Times political commentator, has stated: "Most of us accept as 'fair' this principle: the poor should pay nothing, the middlers something, the rich the highest percentage." William Safire, The 25% Solution, N.Y. Times, Apr. 20, 1995, at A23, quoted in Graetz, The U.S. Income Tax, supra note 2, at 11. Indeed, most observers would readily concede that in the A-B example, B has a much greater ability-to-pay than A, and should pay a much greater tax, regardless of where these observers stand on the issue of progressive income taxation. That consensus is sufficient for purposes of this article.

For a sampling of the rich literature on the progressive taxation controversy, see Blum & Kalven, supra note 1; Friedrich A. Hayek, The Constitution of Liberty (1960); Klein, supra note 1, at 12-45; Arthur M. Okun, Equality and Efficiency: The Big Tradeoff (1975); Randolph E. Paul, Taxation in the United States 714-64 (1954); John F. Witte, The Politics and Development of the Federal Income Tax (1985); Fried, supra note 1; Lindsey, supra note 1; Michael A. Livingston, Blum and Kalven at 50: Progressive Taxation, "Globalization," and the New Millennium, 4 Fla. Tax Rev. 731 (2000); McMahon & Abreu, supra note 13; Joel B. Slemrod, The Economics of Taxing the Rich, in Does Atlas Shrug?–The Economic Consequences of Taxing the Rich 1 (Joel B. Slemrod ed., 2000); Lawrence Zelenak & Kemper Moreland, Can the Graduated Income Tax Survive Optimal Tax Analysis? 53 Tax L. Rev. 51 (1999).

For a dissenting view arguing that government should be financed by a modified regressive head tax, see Jeffrey A. Schoenblum, Tax Fairness or Unfairness? A Consideration of the Philosophical Bases for Unequal Taxation of Individuals, 12 Am. J. Tax Pol'y 221 (1995). For a response, see Donna M. Byrne, Locke, Property and Progressive Taxes, 78 Neb. L. Rev.

D. *Compared to Whom?*

One could argue that if individual C is an X Country resident who also earns $10,000,000 of X Country-source business income and pays the low X Country rate thereon, fairness requires the A-B comparison to be replaced with a B-C comparison and requires that B's $10,000,000 X Country-source income be exempted from the U.S. tax base so that this income bears only the low X Country tax paid by C.[28] If, however, the U.S. Congress decides to tax U.S. residents' entire taxable incomes at a high rate (with a credit for foreign taxes) and Country X decides to impose tax at a low rate on its residents and on income sourced within its borders, there is no fairness-based reason why the level of X Country source-based taxation should dictate the U.S. conception of fairness with respect to U.S. residents. Each country has the right to decide the notions of tax fairness that will prevail with respect to members of its society.[29] Moreover, if X Country's tax rate on B's and C's Country X-source income were higher than the U.S. rate on B's Country X-source income, it would be difficult to find advocates for the view that the B-C comparison compels the United States to raise its rate on B's Country X income up to the Country X rate (so that B would not have any X Country tax in excess of the U.S. credit that could be cross-credited against low foreign taxes on other income or carried back to prior years or forward to future years).[30]

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700 (1999). The merits and deficiencies of a head tax need not be included in this discussion because such a tax is not within the range of plausible policy alternatives. See Blum & Kalven, supra note 1, at 3; Graetz & Schenk, supra note 1, at 38-39; Slemrod & Bakija, supra note 1, at 136; Fried, supra note 1, at 161-62, 194.

28. See generally Klaus Vogel, The Search for Compatible Tax Systems, in Tax Policy in the Twenty-First Century 76, 85 (Herbert Stein ed., 1988); Vogel, supra note 9, at 156-57.

29. See Restatement (Third) of Foreign Relations Law of the United States §§ 411-413 (1987); Commission of the European Communities, Tax Policy in the European Union–Priorities for the Years Ahead 9, 25 (May 23, 2001); Woellner, Barkoczy & Murphy, supra note 7, at 1303; Avi-Yonah, supra note 10, at 1629; Graetz, supra note 4, at 277-282; Roin, supra note 10, at 597; Stanley S. Surrey, Current Issues in the Taxation of Corporate Foreign Investment, 56 Colum. L. Rev. 815, 824 (1956); Alvin C. Warren, Jr., Alternatives for International Corporate Tax Reform, 49 Tax L. Rev. 599, 612 (1994); see also Harris, supra note 3, at 443-44, 474; Dan R. Mastromarco, Department of Treasury Exercises Good Judgment on OECD Initiative, News, Commentary and Analysis, 91 Tax Notes 1623, 1624 (2001); Mitchell, supra note 9, at 814-15; U.S. Treasury Secretary Statement on OECD Tax Havens, Official Announcements, Notices and News Releases, 22 Tax Notes Int'l 2617 (2001); Letter from Congressman Dick Armey to Secretary of the Treasury Lawrence Summers (Sept.7, 2000), reprinted in 88 Tax Notes 1539, 1540 (2000).

30. See Mitchell, supra note 9, at 803-06, 814-15, 821-22; Surrey, supra note 29, at 825 ("when all of the recommendations of these organizations for eliminating double taxation are added up, the basic jurisdictional rule they suggest is not that of the country of citizenship and not that of the country of source, but rather that of the country with the lowest tax rate.").

III. WHAT IF EVERYBODY CAN DO IT?

A. *A Self-Inflicted Wound?*

Assume that the United States has adopted an exemption system and that U.S. residents E and F each has sufficient capital to invest in a business that will produce before-tax net income of $10 million per year. Assume further that all U.S. residents have ready access to foreign investment opportunities. E chooses to acquire a business in low-tax Country X. Therefore, he pays no U.S. tax on his $10 million of Country X-source income. F could do the same as E but, instead, she acquires a U.S. business. As a result, she pays U.S. tax on her $10 million of U.S.-source income. Some analysts would argue that this disparate treatment of E and F does not contravene the ability-to-pay principle. This is because we are assuming that F had an equal opportunity to make a Country X investment annually yielding $10 million of foreign-source net income. Under this assumption, the fact that the United States imposes a heavier tax on F's income of $10 million than on E's income of the same amount is due entirely to F's affirmative choice to earn U.S.-source income instead of exempt Country X-source income. Thus, some commentators would argue that although this hypothetical exemption system is a poorly-designed tax expenditure that improperly encouraged E to make a foreign investment, F is the victim of a "self-inflicted wound"[31] and is not suffering from a violation of the ability-to-pay norm.[32]

We disagree with this argument because it is impractical to measure ability-to-pay in terms of forgone opportunities. The only feasible way of comparing the abilities-to-pay of separate taxpayers is by looking at their *actual incomes* from all sources. Thus, the predominant approach to measuring ability-to-pay would regard the disparate U.S. taxation of E's and F's incomes as violating the ability-to-pay concept.[33]

A more fundamental problem with this "self-inflicted wound" analysis, however, arises from its critical assumption that opportunities to earn foreign-source business income are freely and equally available to all U.S. residents. This is plainly not correct. There are barriers of distance, language, custom and unfamiliar and complex legal regimes that exclude numerous U.S. residents from the opportunity to earn foreign-source business income with anything approaching the foreign income earning facility of other U.S. residents. Consequently, the fact that F pays a heavier U.S. tax on her income in the

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31. Boris I. Bittker, Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?, 16 San Diego L. Rev. 735, 739 (1979).

32. See Ault & Bradford, supra note 13, at 29-30; Zolt, supra note 1, at 91-92.

33. See authorities cited in supra note 1.

preceding example than does E cannot necessarily be dismissed as the result of F's bad judgment.

This lack-of-equal-access point becomes many times larger when we return to our example of A, the U.S. resident convenience store clerk who earns $8,000 of U.S.-source net income per year and B, the U.S. resident who owns a U.S. LLC that produces $8,000 per year of U.S.-source net income and $10 million per year of active business net income in low-tax Country X. If one argues that the hypothetical U.S. exemption system does not violate the ability-to-pay principle in the case of E and F, above, one would seemingly be forced to also argue that since A "chose" to earn his $8,000 of wage income in the United States instead of achieving exemption from U.S. taxation by working at a Country X convenience store, the ability-to-pay principle is not violated by the fact that a U.S. exemption system would levy identical U.S. income taxes on A's and B's vastly different incomes. But the stipulation that Country X is a low-tax jurisdiction means that it is not contiguous to the United States. Thus, U.S. resident A cannot freely elect to work in a Country X convenience store. This illustrates a larger point: the wage income that dominates the earnings of A and most other individual taxpayers is far less mobile than other business income. Indeed, most of the international income earned by U.S. residents is from capital–either direct or portfolio investments of capital.[34] Thus, the key premise of the preceding discussion, equal opportunity to earn foreign-source business income, does not really exist so long as there are disparities in wealth among taxpayers that result in some U.S. residents being able to earn foreign-source income from investing mobile capital while many more U.S. residents are effectively limited to earning relatively immobile wage income from U.S. sources.

B. *Portfolio Investment as a Possible Answer*

Some would point out at this juncture that although A and F might not have a ready opportunity to earn foreign-source business income from foreign direct investment, there are abundant opportunities for U.S. residents to earn foreign-source portfolio income by purchasing shares in foreign companies and by investing in mutual funds that buy foreign securities.[35] This point is not responsive, however, because the advocates of a U.S. exemption system do not ordinarily contemplate that the system would cover foreign-source passive

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34. For 1998, aggregate U.S. income receipts on non-government U.S. assets owned abroad were $252,247,000,000, while employee compensation earned abroad by Americans was $1,857,000,000. See U.S. Dep't of Commerce, supra note 2, at 790; see also Avi-Yonah, supra note 10, at 1617-18; Green, supra note 13, at 60.

35. See Ault & Bradford, supra note 13, at 29-30.

income.[36] This reticence is probably due to the fact that a generally available zero U.S. rate for offshore passive income would be seen as inconsistent with a fundamental feature of an income tax, as opposed to a consumption tax, namely, that income from capital should be taxed.[37] Moreover, the exemption of foreign portfolio investment income from U.S. taxation would likely encourage U.S. residents to effect a large shift of passive investments from the United States to low- or zero-tax rate foreign jurisdictions.[38]

C. *Implicit Taxes as a Possible Answer*

But suppose the exemption system adopted by the United States causes internationally sophisticated U.S. residents to engage in so much direct investment in Country X that the before-tax rate of return on B's active business investments in Country X is driven down to a point where B's after-tax return on those investments equals the after-tax rate of return available to A on U.S. investments. Exemption system advocates could argue that the ability-to-pay objection to the hypothetical U.S. exemption system has been eliminated because B is now paying an implicit tax[39] on her Country X income, in the form of a decreased before-tax rate of return, that results in her greater income bearing a larger aggregate tax than A's smaller income.

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36. See National Foreign Trade Council, supra note 6, at 6-29; Grubert & Mutti, Dividend Exemption, supra note 10, at 2; Merrill, supra note 14, at 103; H. David Rosenbloom, From the Bottom Up: Taxing the Income of Foreign Controlled Corporations, 26 Brook. J. Int'l L. 1525, 1549 (2001); Joel Slemrod, The Taxation of Foreign Direct Investment: Operational and Policy Perspectives, in Borderline Case 11, 34 (James M. Poterba ed., 1997). Indeed, countries that have adopted exemption systems have typically excluded foreign-source portfolio income from their exemption regimes. See Ault, supra note 16, at 402-06.

37. See Dodge, Fleming & Geier, supra note 3, at 472-78; Stephen E. Shay & Victoria P. Summers, Selected International Aspects of Fundamental Tax Reform Proposals, 51 U. Miami L. Rev. 1029, 1032-33 (1997).

38. Of course, many types of modern business income are also quite mobile and that is one key reason why an exemption for foreign business income would likely lead to tax motivated business investment in low-tax foreign countries. See U.S. Treas. Dep't, Deferral, supra note 7, at 44-45, 182-84, 197-209.

39. For explanations of implicit taxes, see U.S. Treas. Dep't, Blueprints, supra note 1, at 152-53; George Cooper, The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance, 85 Colum. L. Rev. 657, 698-99 (1985); Harvey Galper & Dennis Zimmerman, Preferential Taxation and Portfolio Choice: Some Empirical Evidence, 30 Nat'l Tax J. 387, 388 (1977); Calvin H. Johnson, Inefficiency Does Not Drive Out Inequity: Market Equilibrium & Tax Shelters, 71 Tax Notes 377, 381-82 (1996); Stanley S. Surrey & Paul R. McDaniel, The Tax Expenditure Concept and the Budget Reform Act of 1974, 17 B.C. Indus. & Com. L. Rev. 679, 702-06 (1976); Edward Yorio, Equity, Efficiency, and the Tax Reform Act of 1986, 55 Fordham L. Rev. 395, 397-400 (1987). On these facts, of course, the exemption system produces an inefficient result in the sense that it induces U.S. residents to over-invest in Country X. See Altshuler, supra note 10, at 1581; Avi-Yonah, supra note 10, at 1604-05; Zolt, supra note 1, at 92.

The problem with this line of argument is that implicit taxes are not collected by governments. Thus, the implicit tax paid by B, in the form of a lower before-tax rate of return on her Country X investment, does not go to the U.S. Treasury and, therefore, it does nothing to increase the portion of the cost of the U.S. government borne by B vis-a-vis A. Stated differently, the implicit tax borne by B fails to correct the misallocation of the U.S. tax burden that exists between A and B if A pays the same amount of U.S. tax as B. Nor does the implicit tax go to the Country X Treasury where it would support a claim by B against the United States for double tax relief.[40] In short, the implicit tax suffered by B does not solve the ability-to-pay objection to the hypothetical U.S. exemption system. Thus, there seem to be no market dynamics undermining the critical observation that the ability-to-pay principle requires B's larger income to bear a greater U.S. tax than A's smaller income and that an exemption system produces a contrary result.

IV. U.S. C CORPORATIONS AND ABILITY-TO-PAY[41]

A. *The Need for an Anti-Deferral Device*

Some commentators apparently concede that the preceding analysis establishes a persuasive case for worldwide taxation of U.S. resident individuals but, nevertheless, they are attracted to U.S. exemption treatment for the foreign-source income of U.S. resident C corporations.[42] This raises the question of whether the preceding ability-to-pay analysis is applicable to income earned through C corporations.

A useful way to pursue an answer is to revisit the preceding example in which U.S. resident individual B owns a U.S. LLC earning $8,000 per year of U.S.-source net income and $10 million per year of active business net income in low-tax Country X. Now assume that B converts her wholly owned LLC into a U.S. C corporation named USCo. B then sells half of her new USCo stock in a public offering to 10,000 residents of Country X and donates the stock sales proceeds to her favorite law school as an endowment for a tax law chair. Thereafter, the shares of USCo are traded on an established securities

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40. Moreover, it is doubtful that the flow of direct investment capital into low-tax foreign countries would be sufficient to result in a convergence of after-tax rates of return. See National Foreign Trade Council, supra note 6, at 6-16. With respect to the failure of after-tax rates of return on tax exempt municipal bonds and taxable bonds to converge, see Johnson, supra note 39, at 377.

41. For the sake of simplicity, we assume throughout the remainder of this article that all shareholders are individuals unless otherwise stated. Thus, we reserve for a future article a discussion of the extent to which look-through rules are appropriate where stock is owned by juridical entities.

42. See Bouma, supra note 8; Graetz, supra note 4, at 325-31, 333-35.

market. On these facts, B's amounts of U.S.-source and foreign-source income are reduced by half to $4,000 and $5 million respectively (she owns only 50% of the USCo stock), but both amounts should be taken into account for U.S. income tax purposes in measuring B's ability to pay vis-a-vis low-income A. This result would be achieved directly if C corporation income were taxed to shareholders under a pass-through integration regime based on the principles of Subchapter K or S.[43] This is not, however, the way that the United States generally taxes C corporations. The income of a U.S. C corporation[44] is typically subjected to both a corporate-level tax as it is earned by the corporation and also to a shareholder-level tax at the, perhaps distant, time when the shareholders receive the income from the corporation or sell their shares.[45]

This taxation scheme cannot be explained on ability-to-pay grounds because liability under the corporate-level tax is calibrated to the taxable income of the corporation and bears no necessary relationship to the respective abilities to pay of any individuals.[46] Thus, several rationales other than ability-

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43. See IRC §§ 702(a), 1366(a); Jeffrey L. Kwall, The Uncertain Case Against the Double Taxation of Corporate Income, 68 N.C. L. Rev. 613, 629 (1990). For a description of such an integration scheme, see U.S. Treas. Dep't, Blueprints, supra note 1, at 69-73, 98-100. Some of the most prominent recent integration proposals have, however, regarded this approach to integration as unfeasible and have advocated schemes that rely on a corporate-level tax. See U.S. Treas. Dep't, Integration of the Individual and Corporate Tax Systems 39-49 (1992) [hereinafter U.S. Treas. Dep't, Integration]; American Law Institute, Integration of the Individual and Corporate Income Taxes 92-94 (1993) [hereinafter American Law Institute, Integration].

44. In the example in the text, the number of shareholders and the nonresident alien status of 10,000 of them will prevent taxpayer B from using a Subchapter S election to get her corporation out of C status. See IRC § 1361(b)(1). Moreover, if B had forgone conversion of her LLC to a C corporation and had, instead, sold half her interest in profits and capital to 10,000 investors, the probable public trading in the ownership interests of taxpayer B's LLC would prevent the LLC owners from avoiding C status by failing to formally incorporate the LLC. See IRC § 7704 and assume that IRC § 7704(c) is inapplicable.

45. See IRC §§ 11, 61(a)(3), (7). The shareholder-level tax is not reduced by credits reflecting corporate-level tax. Thus, the corporate-level and shareholder-level income taxes function as independent, cumulative levies. This article assumes that this classical double taxation of C corporation income will continue as the general pattern under the Internal Revenue Code for the foreseeable future even though we believe that integration of the corporate and shareholder income taxes would be a desirable policy move.

Double taxation is avoided in the cases of domestic C corporations reporting their income with a parent corporation on a consolidated return, see IRC §§ 1501-1504, and certain wholly owned domestic subsidiaries of S corporations, see IRC § 1361(b)(3).

46. See IRC § 11(a), (b)(1); M. Slade Kendrick, Corporate Income Tax Rate Structure, in 3 House Comm. Compendium, supra note 1, at 2289, 2297; Yin, supra note 11, at 152. Because the corporate-level tax is generally regarded as borne by living taxpayers and not the entity itself, the question of a C corporation's ability-to-pay is commonly viewed as irrelevant. See U.S. Treas. Dep't, Blueprints, supra note 1, at 4; Harris, supra note 3, at 104; Graetz, supra note 4, at 301-02; see also Katherine Pratt, The Debt-Equity Distinction in a Second-Best World, 53 Vand. L. Rev. 1055, 1113-14 (2000).

to-pay have been proposed as justifications for the corporate-level tax and there is disagreement regarding which of these is the "best" and, indeed, whether the basic concept of a separate, unintegrated corporate income tax is defensible at all.[47] The merits of this controversy are outside the scope of this article. More importantly, in spite of this dispute over the theoretical justification for a separate, unintegrated tax on corporate income, there is broad agreement that because pass-through treatment cannot be practically imposed on corporations with large numbers of shareholders[48] and because Congress is quite unlikely, in the near term, to adopt other means of currently taxing shareholders on corporate income through integration of the corporate and individual income taxes, the present corporate-level tax must be maintained as a crude, second-best anti-deferral device.[49] Otherwise, C corporation shareholders would be

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47. See American Law Institute, Integration, supra note 43, at 44-46; American Law Institute, Taxation of Private Business Enterprises 51-55, 59-63 (1999); Bradford, supra note 1, at 103; Jeffrey A. Maine, Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises, 62 U. Pitt. L. Rev. 223, 241-44, 253-57 (2000); Pratt, supra note 46, at 1100-03, 1109-10. With respect to the historical origins of the corporate-level tax, see Majorie E. Kornhauser, Corporate Regulation and the Origins of the Corporate Income Tax, 66 Ind. L.J. 53 (1990).

48. See Graeme S. Cooper & Richard K. Gordon, Taxation of Enterprises and Their Owners, in 2 Tax Law Design and Drafting 811, 817 (Victor Thuronyi ed., 1998); Pratt, supra note 46, at 1112-13; George K. Yin, Corporate Tax Integration and the Search for the Pragmatic Ideal, 47 Tax L. Rev. 431, 434 (1992); see also U.S. Treas. Dep't, Integration, supra note 43, at 27-35. Among other things, large numbers of shareholders imply frequent trading in a corporation's stock which creates difficulties in allocating income and losses to the shareholders. For contrary views asserting that a pass-through system can be constructed for corporations with large numbers of shareholders, see U.S. Treas. Dep't, Blueprints, supra note 1, at 69-74; Yin, supra note 11, at 195-96.

49. See U.S. Treas. Dep't, Integration, supra note 43, at 189 n.1; 1 U.S. Treas. Dep't, Tax Reform, supra note 1, at 118-21; Howard E. Abrams & Richard L. Doenberg, Federal Corporate Taxation 8 (4th ed. 1998); J.D.R. Adams & J. Whalley, The International Taxation of Multinational Enterprises in Developed Countries 8 (1977); American Law Institute, Integration, supra note 43, at 94; Bradford, supra note 1, at 55; Harris, supra note 3, at 102-04; Joseph A. Pechman, Federal Tax Policy 136 (5th ed. 1987); Slemrod & Bakija, supra note 1, at 235-36; Ault & Bradford, supra note 13, at 37; Cooper & Gordon, supra note 48, at 812-13; Malcolm Gammie, The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement, 49 Tax L. Rev. 615, 628-29 (1994); Graetz, supra note 4, at 302; Kwall, supra note 43, at 629-30; see also U.S. Treas. Dep't, Deferral, supra note 7, at 4; Jeffrey L. Kwall, The Federal Income Taxation of Corporations, Partnerships, Limited Liability Companies, and Their Owners 6-8 (2d ed. 2000); Utz, supra note 13, at 177-78; Pratt, supra note 46, at 1115; Rebecca S. Rudnick, Who Should Pay the Corporate Tax in a Flat Tax World, 39 Case W. Res. L. Rev. 965, 1066-69 (1988-89); Joseph A. Snoe, The Entity Tax and Corporate Integration: An Agency Cost Analysis and a Call for a Deferred Distribution Tax, 48 U. Miami L. Rev. 1, 43 (1993).

Of course, if the corporate-level tax were integrated with the shareholder-level tax, the corporate-level tax could continue to serve its anti-deferral function without imposing the double tax result that characterizes the present approach to taxing C corporations. There is, however, no near-term likelihood of such an integration scheme being adopted and this article assumes continuation of the current regime of C corporation taxation, no matter how ill-advised that may able to completely defer taxation until they withdrew the corporations's earnings (or sold their shares), thus achieving a deferral of U.S. tax that is not available to the owners of closely held businesses[50] taxed under the Subchapter K or S pass-through regimes. Indeed, we believe that the anti-deferral effect of the present U.S. corporate income tax is the only persuasive reason for a large, unintegrated levy on corporate earnings.

B. *The Overbreadth of the Corporate Income Tax*

The corporate-level income tax, however, is indeed a crude anti-deferral instrument for three reasons. First, its rates (15% to 35%) bear no direct relationship to the length of time that shareholder-level tax is deferred. Thus, the corporate-level tax is usually either greater than, or less than, the amount necessary to offset the economic benefit gained from deferring the shareholder-level tax. Second, the corporate-level tax in the preceding example may be partially shifted to investors in the noncorporate sector and to USCo's customers and suppliers of materials and labor,[51] none of whom are engaged in deferring shareholder-level tax on shares of USCo's income.[52] Finally, USCo may satisfy the 80% active foreign business requirement of Sections 871(i)(2)(B) and 881(d) so that the part of the dividends received by USCo's foreign shareholders that is proportionate to the corporation's foreign-source gross income would be exempt from U.S. tax.[53] To that extent, the foreign shareholders are not engaging in deferral of investor-level tax with respect to USCo's income and they are not proper targets of the corporate-level anti-

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be from a tax policy standpoint.

50. Generally speaking, only closely held businesses can qualify for the Subchapter K or S regimes. See IRC § 1361(b)(1)(A) regarding Subchapter S and IRC § 7704 regarding Subchapter K. There are also many closely held C corporations left over from the era preceding the rise of the LLC and the check-the-box, entity classification regulations. But the current structure of the income tax creates an incentive for new closely held enterprises to operate under Subchapter K or S pass-through taxation. See U.S. Treas. Dep't, Taxes and Corporate Choice of Organizational Form, OTA Paper No. 73 (1997). But see John W. Lee, A Populist Political Perspective of the Business Tax Entities Universe: "Hey the Stars Might Lie but the Numbers Never Do," 78 Tex. L. Rev. 885 (2000) (pointing out that despite the conventional wisdom that the choice of entity for new, closely held ventures is an LLC, in all but one state, new formations of corporations (either C corporations or S corporations) outnumbered new LLC formations, usually by a 2-to-1 or greater margin, in the 1995-1998 period).

51. See U.S. Treas. Dep't, Blueprints, supra note 1, at 4-5; U.S. Treas. Dept., Distributional Analysis, supra note 11, at § 6.4; U.S. Treas. Dep't, Integration, supra note 43, at 146-47; Bradford, supra note 1, at 136-39; Slemrod & Bakija, supra note 1, at 66-67; William A. Klein, The Incidence of the Corporation Income Tax: A Lawyer's View of a Problem in Economics, 1965 Wisc. L. Rev. 576; Pratt, supra note 46, at 1108; Roin, supra note 10, at 576-77.

52. See Kwall, supra note 43, at 635 n.115.

53. See IRC §§ 861(c), 871(i), 881(d).

deferral regime. Moreover, a pass-through tax regime modeled on Subchapter K would relieve the foreign shareholders from paying tax on the $5 million of USCo's foreign-source net income that is attributable to them.[54] Therefore, it is inappropriate to apply a corporate-level anti-deferral tax to that income even if USCo does not satisfy the 80% foreign business requirement. Nevertheless, under current law the foreign shareholders' entire portion of USCo's income bears U.S. corporate-level tax to the extent that the tax burden is not shifted to others.

We should note, however, that the first two of these criticisms (the lack of relationship between the corporate-level tax rates and the deferral period and the partial shifting of the corporate-level tax) apply even if a C corporation's income is entirely from U.S. sources. Only the third criticism (that the corporate-level tax reaches foreign stockholders' shares of foreign-source corporate income) is directly relevant to the issue of whether a U.S. corporation's foreign-source income is properly subject to the corporate-level tax. Moreover, the cure for this third criticism (as well as the first two) lies in the United States adopting a responsive integration system. Thus, the imprecision of the corporate-level tax does not present a case for exempting the foreign-source income of U.S. C corporations.[55] Instead it presents a case for a corporate integration regime that would (1) relieve foreign shareholders of U.S. tax on their portion of corporate foreign-source income, but (2) also uphold the ability-to-pay principle by imposing current U.S. tax on all corporate income (foreign-source as well as U.S.-source) attributable to U.S. resident shareholders.[56]

C. *Searching for the Lesser Evil*

Unfortunately, the United States has not adopted the necessary integration scheme and is unlikely to do so in the near future. Thus, the federal income tax system continues to require a corporate-level tax that functions as a second-best anti-deferral device. This means that although exempting foreign-source income of U.S. C corporations from the corporate-level tax would cure the overbreadth of that tax with respect to foreign-source income attributable to foreign shareholders, it would do so at the cost of allowing U.S. stockholders to substantially remove their shares of corporate foreign-source income from the U.S. tax base by causing U.S. C corporations to defer distributions until the

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54. See IRC §§ 871, 881; Regs. § 1.1441-5(b)(2)(i); Rev. Proc. 89-31, 1989-1 C.B. 895.

55. See also U.S. Treas. Dep't, Deferral, supra note 7, at 35; Avi-Yonah, supra note 10, at 1609.

56. For a description of such an integration regime, see U.S. Treas. Dep't, Blueprints, supra note 1, at 69-73, 98-100.

present value of the shareholder-level tax shrinks to insignificance.[57] This would effectively defeat the ability-to-pay principle, which requires that both U.S.-source and foreign-source income be included in determining a U.S. resident's appropriate share of the expense of government. Stated more broadly, granting exemption from the corporate-level tax for all foreign-source income of U.S. C corporations would allow U.S. resident individuals to escape the inclusionary requirement of the ability-to-pay principle by interposing a U.S. C corporation between themselves and their foreign-source income. By contrast, maintaining an unintegrated corporate-level tax on the worldwide income of U.S. C corporations would uphold the ability-to-pay principle with respect to U.S. shareholders but, as explained above,[58] would incorrectly tax the portion of the foreign-source income of U.S. C corporations that is attributable to foreign shareholders.

This difficult dilemma should be resolved in favor of sustaining the ability-to-pay principle with respect to U.S. shareholders by imposing U.S. corporate-level tax on the foreign-source income of U.S. corporations regardless of the presence of foreign shareholders. This is burdensome to the foreign shareholders but not unfair because the corporate-level tax is a clearly disclosed element of the U.S. tax system and nonresidents purchase the shares of U.S. corporations with their eyes wide open.[59]

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57. See authorities cited in infra note 101. Neither the U.S. domestic nor international anti-deferral regimes are serious threats to this tax planning approach. See generally Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ch. 7 (7th ed. 2000); 1 Joel D. Kuntz & Robert J. Peroni, U.S. International Taxation chs. B2, B3 (1992); Peroni, Fleming & Shay, supra note 10, at 460-64. Moreover, as discussed recently by the U.S. Treasury Department, exempting a C corporation's foreign-source income from U.S. tax while maintaining an entity-level tax on U.S.-source income would distort investment behavior by corporations:

> [R]educing only the tax on foreign investment income would cause domestic corporate investors to favor a foreign investment over a domestic alternative that has a higher pretax return. The tax bias against corporate investment [because of the U.S. double tax regime], by itself, does not provide a compelling reason to favor foreign or domestic corporate investments if the overall goal is to minimize distortions in investment decisions.

U.S. Treas. Dept, Deferral, supra note 7, at 35. In other words, the appropriate solution to the overbreadth problem of the U.S. corporate tax is not lowering or eliminating the tax on only foreign-source income.

58. See supra Part IV.B.

59. This issue was presented in 1876 to the Exchequer Court under the British regime which taxed the worldwide income of British resident corporations. In upholding the imposition of this tax on the foreign-source income of a British resident corporation whose shares were owned primarily by nonresidents, Chief Baron Kelly stated, "that if a foreigner residing abroad . . . thinks fit to come and invest his money in this country, and so to obtain the broad shield of protection of the law to his property, he must take it with the burdens belonging to it." Calcutta Jute Mills Co. v. Nicholson and Cesena Sulphur Co. v. Nicholson, 1 Reports of Tax Cases 83, 88, 102 (1876).

D. *Defining Corporate Residence and Pursuing Runaway Corporations and Shareholders*

In the preceding discussion, we have referred to corporations taxed by the United States on their worldwide incomes as "U.S. corporations" and "U.S. C corporations" without further explanation. We recognize that in taking this approach, we have oversimplified matters by acting as if the identification of such corporations were an obvious, non-controversial matter. We did so because this is, in fact, a difficult and complex issue and a thorough analysis would substantially detract from our focus on the international implications of the ability-to-pay principle. Nevertheless, the problem of identifying the corporations that should be subjected to U.S. taxation of their worldwide incomes has important implications regarding the ability-to-pay principle and a brief discussion is appropriate at this point.

A corporation is treated as a U.S. resident, taxed by the United States on its worldwide income, if it satisfies the Internal Revenue Code's definition of a "domestic corporation"–i.e., if it is incorporated under the laws of the United States, one of the 50 states or the District of Columbia.[60] Commentators have argued that when this place-of-incorporation rule is coupled with the U.S. worldwide taxation system, it creates the indefensible possibility of a corporation with no U.S. shareholders, no U.S. assets and no U.S.-source income incurring U.S. tax on its foreign-source income merely because it was incorporated in a U.S. jurisdiction.[61]

We recognize that when U.S. resident status is bestowed on a corporation owned exclusively by foreign shareholders and earning its income entirely outside the United States, the result is overtaxation of the foreign shareholders by the United States. We do not view this as a significant practical problem, however, because the universe of domestic corporations with no U.S. shareholders, no U.S. assets and no U.S.-source income is surely very small and nearly always the result of informed planning.[62]

A related suggestion has been made that the combination of the U.S. approach to defining corporate residency and the U.S. system of worldwide taxation will drive U.S. resident corporations to incorporate their new ventures (say Intel's development of its next-generation processor) in low-tax offshore

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60. IRC §§ 11, 7701(a)(4), (5).

61. See Herman B. Bouma, Two Arguments Against an Alternative View of Deferral, 20 Tax Notes Int'l 875 (2000); H. David Rosenbloom, The David R. Tillinghast Lecture: International Tax Arbitrage and the "International Tax System," 53 Tax L. Rev. 137, 139 (2000).

62. See Slemrod, supra note 36, at 31. For example, towards the end of the boom in technology stocks, Israeli technology start-up companies were routinely formed as U.S. corporations in anticipation of issuing Nasdaq-traded stock.

jurisdictions.[63] The new corporations would then be foreign residents that escape current U.S. taxation of their foreign-source income. However, if runaway corporations are truly a threat to the U.S. income tax base, the problem can be properly addressed by expanding the definition of "domestic corporation." To be specific, if U.S. resident corporations incorporate their new product developments offshore, the United States could counter that tax-avoidance strategy by enlarging the definition of "domestic corporation" to include entities whose stock is held in significant percentages by U.S. residents.[64] Even better, the United States could totally end deferral of U.S. tax on income earned by U.S. shareholders through foreign corporations by applying a pass-through regime to such income.[65]

More importantly, the concept of corporate residence is critical to a system of worldwide taxation because only residents are taxed by their residence country on their worldwide incomes. Recently, Professor Michael Graetz has cast doubt on whether any definition of corporate residence, including the stock ownership approach suggested immediately above, is defensible or practical. His specific statements are:

> [I]n the case of corporations, the idea of residence is largely an effort to put flesh into fiction, to find economic and political substance in a world occupied with legal niceties . . . .[66]
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> . . . .
>
> It is precarious to turn significant U.S. tax consequences on the status of a corporation as a resident or nonresident, given the difficulty of assessing the "true" residence of corporations, except in the case of closely-held companies where the residence of the owners easily can be determined. Linking corporate residence to the residence of its owners simply does not seem practical in the context of multitiered multinationals. On the other hand, insisting that a corporation's residence is the same as that of its managers or officers seems difficult to justify.[67]

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63. See Bouma, supra note 9, at 813; Ryan J. Donmoyer, Multinationals Beg Finance to Simplify International Laws, 82 Tax Notes 1539 (1999); Roin, supra note 10, at 589 n.151, 590; see also Avi-Yonah, supra note 10, at 1594, 1665-66, 1670; Graetz, supra note 4, at 328-29.

64. The Australian definition of resident corporation generally follows the shareholder residence approach. See Income Tax Assessment Act 1936, § 6(1).

65. For a proposal to do so, see Peroni, Fleming & Shay, supra note 10, at 507-16.

66. Michael J. Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies, 54 Tax L. Rev. 261, 320 (2001).

67. Id. at 323.

Professor Graetz uses these assertions regarding the difficulty of formulating a defensible and feasible definition of corporate residence as an element in constructing a case for seriously considering exemption treatment of corporate foreign-source income by the United States.[68] We agree that any definition of corporate residence is inevitably artificial because corporations themselves are artificial beings. But as previously noted, failure by the United States to tax U.S. corporations on their worldwide incomes would allow U.S. resident individuals to materially avoid U.S. taxation through interposing a corporation between themselves and their foreign-source income.[69] This would significantly undermine the ability-to-pay principle. The United States should not go down this road unless it is clearly established that there is no feasible and defensible definition of U.S. corporate residence. We do not believe that this is the case.

As explained above, a principal purpose of the U.S. tax on corporate income is to serve as an anti-deferral device that preserves the efficacy of the shareholder-level tax on the worldwide incomes of U.S. shareholders.[70] This suggests that a definition of corporate resident is defensible if it is constructed to reach corporations with substantial numbers of U.S. resident shareholders. A definition grounded on place of incorporation (the present U.S. approach) or place of management (an approach commonly used in British Commonwealth countries[71]) might satisfy this requirement because it seems quite possible that most corporations that are incorporated or managed in the United States are substantially owned by U.S. residents. This is, unfortunately, an empirical question for which we do not have the definitive answer but which could be usefully investigated with empirical research techniques.

It is clear, however, that defining corporate residence in terms of the level of share ownership by U.S. residents would be consistent with the role of the U.S. corporate income tax as a device to protect the shareholder-level tax. Granted, if the required level of U.S. ownership were set at any point less than 100%, foreign shareholders would be overtaxed on their portion of the U.S. corporation's foreign-source income. But for the reasons stated above,[72] this is an acceptable result in a decidedly second-best world. Moreover, the imperfection of this second-best answer makes out a case for integration, not exemption. In this second-best context, defining a U.S. resident corporation as one in which U.S. residents own some considerable percentage of the stock of the corporation, e.g., more than 50% of the vote or value of the stock, strikes us as about right.

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68. See id. at 331.
69. See supra Part IV.C.
70. See supra Part IV.C.
71. See Ault, supra note 16, at 371-72.
72. See supra Part IV.C.

As noted above, Professor Graetz has argued that such an approach "simply does not seem practical in the context of multitiered multinationals."[73] We respectfully disagree. It strikes us that we already use look-through rules in a number of contexts in the international tax provisions, which penetrate layers of entity shareholders and reach the ultimate individual owners.[74]

The suggestion has also been made that taxing U.S. resident corporations on their worldwide incomes is rendered indefensible by the fact that U.S. resident individuals can obtain the benefits of exemption treatment of corporate income simply by purchasing portfolio investments in the shares of corporations located in exemption system countries.[75] However, this runaway shareholder problem could be addressed by adopting a system of currently taxing U.S. resident stockholders on their shares of foreign corporate income regardless of how small their percentage of stock ownership might be.[76]

In summary, we conclude that the challenges of constructing a defensible and feasible definition of corporate residence, or of dealing with U.S. residents who become portfolio investors in foreign corporations, do not rise to a level that justifies compromising the ability-to-pay principle by adopting an exemption regime on the foreign-source income of U.S. corporations.

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73. Graetz, supra note 4, at 323.

74. See, e.g., IRC §§ 902 (indirect credit for domestic corporations owning 10% or more of a foreign corporation's voting stock), 904(d)(3) (look-through rules for foreign tax credit limitation purposes for "United States shareholders" of controlled foreign corporations), 904(d)(4) (look-through rules for foreign tax credit limitation purposes for domestic corporations owning 10% or more of a foreign corporation's voting stock), 960 (indirect credit for "United States shareholders" of controlled foreign corporations owning 10% or more of the corporation's voting stock).

One commentator has suggested that using a shareholder residence test for defining corporate residence is unworkable in the case of corporations whose shares are publicly traded, particularly where the trading occurs in more than one country. See Avi-Yonah, supra note 10, at 1666, 1670. Nevertheless, it would seem that if the U.S. ownership threshold were set at a substantial level, say more than 50% of the vote or value of the stock, public trading would rarely create a situation in which a corporation drifted into or out of residency qualification. Cf., e.g., IRC § 884(e)(4) ("qualified resident" includes more than 50% ownership by residents of a country, with a special rule for publicly traded corporations that looks to regular trading on an established securities market in that country). The problem of foreign corporations that refuse to provide information concerning the U.S. residency of their shareholders could be addressed by a presumption that each foreign corporation that solicited U.S. investors, either by registering shares for sale to U.S. persons with the Securities and Exchange Commission (SEC) or by offering shares to U.S. persons under a private placement exemption from SEC registration, is a U.S. resident under the shareholder residence test unless the corporation proves otherwise.

75. See National Foreign Trade Council, supra note 6, at 6-23 to 6-24.

76. For a proposal to do so, see Peroni, Fleming & Shay, supra note 10, at 507-16.

V. THE FOREIGN TAX CREDIT AND ABILITY-TO-PAY

A. *The Exemption Effect of the Foreign Tax Credit*

Preceding portions of this article have argued that the ability-to-pay principle requires foreign-source income of U.S. residents to be included in the U.S. tax base to the same extent as U.S.-source income. Is this argument undermined by the U.S. policy of employing a foreign tax credit to mitigate international double taxation of U.S. residents' foreign-source income?

To illustrate this issue, assume that if USCo, a U.S. resident corporation, builds its next plant in the United States, it will earn a 10% before-tax rate of return on the invested capital but that if the plant is built in Country D, the before-tax rate of return will be 15%. Clearly, the Country D investment is economically superior. Now assume that Country D taxes income earned therein at 35%, that the United States applies the same rate to its residents' worldwide incomes and that there is no United States-Country D income tax treaty. If double taxation is not ameliorated, the U.S. plant will produce a 6.5% rate of return after the 35% U.S. tax (.10 x [1 - .35]) but the Country D plant will yield a only a 4.5% rate of return (.15 x [1 - .70]) after the combined 70% U.S. and Country D taxes. In these circumstances, the tax system will push USCo to choose the economically inferior U.S. investment. There is broad agreement that this is an inappropriate result and that because the United States is the residence country and there is no tax convention in force that remedies the problem, the United States should act unilaterally to relieve USCo's double taxation.[77]

If fairness were the only consideration, we would advocate that the United States handle USCo's tax payments to Country D like any other business expense–i.e., as allowable deductions in calculating net income. Under this approach, U.S. taxpayers would pay the same rate of U.S. tax on their aggregate U.S.- and foreign-source income.

Although allowing only a deduction for foreign taxes would satisfy the ability-to-pay criterion, it would, however, leave USCo with a substantial tax

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77. See Gustafson, Peroni & Pugh, supra note 7, at 18-20; Green, supra note 13, at 23-24; see also Joint Comm., Description, supra note 10, at 26; U.S. Treas. Dep't, Deferral, supra note 7, at 25-42. But see Richard L. Doernberg, Electronic Commerce: Changing Income Tax Treaty Principles a Bit?, 21 Tax Notes Int'l 2417, 2423 (2000) (suggesting that international double taxation is not objectionable where the sum of the two taxing countries' marginal tax rates does not exceed 10%).

The need for remedial action by the United States as the residence country is so well-settled, and so powerfully driven by the capacity of source countries to effectively claim priority for their income taxes vis-a-vis the income taxes of residence countries, that we accept it as given that the United States must act unilaterally (in the absence of an applicable income tax treaty) to mitigate international double taxation when the United States is in the residence country role.

disincentive to pursue the superior Country D investment. To illustrate this fact, assume that in the preceding example, USCo is deciding between investing $1,000 in a U.S. plant (with a 10% before-tax rate of return) and $1,000 in a Country D facility (with a 15% before-tax rate of return) and that the United States treats Country D tax payments as a deductible business expense. The $1,000 Country D investment would produce $150 of before-tax net income for Country D tax purposes ($1,000 x .15) and a $52.50 tax ($150 x .35) would be paid to Country D. For U.S. tax purposes, however, before-tax net income in this case would be $150 - $52.50 = $97.50 and $34.13 would be payable to the U.S. Treasury ($97.50 x .35). Thus, after payment of both taxes, USCo would have $63.37 of its $150 left. By contrast, investment of the $1,000 in a U.S. plant would produce $100 of before-tax net income ($1,000 x .10) and $65 after the 35% U.S. tax ($100 x [1 - .35]). All other factors being neutral, USCo would invest in the economically inferior U.S. plant because of its higher after-tax return. In other words, the U.S. decision to treat the Country D tax payment as a business expense deduction in this case would not overcome the double-tax barrier to USCo's making the superior Country D investment and would not remedy the double-tax problem in a wide range of other cases.

Thus, the United States has been faced with a choice between (1) pursuing a tax system that is totally faithful to fairness concerns (i.e., that treats foreign tax payments as income tax deductions) but that leaves international double-taxation substantially in place as a barrier to its residents' foreign business and investment activities, or (2) finding a way to ameliorate the double-tax barrier while preserving the ability-to-pay tax base to the greatest extent possible.

The first alternative has been judged unacceptable and it is difficult to quarrel with this outcome. The issue then is which of the generally accepted methods to ameliorate double taxation is superior from a fairness perspective. We submit that adopting a foreign tax credit system while prohibiting deferral of any residual U.S. tax remaining after allowance of the foreign tax credit is the preferred way to achieve fairness and efficiency objectives.[78]

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78. "Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign-source income." Joint Comm., Description, supra note 10, at 26.

We use the term "residual tax" in its conventional sense–i.e., the residence country tax liability remaining after allowance of a credit for source country tax that was levied at a lower rate than the residence country tax.

Deferral of residual tax refers to the feature of many residence country tax systems that generally allows payment of residual tax on income earned through a foreign corporation to be postponed until residents receive dividends or sell their stock. Deferral reduces the present value of residual tax and allows residents who defer for lengthy periods to achieve the approximate result of an exemption system. For further discussion of deferral, see text accompanying infra notes 100-101.

For a discussion of why a deduction is sufficient to achieve fairness objectives, see

Under a credit system without deferral, if USCo built the plant in Country D, USCo's 35% foreign tax liability would eliminate its 35% U.S. tax liability, so that the Country D investment would bear only the Country D tax (i.e., the U.S. residual tax would be zero). Thus, the Country D investments' after-tax rate of return would be 9.75% (.15 x [1 - .35]), which would make it superior to the 6.5% after-tax return on the U.S. investment (.10 x [1 - .35]). Double taxation of USCo's Country D profits would be remedied and the tax system would not pose a barrier to pursuing the superior Country D investment.

The foreign tax credit approach means, however, that whenever the foreign income tax rate is greater than zero, the foreign-source income of U.S. residents will bear a *lower U.S. tax rate* than domestic-source income. Indeed, in the preceding example, allowing USCo to claim a credit for the Country D tax will result in USCo's foreign-source income bearing a zero U.S. tax while its U.S.-source income is taxed at 35% even though both types of income contribute equally to a taxpayer's ability-to-pay. Speaking more broadly, mitigating international double-taxation by allowing a credit for foreign income tax payments is the economic equivalent of exempting foreign-source income in proportion to the amount of U.S. income tax that is offset by the credit. Thus, on the facts of the preceding USCo example, the foreign tax credit will fully offset the U.S. tax on Country D-source income and effectively exclude that income from the U.S. tax base.

To restate the issue, do the preceding consequences which flow from the decision of the United States to ameliorate international double taxation by employing a foreign tax credit invalidate the ability-to-pay principle with respect to U.S. residents' foreign-source income that bears a foreign income tax? The answer to this question is no. This is simply a situation in which policy makers have required an important value (fairness, as expressed in the ability-to-pay principle) to give ground to another important, but conflicting, value (ameliorating international double taxation).[79] The compromise is a

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Kaufman, supra note 4, at 177-78.

79. See also supra note 19. It has been suggested that a credit for foreign income tax payments also may be analyzed as the economic equivalent of having USCo pay the 35% U.S. tax to the U.S. government and having the U.S. government in turn pay USCo's tax owed to Country D. See Kaufman, supra note 4, at 179. Treating the foreign tax as a U.S. tax for this purpose, however, links payment of the deemed U.S. tax with use of the tax proceeds as a grant to the foreign government at the behest of the taxpayer. This kind of directed benefit is inconsistent with the redistributive objective for the U.S. tax.

We recognize that in many situations involving a U.S. resident's foreign-source passive nonbusiness income (such as nonbusiness interest income) that is subject only to a gross basis foreign withholding tax, a strong argument could be made that no double taxation problem exists that would distort economic behavior because the U.S. resident-creditor does not bear the economic burden of the foreign tax (which instead is borne by the foreign debtor who pays the U.S. creditor an amount of interest income that was agreed to be net of foreign taxes). See Deborah A. Geier, Some Thoughts on the Incidence of Foreign Taxes, 87 Tax Notes 541 (2000).

reasonable one and it in no way invalidates the proposition that an income tax system that gives great weight to the ability-to-pay principle should generally include foreign-source income in the tax base.

Note, however, that on the facts of the USCo example above (35% tax rate in both the United States and Country D), the foreign tax credit creates the same result as an exemption system—a zero U.S. tax on income earned in Country D. The same will be true whenever the source-country tax rate equals or exceeds the U.S. rate. This raises the issue of why, when choosing a method to ameliorate international double taxation, the United States should choose the foreign tax credit approach instead of an exemption system. One response is that under the foreign tax credit approach, if the foreign country's income tax rate is below the U.S. rate, the U.S. collects a current residual tax on foreign-source income, assuming no deferral of residual tax. Stated differently, where the foreign tax rate is less than the U.S. rate, a foreign tax credit system (without deferral) effectively includes foreign-source income in the U.S. tax base, and gives effect to the ability-to-pay principle, in proportion to the amount of U.S. tax that remains after allowing the foreign tax credit. Thus, the foreign tax credit recognizes that ameliorating double taxation indeed involves a compromise with the ability-to-pay principle. By contrast, an exemption system would leave foreign-source income out of the U.S. tax base in all cases regardless of the relationship of the foreign tax rate to the U.S. rate. This would amount to a blanket renunciation of the ability-to-pay principle instead of a compromise between ability-to-pay and mitigation of international double taxation.

Moreover, when we move away from cases where the foreign tax rate is equal to, or greater than, the U.S. tax rate, an exemption system (and the current U.S. deferral system) introduces a highly distortive element into the income tax that is not presented by the foreign tax credit. To illustrate this point in a worst case scenario, return to the example above involving USCo and assume that its choice is between building the plant in the United States, where it will produce a 10% return, before U.S. income taxation, and building it in Country E, where it will produce an 8% return, before U.S. income taxation. Assume further that the United States will tax USCo at a flat 35% rate and that Country E will impose a zero rate under an investment incentive regime. If the United States had a real worldwide system (no deferral of residual tax), USCo would face a 35% tax rate if it located the new business in the United States and a 35% cumulative tax rate (zero foreign tax plus 35% U.S. residual tax) if it established the new business in Country E. Consequently the after-tax rates of return would be 6.5% for the U.S. location (.10 x [1 - .35]) and 5.2% for the foreign location (.08 x [1 - .35]). Thus, the U.S. location's comparative before-

In such situations, both efficiency and ability-to-pay considerations support allowing the U.S. resident only a deduction (rather than a credit) for foreign taxes.

tax superiority (.10 ÷ .08 = 1.25) would continue to exist after-tax (.065 ÷ .052 = 1.25) and USCo's location decision would be unaffected by the U.S. tax system.

By contrast, if USCo can avoid paying U.S. tax on the foreign profits (either because USCo engages in deferral planning under the current U.S. system or because the United States adopts an exemption system), USCo will be choosing between after-tax returns of 6.5% (.10 x [1 - 3.5]) in the U.S. location and 8% (.08 x [1 - 0]) in the Country E location. Thus, the effect of the current U.S. system, and of an exemption regime, is to create a strong incentive for USCo to make the economically inferior foreign investment.

In summary, a foreign tax credit system (without deferral) is superior to an exemption system as a double-tax mitigation approach because it avoids international double taxation, minimizes the effect of tax considerations on investment choice and achieves fairness objectives. Stated differently, a foreign tax credit system (without deferral) achieves a compromise between the ability-to-pay principle and elimination of double taxation, instead of abandoning ability-to-pay, and does so without the distortions of economic behavior resulting from an exemption system.

B. *The Foreign Tax Credit Limitation*

One might raise an objection, however, to the U.S. foreign tax credit limitation that restricts the credit to the amount of U.S. tax on foreign income in a particular foreign tax credit limitation category.[80] Where this limitation prevents the current utilization of excess foreign tax credits, the foreign income effectively bears a greater aggregate tax burden than domestic-source income and the ability-to-pay criterion arguably is violated in those cases where the result is substantially disparate treatment of U.S. residents with similar amounts of total income. This is, however, another instance in which a countervailing concern (the possibility of high foreign taxes eroding or eliminating the U.S. tax on U.S.-source income) outweighs the ability-to-pay criterion.[81]

To illustrate this point, if the Country D and U.S. tax rates in the initial example above were 45% and 35%, respectively, and a U.S. resident earned Country D-source and U.S.-source income, an unlimited U.S. foreign tax credit would require the United States to forgo its full 35¢ of tax on each dollar earned by the U.S. resident in Country D plus an additional 10¢ of revenue on

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80. See IRC § 904.

81. See Joint Comm., Description, supra note 10, at 28 ("Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned from U.S. sources."); Graetz, supra note 4, at 324 ("No one urges an unlimited foreign tax credit, because it would both undermine the ability of the United States to collect taxes on U.S. source income and invite other nations to impose high taxes on U.S. companies as a way to shift revenues from our treasury to theirs.").

a dollar of the resident's U.S.-source income. The United States is understandably unwilling to allow Country D to finance its governmental operations by effectively appropriating U.S. taxes on U.S.-source income.

The U.S. foreign tax credit, with its limitation, addresses the issue of how the United States will respond to the fact that other governments also have legitimate claims to a portion of its tax base.[82] A resolution of that problem does not necessitate abandonment of the ability-to-pay principle for purposes of defining the tax base. Instead, it requires an intergovernmental compromise regarding a sharing of that base. The United States has responded to the need for compromise by granting a credit for foreign income tax, limiting U.S. tax collection to a residual tax on foreign-source income of U.S. residents and declining to surrender U.S. tax on U.S.-source income. The prudential policy of limiting the credit in a way that preserves U.S. tax on U.S.-source income in no way invalidates the command of the ability-to-pay principle to include foreign-source income in the tax base.

Moreover, an exemption system does not have a superior fairness claim in circumstances where the foreign tax credit limitation would come into play. If a foreign country's effective tax rate on foreign-source income of a U.S. person equals or exceeds the U.S. tax on the same income, a foreign tax credit system subject to a limitation as described above and an exemption system yield equivalent results. In both cases, the residence country would neither collect any residual tax on the foreign income nor allow the foreign tax to reduce the taxpayer's U.S. tax on U.S.-source income.

VI. ATTEMPTING TO OVERCOME ABILITY-TO-PAY BY REVISING THE BENEFITS THEORY

A. *The Collapse of the Original Benefits Theory*

Tax theorists once argued that fairness required the tax burden to be apportioned among taxpayers in relation to the government benefits received by each individual.[83] Tax payments would then be calibrated to the value of the goods and services provided to each person by government. This approach proved unworkable because it was impossible to formulate accurate allocations of important, but generalized, benefits (e.g., national defense, the corrections system, a legal system that protects property rights, and environmental protection) to particular individuals and because much of modern governmental

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82. See Harris, supra note 3, at 313, 443; Musgrave, Consumption Tax Proposals, supra note 20, at 80; Lee A. Sheppard, Rethinking Subpart F, 90 Tax Notes 149, 150 (2001).

83. See Report on Double Taxation, League of Nations Doc. E.F.S. 73.F.19, at 18 (1923), in 4 Staff of Joint Comm. on Taxation, Legislative History of United States Tax Conventions 4003, 4022 (1962); Fried, supra note 1, at 159-60.

expenditure is for redistributive assistance provided to recipients precisely because they are too poor to pay.[84] Thus, the notion of financing government by levying taxes on separate individuals in amounts that reflect government benefits received by each of those individuals is a historical curiosity except for charges that can be feasibly traced to one's use of a discrete government good or service (e.g., bridge and highway tolls, municipal water use charges and postage stamps).[85] Instead, as discussed above, the ability-to-pay principle, which makes no attempt to account for benefits received by taxpayers,[86] is now the prevailing U.S. norm for effecting a fair allocation of the income tax burden.[87]

B. *The Revised Benefits Theory*

Recently, however, a few commentators have sought to displace the ability-to-pay norm with a revised benefits theory.[88] Their objective is to create a fairness justification for at least partially exempting international income.

These commentators begin by effectively dividing income into three classes: (1) income earned within the taxing country by its residents, (2) income earned outside the taxing country by its residents and (3) income earned within the taxing country by nonresidents.[89] Class (1) is pure single-nation income and classes (2) and (3) embrace all the categories of international income because they cover all situations in which residents of one country earn income in another. Moreover, both classes (2) and (3) always involve a pair of countries with potentially competing tax claims–the country in which the income earner resides (residence country) and the country where the income is earned (source country).

The advocates of the revised benefits theory assert that the fair way to tax these three income groups is to apply separately to each class a rate, or set

84. See Blum & Kalven, supra note 1, at 36; Dodge, Fleming & Geier, supra note 3, at 24; Harris, supra note 3, at 13-14; Palmer, supra note 13, at 25-26; see also Roin, supra note 10, at 555 ("the nature of the tax base makes the correspondence between any particular taxpayers' tax costs and tax benefits loose at best.").

85. See Dodge, supra note 1, at 90-91; Graetz & Schenk, supra note 1, at 39; Slemrod & Bakija, supra note 1, at 52-54.

86. See Harris, supra note 3, at 14-15; Utz, supra note 13, at 42.

87. See authorities cited in supra note 13.

88. The most fully developed statement of the revised benefits theory is in Harris, supra note 3, at ch. 7. Three other statements are Roin, supra note 10, at 588-94; Jefferson VanderWolk, The Deferral Debate and the Benefits Theory, 20 Tax Notes Int'l 1469, 1469-71 (2000), and Vogel, supra note 9, at 152-66. (Professor Vogel presents the revised benefits theory as an alternative to his preferred approach of an exemption system.)

89. Harris, supra note 3, at 445-49, 457-59, 462; Roin, supra note 10, at 588-94; VanderWolk, supra note 88, at 1470; Vogel, supra note 9, at 155-56; see also Warren, supra note 14, at 134.

of rates, calculated to produce an aggregate tax yield from each class that compensates each government for the cost of benefits provided to assist in the earning and enjoyment of the total income in each class.[90] Moreover, residence and source country governments should set the rates on classes (2) and (3) at levels lower than the "normal" rates applicable to class (1) (single-nation income) because governments provide more services for the earning and enjoyment of class (1) income than they provide for the earning and enjoyment of income classes (2) and (3).[91] This approach to levying taxes in relationship to benefits received by taxpayers is supposed to avoid the infirmity of the original benefits theory because the new version directs the allocation of total benefits to only three classes of aggregate income and does not require that particular benefits be traced to numerous specific taxpayers.[92]

C. *The Revised Benefits Theory as a Partial Exemption System*

The consequence of residence countries and source countries imposing lower than normal tax rates on international income (classes (2) and (3)), is that each group of countries effectively operates a partial exemption system. For example, if the United States imposes 20% of normal class (1) tax on business income earned by its residents in Mexico, and Mexico imposes a tax on this income equal to 80% of its normal business income tax, the result is mathematically indistinguishable from the United States charging its regular rate but exempting 80% of its residents' Mexican-source income and Mexico charging its regular rate but exempting 20% of the Mexican-source income of U.S. residents.

To illustrate this point, assume that under the 20%/80% system described above, both the United States and Mexico charge a 35% normal rate and that a hypothetical U.S. resident earns $100 of income in Mexico. The United States will charge a tax of .20 x .35 x $100 = $7, which is mathematically indistinguishable from the United States exempting $80 of the Mexican-source income and applying the 35% normal tax to the $20 remainder (.35 x $20 = $7). Conversely, Mexico will charge a tax of .80 x .35 x $100 = $28, which is mathematically indistinguishable from Mexico exempting $20 of the Mexican-source income and applying the 35% normal tax to the $80 remainder (.35 x $80 = $28).

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90. See Harris, supra note 3, at 446-50, 458-62, 468-70, 478-89; Roin, supra note 10, at 555, 588-89, 591-93; VanderWolk, supra note 88, at 1470; Vogel, supra note 9, at 155-66; see also Warren, supra note 14, at 134 (discussing several possible methods for allocating the tax base).

91. See Harris, supra note 3, at 449, 458-59, 462, 468-70, 486; Roin, supra note 10, at 588-89, 591-93; VanderWolk, supra note 88, at 1470; Vogel, supra note 9, at 156.

92. See Harris, supra note 3, at 446-47, 477, 489; Vogel, supra note 9, at 155-56.

The result for the United States in this hypothetical case (collection of a $7 tax) is actually better than under the current U.S. worldwide system, which would allow the United States to collect no tax because the $35 tentative U.S. tax would be offset by a $35 credit for the Mexican tax, assuming that the taxpayer is not in an excess credit position. If, however, the source country rate were significantly less than the U.S. tax rate, this hypothetical partial exemption system would cause the United States to lose revenue in comparison to the residual tax that it would collect under the present worldwide system.

A useful framework for evaluating this partial exemption system that emerges from the revised benefits theory is to adopt the analytical approach applied in the preceding section regarding the relationship between ability-to-pay and the foreign tax credit. In other words, this partial exemption system can be effectively examined first by scrutinizing it in terms of a proper formulation of the income tax base and second by evaluating it as a mechanism for mitigating international double taxation when nations find that their tax bases overlap.

D. *Fairness and Partial Exemption*

As explained above, the revised benefits theory effectively argues for partially exempting international income from both the source country's and the residence country's tax base on the premise that international income (classes (2) and (3)) receives fewer benefits from either the residence country or the source country than does class (1) income, which merits a full normal tax. Accordingly, the revised benefits theory requires the extent of the respective exemptions for class (2) and class (3) income to be determined by comparing the costs of services provided by each taxing country for the earning and enjoyment of that income with the services provided by that country for the earning and enjoyment of class (1) income. The problem with this approach, however, is that the approximate cost of government benefits allocable to each of these three classes of income is no more measurable than the cost of government benefits allocable to each of a multitude of individuals under the original benefits theory. This point is illustrated by the disarray among the advocates of the revised benefits theory. One of them effectively argues for the residence and source countries to each exempt 50% of international income.[93] A second suggests that the source country might exempt 25% and the residence country 75%. But the residence country is then directed to reduce the 25% retained in its tax base to reflect any indirect taxes imposed on residents.[94] Other analysts assert that the correct answer is for each residence and source country to make its own independent determination of how much international

93. See VanderWolk, supra note 88, at 1470.
94. See Vogel, supra note 9, at 156.

income to retain in the tax base and how much to exempt, but no practical guidance is given regarding these decisions.[95]

The revised benefits theory also suffers from a lack of clarity regarding a crucial point that bedeviled the original benefits theory–the reality that a huge portion of the budgets of the United States and many other countries provides redistributive benefits to lower income people who cannot pay a quid pro quo in taxes. To be specific, one of the advocates of the revised benefits theory seems to argue that no part of a taxing country's welfare budget should be borne by income earned inside the taxing country by nonresidents (class (3) income) or by the foreign-source income of residents (class (2) income).[96] This position is partially plausible with respect to class (3) income because the tax thereon is usually regarded as a benefits-based levy;[97] but even so, welfare benefits contribute to a stable social order that fosters the earning of class (3) income. Furthermore, it is completely implausible to argue that the ability-to-pay of residents can be called on to fund welfare benefits if that ability-to-pay is based on income earned in the residence country (class (1)) but not if it is based on foreign-source income (class (2)).

Other advocates of the revised benefits theory seem unaware of the difficulty of accounting for the cost of welfare assistance under a scheme that attempts to allocate the tax burden in relationship to the distribution of government benefits. Accordingly, they do not explain how this problem should be resolved.[98]

In short, the revised benefits theory fails as a fairness guide largely for the same reasons that the original theory failed–the benefit allocations required by the theory are not feasible and it is not clear how the theory would cope with the large portion of the national budget that funds benefits for the poor. Thus, this new iteration for the benefits theory cannot displace ability-to-pay from its position as the benchmark for determining fairness in the U.S. income tax system.

Indeed, one can persuasively argue that the only relevance of the benefits theory to the issue of whether a country should tax its residents on their foreign-source income is as a supplement to the affirmative answer provided

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95. See Harris, supra note 3, at 479, 489; Roin, supra note 10, at 588-94.

96. See Vogel, supra note 9, at 155-56, 159-61, 165-66.

97. See supra text accompanying note 13.

98. See Harris, supra note 3, at 11, 446-49, 488-89; VanderWolk, supra note 88, at 1470. (Professor Roin seems to regard the cost of welfare assistance as part of the benefit charge that should be apportioned to class (1) and class (2) income, but not to class (3) income, and gives no guidance as to how the apportionment should be made. See Roin, supra note 10, at 589, 591.) When these analysts fully address the issue of apportioning the burden of welfare assistance, they may decide that this component of each country's annual budget should be allocated in some way among all residents with incomes above the threshold required for inclusion in the tax rolls. Such an approach, however, abandons any attempt at a benefits-received allocation for this major portion of the cost of modern government.

by the ability-to-pay principle. Specifically in the case of the United States, federal expenditures for trade promotion, economic development of foreign customer countries, a generally stable commercial world order,[99] U.S. diplomatic assistance abroad and U.S. military readiness to protect foreign business employees and assets all combine to create enormous benefits for the foreign income activities of U.S. residents and these benefits constitute a secondary ground, in addition to ability-to-pay, for taxing their foreign-source income.

E. *Double Taxation and Partial Exemption*

Thus, the revised benefits theory fails to establish a fairness case in favor of a partial exemption system. But does the revised benefits theory nevertheless point to a cure for the double tax burden that arises when both residence and source countries assert taxing jurisdiction over the same income? Would the problem of international double taxation be better handled by fractionally apportioning international income between the source and residence countries instead of applying the current U.S. approach under which the source country imposes the amount of tax it deems appropriate and then the residence country collects any residual tax that remains after it allows a credit for the source country tax?

Mitigation of double taxation by fractionally apportioning international income between residence and source countries would be feasible where pairs of countries are able to reach bilateral apportionment agreements. Of course, for reasons explained above, the countries would have to abandon any pretense of objectively basing the allocation fractions on the cost of governmental services provided with respect to the earning and enjoyment of international income. Instead, each pair of negotiating countries would have to agree on allocation fractions for the source and residence countries that were purely the product of national self-interest and relative bargaining power. This process would probably yield tax treaties that are workable, but not demonstrably superior to the current U.S. system in which the source country takes the priority position in taxing international income and the residence country collects any residence country tax that remains after allowing a credit for source country tax. (Multilateral agreements would not improve on theses outcomes significantly.)

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99. "As far as the next 25 years are concerned, most important in any consideration of U.S. national security is the extent to which the global economic system will continue its path toward integration . . . . Continued integration promises greater wealth for most countries, including the United States . . . ." United States Commission on National Security/21st Century, New World Coming: American Security in the 21st Century, Phase I Report, Supporting Research and Analysis 21 (1999).

Moreover, the United States does not have bilateral tax treaties with most of the world's nations. Thus, the United States must adopt a unilateral measure to mitigate double taxation of its residents' international income when a treaty does not apply. A fractional allocation system would be highly problematic as a unilateral measure because it would reach the correct result only in situations where the other country had unilaterally adopted a fractional allocation scheme that was perfectly complementary to the U.S. system. In all other cases, which could well be most cases, double taxation would be over- or under-mitigated.

To illustrate this point, assume a U.S. policy decision that the proper unilateral double tax mitigation approach is to exempt half the foreign-source income of U.S. residents. If a U.S. resident then earns income in a source country that has unilaterally determined to exempt 75% of the local income of nonresidents, one quarter of the U.S. resident's foreign-source income will be free of both U.S. tax and source country tax. This goes far beyond what is required to ameliorate international double taxation and provides a distortionary incentive for U.S. residents to earn income in the source country. By contrast, if the source country unilaterally decides to exempt only 25% of the local income of nonresidents, one quarter of the U.S. resident's foreign-source income will be subject to double taxation and the economic harm of double taxation will persist to that extent. For these reasons, the fractional apportionment system has little attraction as a measure for ameliorating international double taxation.

VII. ABILITY-TO-PAY AND THE DEFERRAL PRIVILEGE

A. *Exemption Through the Back Door*

The "deferral privilege," which is among the most prominent features of the U.S. system for taxing international income, is broadly available to U.S. residents that conduct overseas business operations through controlled foreign corporations.[100] This privilege generally allows such residents to defer paying U.S. tax on a controlled foreign corporation's foreign-source business earnings until those earnings are repatriated through distributions to U.S. resident shareholders or through shareholder sales of controlled foreign corporation stock at a price which reflects accumulated income. If the deferral period is sufficiently long, the present value of the deferred U.S. tax will fall to such a low level that deferral virtually equals exemption of the foreign-source income

100. See Peroni, Fleming, & Shay, supra note 10, at 459-64, 501-05; Fleming, Peroni & Shay, supra note 10, at 839-43.

from U.S. tax.[101] Thus, deferral can be regarded as an indirect, elective method for well-advised U.S. residents to achieve an exemption-like treatment for their foreign-source income.[102]

This means that in addition to being faulted for distorting decision making[103] by encouraging U.S. residents to locate business operations in low-tax foreign countries,[104] deferral should also be criticized–just like an explicit exemption system–as being a substantial departure from the ability-to-pay norm. Stated differently, the deferral privilege is fundamentally inconsistent with the ability-to-pay principle and, therefore, fundamentally inconsistent with an income tax system based on the ability-to-pay norm.

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101. For example, assuming a 7% after-tax interest rate, $1.00 of U.S. income tax has a present value of only about 13¢ if payment of the tax is deferred, interest free, for 30 years. Consistent with this phenomenon, a recent study found that there were virtually no repatriations of controlled foreign corporation income in the first 15 years after such a corporation had been incorporated in a low-tax, foreign country. See Grubert & Mutti, Dividend Exemption, supra note 10, at 13. Moreover, the effective U.S. tax rate on active foreign-source income has been calculated in a range from 2.7% to *negative* 2.6%. See Altshuler, supra note 10, at 1589; see also Rosanne Altshuler & T. Scott Newlon, The Effects of U.S. Tax Policy on the Income Repatriation Patterns of U.S. Multinational Corporations, in Studies in International Taxation 77, 109 (Alberto Giovannini, R. Glenn Hubbard & Joel Slemrod eds., 1993) ("[U.S. corporations] . . . are able to take advantage of deferral and the overall limitation on the foreign tax credit to avoid paying much U.S. tax on their foreign income."); Hines, supra note 14, at 401 ("[E]ach year U.S. taxes are deferred on roughly half of the income earned by the foreign subsidiaries of American multinational corporations."); Sheppard, supra note 82, at 151 ("[T]he privilege of deferral under the present Swiss–cheese subpart F is so great that all the whining amounts to nothing more than just whining."). Of course, the cross-crediting of foreign taxes in the IRC § 904(d)(1)(I) "basket" also plays a substantial role in producing this low effective tax rate on foreign-source income. In fact, the combination of deferral, poorly designed source rules (e.g., the title-passage test for sales of inventory), defective deduction-allocation rules and a foreign tax credit system that allows liberal cross-crediting of high and low-taxed foreign-source business income imposes lower effective U.S. income tax than would a properly designed exemption system. See U.S. Treas. Dep't, Deferral, supra note 7, at 46, 193-95; Altshuler, supra note 10, at 1588-90, 1593; Robert J. Peroni, The Proper Approach for Taxing the Income of Foreign Controlled Corporations, 26 Brook. J. Int'l L. 1579, 1586 (2001); Rosenbloom, supra note 36; Grubert & Mutti, Dividend Exemption, supra note 10, at 6, 8-24.

102. See Chorvat, supra note 9, at 841-45; Hartman, supra note 10, at 116; Rosenbloom, supra note 36.

103. For evidence that the distortion is substantial, see U.S. Treas. Dep't, Deferral, supra note 7, at 44-45; Grubert & Mutti, Where U.S. Corporations Invest, supra note 10, at 835; Jacqueline Manasterli, Offshore Financial Centers and Harmful Tax Regimes Trigger Flurry of International Developments, 21 Tax Notes Int'l 2541 (2000); Martin A. Sullivan, U.S. Firms Invest Heavily in Low-Tax Countries, 89 Tax Notes 1349, 1349-52 (2000).

104. See Peroni, Fleming & Shay, supra note 10, at 464-70; Fleming, Peroni & Shay, supra note 10, at 841-46.

B. *Creeping Towards Taxing Consumption*

Consumption tax devotees might object to this conclusion. This is because corporate income is not taxed under a theoretically pure cash-flow consumption tax[105] and although corporations appear to be taxpayers under a value added tax or a retail sales tax, those levies are actually borne by consumers with corporations serving as mere collection agents for the government.[106] Thus, consumption tax advocates might see the near-zero U.S. corporate tax that can be achieved through deferral of U.S. tax on controlled foreign corporation income as a welcome incremental step towards a comprehensive consumption tax regime.[107]

We submit, however, that granting consumption tax treatment to income earned through a controlled foreign corporation (as well as to other items such as IRA contributions), while generally maintaining an income tax regime with respect to domestic income-producing activities, creates unacceptable distortions in taxpayer investment decisions. If a consumption tax regime is the right approach for providing most of the federal government's revenues (we believe that it is not), then Congress should adopt a comprehensive consumption tax instead of including ad hoc, distortive consumption tax features in the income tax. In making this argument, however, we recognize that administrability concerns may require consumption tax treatment of certain items (e.g., unrealized appreciation) with the result that the federal income tax likely will continue to be a hybrid income-consumption tax regime. Nevertheless, the distortion and unfairness that result from deferral of controlled foreign corporation income persuasively argue against including the feature of deferral in the U.S. income tax regime.

VIII. TAX COMPETITION AND EXEMPTION

Many countries offer low general income tax rates or specific income tax incentives, such as tax holidays for set periods, to attract investments within their borders by foreigners. This approach to international economic development has recently become identified as "tax competition."[108]

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105. See U.S. Treas. Dep't, Blueprints, supra note 1, at 133; 1 U.S. Treas. Dep't, Tax Reform, supra note 1, at 208.

106. See Congressional Budget Office, The Economic Effects of Comprehensive Tax Reform ch. 2 (1997); Staff of Joint Comm. on Taxation, Description and Analysis of Proposals to Replace the Federal Income Tax 51-55 (Comm. Print 1995).

107. For a more detailed examination of the parallels between a consumption tax regime and deferral of U.S. tax on income earned through a controlled foreign corporation, see Peroni, Fleming & Shay, supra note 10, at 466-68.

108. See Avi-Yonah, supra note 10, at 1575-76. In 1998, the Council of Ministers of the OECD adopted a report identifying certain practices as harmful tax competition. See OECD, Harmful Tax Competition: An Emerging Global Issue (1998). In this report, the OECD made a number of recommendations, including that countries enact controlled foreign corporation and

A. *Tax Competition and the Incentive to Invest Abroad*

In an international context, the tax competition strategy is negated to the extent that capital exporting residence countries maintain systems of worldwide taxation without deferral. This is because such a residence country collects a current residual tax equal to the excess of its regular tax over the low taxes paid by its residents to tax competitors. Thus the investment inducing effect of low source taxes is negated by the residual tax.[109] However, the deferral of U.S. tax on foreign-source income that is permitted under the present U.S. system substantially reduces the impact of the U.S. residual tax and permits U.S. residents to capture a significant part, if not all, of the benefit from low tax rates offered by countries as investment incentives.[110] If the United States adopted an exemption system with an explicit zero tax rate on the foreign-source income of U.S. residents, the enjoyment of low foreign tax rates by U.S. residents who invest in countries offering these tax incentives would be accomplished more directly. Thus, a defense of tax competition can be seen as an integral part of building the case in favor of deferral and exemption.[111]

Advocates of tax competition argue that it promotes capital formation by creating worldwide pressure for lower taxes[112] and that it causes governments to be less wasteful.[113] They further argue that tax competition enhances worldwide economic efficiency by encouraging the nations of the world to arrange themselves into a menu of countries with varying mixes of tax burdens and government service levels from which investors can choose the combinations that most appeal to them.[114]

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passive foreign investment company regimes in order to combat harmful tax competition. See id.; see also Gustafson, Peroni & Pugh, supra note 7, at 564.

109. See Gustafson, Peroni, & Pugh, supra note 7, at 348-49; Alan R. Rado, United States Taxation of Foreign Investment: The New Approach 51 (1963); Avi-Yonah, supra note 10, at 1642; William W. Park, Fiscal Jurisdiction and Accrual Basis Taxation: Lifting the Corporate Veil to Tax Foreign Company Profits, 78 Colum. L. Rev. 1609, 1637 (1978); Roin, supra note 10, at 547. The term "tax competition" previously was associated principally with competition among sub-national political jurisdictions. Within the United States, constitutional restrictions on burdens on interstate commerce limit the ability of States to combat tax reduction incentives of other States other than by matching the tax reduction. As discussed in the text, in an international context it is permissible for a residence country to counteract source country income tax incentives by imposing tax on the same income.

110. See Peroni, Fleming & Shay, supra note 10, at 464-66; Surrey, supra note 29, at 823; authorities cited in supra note 101.

111. See generally Mastromarco, supra note 29; Mitchell, supra note 9, at 814; Letter from Congressman Dick Armey to Treasury Secretary Paul O'Neill (March 16, 2001); Center for Freedom and Prosperity Praises U.S. Administration's Policy Towards OECD's Harmful Tax Initiative, 22 Tax Notes Int'l 2621, 2622 (2001).

112. See Mitchell, supra note 9, at 805.

113. See Mitchell, supra note 9, at 806.

114. See Roin, supra note 10, at 554-61.

By contrast, the critics of tax competition argue that it forces countries to shift their taxes from wealthy owners of mobile capital to relatively immobile and less wealthy workers, and to reduce taxes and to cut back services and benefits so that the unfortunate members of society receive less protection from a meaner globalized world.[115] The popular description of this phenomenon is the "race to the bottom."[116]

Both the claimed benefits and asserted harms of tax competition must be regarded as significantly speculative at present.[117] What is clear, however, is that the combination of tax competition and the current U.S. system of worldwide taxation with deferral distorts the decision making of U.S. residents by encouraging them to locate their income earning activities in low-tax countries instead of in the United States.[118] Adoption of a generally applicable exemption system would only worsen this situation. Indeed, one tax competition advocate[119] has recognized this weakness in an exemption system and suggested mitigating the problem with a partial exemption system along the lines described above.[120] For the reasons previously given,[121] however, this is not a workable solution.

In addition, we believe that proponents of tax competition fail to articulate the full implications of their position vis-a-vis the United States as a tax competitor in the global economy. There are two tax policy options available to the United States to compete with other countries' tax incentives. One is to tax worldwide income and, as discussed above, cause the benefit of the foreign tax incentive to accrue to the U.S. Treasury and cause the decisions of U.S. persons regarding whether to invest within or without the United States to be unaffected by foreign tax incentives. The proponents of so-called tax competition, however, seek to deny this policy alternative to the United States. Instead, they would limit the United States to the only other policy option available to retain U.S. investment in the United States, which is to reduce tax rates on domestic investment. Since this is impractical, the proponents of so-called tax competition in essence prefer no competition (by the United States)

115. See Avi-Yonah, supra note 10, at 1575-79.

116. See Roin, supra note 10, at 549.

117. See John E. Anderson & Robert W. Wassmer, Bidding for Business, The Efficacy of Local Development Incentives in a Metropolitan Area (2000); Avi-Yonah, supra note 10; Mitchell, supra note 9; Beverly I. Moran, Economic Development: Taxes, Sovereignty, and the Global Economy, in Taxing America 197 (Karen B. Brown & Mary Louise Fellows eds., 1996); Roin, supra note 10; Vito Tanzi & Howell H. Zee, Tax Policy for Emerging Markets: Developing Countries, 53 Nat'l Tax J. 299, 315-19 (2000); Edwin van der Bruggen, Momentum Builds in Asia to End Tax Holidays, News, Commentary and Analysis, 21 Tax Notes Int'l 2565 (2000).

118. See authorities cited in supra notes 10 and 103.

119. See Roin, supra note 10, at 588-89, 591-93.

120. See supra text accompanying notes 88-92.

121. See supra text accompanying notes 92-98.

so that the benefits of foreign tax incentives accrue to the private U.S. investor for investment outside the United States.

Finally, it is also clear that deferral and exemption violate the ability-to-pay norm. The use of the mantra of tax competition to bring about back-door pressure for reductions in U.S. tax rates does not provide sufficient justification for the United States to either continue deferral or explicitly exempt foreign-source income from the income tax base.

B. *Assistance to Poor Countries*

If the foregoing were the sum and substance of the tax competition debate, this article's discussion of the subject would be concluded. However, tax competition advocates advance another important argument for their position. They contend that in a world where direct aid from prosperous countries to impoverished nations is small in relationship to needs, the only practical way for desperately poor countries to get essential economic development funds is to engage in tax competition that attracts investments of privately held capital from corporate and individual residents of comparatively high-tax countries.[122] For the reasons explained above,[123] the immediate residual tax resulting from a worldwide taxation system without deferral would be deadly to the tax competition strategy of poor nations. This suggests the argument that the United States should maintain deferral as an accommodation to impecunious countries and that, even better, the United States should facilitate the tax competition efforts of poor nations by moving to an across-the-board exemption system.[124]

Of course, the sovereign status of the United States means that it is free to tax its residents without regard to the impact of the U.S. revenue regime on the development strategies of impoverished countries.[125] Thus, to argue that the United States should assist developing countries through deferral or exemption is to argue that the United States should provide discretionary foreign aid, and

122. See Robert Goulder, Heritage Foundation Criticizes OECD War Against Tax Havens, 21 Tax Notes Int'l 1628, 1630 (2000); Mitchell, supra note 9, at 810, 814-15; Roin, supra note 10, at 559, 585; Letter from Congressman Major R. Owens to Treasury Secretary Paul H. O'Neill (February 7, 2001); Letter from Congressman Charles Rangel and 25 others to Treasury Secretary Paul H. O'Neill (March 14, 2001).

123. See supra text accompanying note 109.

124. See Roin, supra note 10, at 586; Surrey, supra note 29, at 823-24.

125. See authorities cited in supra note 29.

that it should do so through a tax expenditure program[126] instead of a direct appropriation scheme.

The wisdom of maintaining deferral, or of adopting a general exemption system, to provide assistance to foreign countries that engage in tax competition can be usefully tested by assuming that the universe of tax competitors consists of the following four nations:

> **Celtica** – an economically developed country with per capita gross domestic product in the top third of all nations but which, nevertheless, maintains a general corporate tax rate of 12% to attract investment from other countries.
>
> **Hostilia** – a poor country that is unfriendly to the United States and its allies, that provides bases for terrorist groups and that is using its limited resources to develop weapons of mass destruction.
>
> **Incorrectia** – a poor country that is ruled by a corrupt dictator and a small group of cronies. Incorrectia oppresses women and racial and religious minorities and generally circumscribes civil liberties. It has a general tax rate for resident corporations of 30% but it attracts foreign investment with a zero corporate tax rate for 5 years and a 5% rate thereafter. Incorrectia also trumpets its minimal environmental and worker safety rules and the availability of child labor as further reasons for foreign multinationals to operate on its soil. Additionally, it is on the Financial Action Task Force's list of countries that have failed to take adequate steps to prevent money-laundering.[127]
>
> **Freelandia** – a poor democratic country with full civil liberties and equality for all residents, environmentally friendly policies and progressive worker safety and child labor rules. Freelandia applies a 5% tax rate to both foreign and domestic corporations. One of its major political parties, however, has begun to argue that Freelandia should

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126. In a classic article, Professor Bittker argued that the tax expenditure concept is a deficient policy guide because it assumes agreement on a normative tax base, departures from which are tax expenditures. But in reality, Professor Bittker demonstrated, there are many points of disagreement regarding the content of a normative tax base. See Boris I. Bittker, Accounting for Federal "Tax Subsidies" in the National Budget, 22 Nat'l Tax J. 244 (1969); see also Bartlett, supra note 12, at 415-17. Professor Bittker's argument, although valid on numerous points, is not applicable to our use here of the tax expenditure concept. This is because current taxation of realized worldwide income is clearly a feature of a normative income tax base (a consumption tax base is somewhat more nuanced on this point) and both deferral and exemption of realized foreign-source income are clearly departures from the norm. See supra Part II; Fleming, Peroni & Shay, supra note 10, at 841-43. Moreover, even if the entire tax expenditure concept were abandoned, an argument for employing deferral or exemption to assist the economic development of indigent nations is, nevertheless, an argument for a particular form of foreign aid that must be evaluated in the light of other approaches for providing such assistance. That is the focus of this portion of our article.

127. See Cordia Scott, FATF Releases New Money-Laundering Blacklist, 23 Tax Notes Int'l 8 (July 2, 2001).

cut back on enforcement of environmental, child labor and worker safety rules so that it can afford to offer a five-year tax holiday like Incorrectia's.

If the United States were considering a program of direct economic development foreign aid to these four countries, a plausible outcome is that no assistance would be provided to the first three and that Freelandia would receive aid only if it gave assurances that it would not significantly degrade enforcement of its environmental, child labor and worker safety regulations.[128] Therefore, a tax expenditure scheme should not be substituted for the direct aid program unless the tax expenditure plan allows the kinds of nuanced distinctions between candidate countries that would be features of a direct aid program.[129] Neither a general exemption system nor a broad deferral system satisfies this criterion because both approaches would confer assistance on all four of these countries indiscriminately.

The logical response to the preceding concerns is to engage in negotiated tax sparing.[130] If a foreign country offers a concessionary tax rate to

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128. We do not wish to quarrel in this article with readers who might disagree as to part or all of these specific conclusions. See, e.g., Steven E. Landsburg, The Imperialism of Compassion, Wall St. J., July 23, 2001, at A14.

> Being poor means making hard choices. . . . Third Worlders are making pretty much the same choices that Americans and other westerners made back in the 19th century when we were poor: They're not worrying a whole lot about the quality of their environment, and they're not spending a lot of quality time with their families. Instead, they're working long, hard, dirty hours to earn enough to eat. And they're putting their children to work, just as poor people have always done.

We only wish to illustrate the larger point that a direct economic aid program will always make distinctions, hopefully rational ones, among countries that are potential aid recipients.

129. See generally Karen B. Brown, Transforming the Unilateralist into the Internationalist, in Taxing America, supra note 117, at 214, 217-18, 230; Graetz, supra note 4, at 309.

130. The Organization for Economic Co-Operation and Development (OECD) has issued a report on tax sparing, which seeks to develop among the OECD countries "a more coherent position on the granting and design of tax sparing provisions." OECD, Tax Sparing: A Reconsideration 3 (1998). The OECD report states: "[t]his report does not suggest that OECD and other countries which have traditionally granted tax sparing should necessarily cease to do so." Id. at 42. The OECD report, however, did identify "a number of concerns that put into question the usefulness of the granting of tax sparing relief," including (1) the vulnerability of tax sparing to taxpayer abuse; (2) the effectiveness of tax sparing as a method for providing foreign aid and promoting economic development; and (3) "general concerns with the way in which tax sparing may encourage countries to use tax incentives." Id. at 41; see also Gustafson, Peroni & Pugh, supra note 7, at 350.

For a sampling of the commentary on tax sparing, see Timo Viherkentta, Tax Incentives in Developing Countries and International Taxation (1991); Mary Bennett, Reflections on Current U.S. Policy for Developing Country Tax Treaties, 2 Tax Notes Int'l 698 (1990); B. Anthony Billings & Gary A. McGill, Tax Sparing on U.S. Multinationals, 48 Tax Notes 615 (1990); Richard D. Kuhn, United States Tax Policy with Respect to Less Developed Countries, 32 Geo. Wash. L. Rev. 261 (1963); Damian Laurey, Note, Reexamining U.S. Tax Sparing Policy with foreign investors that is below the country's normal rate, the tax sparing concept would have the United States give a foreign tax credit equal to the amount of the country's generally applicable tax.[131] Where the selected country employs a low general tax rate without special concessions for foreigners, the tax sparing concept would require a U.S. foreign tax credit that combines both the foreign tax paid and at least part of the difference between the low foreign rate and the U.S. rate.[132] This system could be established by congressional enactment of a list of approved low-tax countries or a set of criteria that defines countries eligible for tax sparing.[133] This approach, however, would inevitably prove awkward in dealing with the diverse array of developing countries and with changes in their tax systems.

A better method would be for the United States to negotiate tax sparing provisions in bilateral tax treaties with low-tax countries.[134] This latter method would allow appropriate distinctions to be made among nations and would assist the United States in negotiating appropriate reciprocal tax concessions for its residents.[135] It also would allow a sunset feature to be included in the tax sparing article of the Freelandia treaty so that the article could be revisited periodically and changed if Freelandia "cheats" on the deal by significantly

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Developing Countries: The Merits of Falling in Line with International Norms, 20 Va. Tax Rev. 467 (2000); Jeffrey Owens & Torsten Fensby, Is There a Need to Reevaluate Tax Sparing? 16 Tax Notes Int'l 1447 (1998); Richard C. Pugh, The Deferral Principle and U.S. Investment in Developing Countries, in U.S. Taxation of Developing Countries, at 267, 270-71 (Robert Hellawell ed. 1980).

131. This is the usual situation in which the tax sparing issue arises. See Gustafson, Peroni & Pugh, supra note 7, at 348-50; Roin, supra note 10, at 547 n.17.

132. The question of whether to grant tax sparing does not usually arise in this situation because countries usually engage in tax competition through narrowly-targeted tax incentives rather than by adopting a low general rate. However, one of the objections to tax sparing is that it abets the distortion that results when a foreign country creates exceptions to its generally applicable tax rate by conferring concessionary rates on a narrow class or classes of activities. See Joint Comm., Description, supra note 10, at 87. Thus, if a developing country responds to this objection by choosing to attract foreign investment through lowering its generally applicable tax rate instead of creating narrow tax concessions, its candidacy for tax sparing should be regarded as enhanced.

133. See IRC §§ 901(j), 999.

134. Of course, the United States does not presently have income tax treaties with many low-tax developing countries. Our recommendation would require a change on this point.

One of the traditional U.S. objections to tax sparing through bilateral treaties has been that tax sparing amounts to giving the affected foreign-source income a lower tax burden than domestic-source income and that this ought not to be accomplished through the treaty process. See Joint Comm., International Competitiveness, supra note 14, at § II.H.1. The logic of this position is not convincing, assuming that the United States decides that tax sparing is a desirable way to assist low-tax developing countries.

135. See Richman, supra note 10, at 70.

compromising its concern for children, the environment and the safety of its workers.[136]

The United States has historically resisted tax sparing.[137] One of the principal reasons for doing so is the view that granting tax sparing to avoid the effect of the U.S. residual tax on low-taxed foreign income is unnecessary because deferral already allows U.S. residents to substantially eliminate the U.S. residual tax.[138] This objection would disappear, however, if the United States adopted our recommendation to abolish deferral and reject exemption.[139]

The United States has also feared that granting tax sparing would encourage poor countries to engage in tax competition by lowering their rates and sacrificing needed revenues.[140] In addition, the cost effectiveness of this form of foreign aid is highly questionable. The U.S. domestic experience with section 936 is instructive. Income tax incentives in the form of reduced tax rates favor the highest profit margin industries, such as pharmaceuticals and electronics. In Puerto Rico, the U.S. General Accounting Office found that before the amendments to severely restrict section 936 in 1996,[141] the tax subsidy for an electing section 936 corporation in the pharmaceutical industry was $70,788 per worker, which was 267% of the average wages paid to pharmaceutical workers.[142] This experience suggests that, to be cost effective, there would have to be a close monitoring of the effects of the subsidy.

Our purpose, however, is not to provide a full analysis of tax sparing in this article. Instead, the larger point to be drawn from this discussion is that if a full consideration of costs and benefits establishes that the United States should assist poor countries by accommodating tax competition, bilateral tax

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136. See Richmond, supra note 10, at 70. However, one of us has previously cautioned that use of tax penalty or "negative tax expenditure" provisions as a means of achieving nontax policy objectives should undergo a cost-benefit analysis. See, e.g., Peroni, supra note 20, at 1010. This author would also apply the same caution to use of tax sparing provisions as a means of achieving child protection, worker safety, or environmental protection goals.

137. See Gustafson, Peroni & Pugh, supra note 7, at 349-50; Brown, supra note 129, at 224-25.

138. See Joint Comm., Description, supra note 10, at 87; Surrey, supra note 29, at 823.

139. See supra Part I; Peroni, Fleming & Shay, supra note 10.

140. See Joint Comm., Description, supra note 10, at 87.

141. See Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1601, 110 Stat. 1755, 1827. The 1996 legislation terminated the § 936 credit for new claimants and phased the credit out over a 10-year period for existing claimants.

142. See United States General Accounting Office, Pharmaceutical Industry Tax Benefits of Operating in Puerto Rico, reprinted in 138 Cong. Rec. 11376, 11377 (May 14, 1992). For critiques of the cost effectiveness of § 936 as a tax subsidy device, see Thomas R. Barker, Note, Ending "Welfare As We Know It" (Corporate Welfare, That Is): International Taxation and the Troubled History of Internal Revenue Code Section 936, 21 Suffolk Transnat'l L. Rev. 57 (1997); Nancy H. Kaufman, Puerto Rico's Possessions Corporations: Do the TEFRA Amendments Go Too Far?, 1984 Wis. L. Rev. 531; Camilla E. Watson, Machiavelli and the Politics of Welfare, National Health, and Old Age: A Comparative Perspective of the Policies of the United States and Canada, 1993 Utah L. Rev. 1337, 1402.

sparing agreements are a better approach for doing so than deferral or exemption. Stated differently, the tax competition strategies of impoverished countries do not establish a case for compromising the ability-to-pay principle by maintaining the current deferral system or by adopting a generally applicable exemption system for foreign-source income of U.S. residents.

IX. ENFORCEMENT OF WORLDWIDE TAXATION

It has been suggested that U.S. residence taxation, i.e., taxation of U.S. residents on their worldwide incomes, has become significantly unenforceable with respect to foreign-source income.[143] This suggestion is based on the realities that the United States cannot practically withhold tax on foreign-source income, that U.S. residents have abundant opportunities to invest in low-tax countries with which the United States has no effective information exchange arrangements and that in this environment, many U.S. residents do, and will continue to, under-report their foreign-source income.[144] From these premises, one might argue that the United States should explicitly exempt foreign-source income instead of turning U.S. residents into tax felons by clinging to a worldwide system that is unenforceable with respect to numerous taxpayers.

We disagree with this argument. The data with respect to noncompliance by U.S. residents with respect to U.S. tax on foreign-source income under current law is limited and highly speculative. Moreover, for the reasons given above,[145] the importance of maintaining fidelity to the ability-to-pay principle and avoiding an exemption system's perverse incentives strongly suggests that before surrendering to an exemption approach out of concerns regarding taxpayer noncompliance, the United States should continue initiatives to enforce taxation of the foreign-source income of U.S. residents. The United States should also continue to widen its network of information exchange agreements with source countries.[146]

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143. See Avi-Yonah, supra note 10, at 1583-86, 1593-98; Roin, supra note 10, at 594.

144. See Avi-Yonah, supra note 10, at 1583-86, 1593-98; Graetz, supra note 4, at 313. This problem is likely confined to individuals and closely held businesses. The pressure on publicly traded corporations to support their stock prices by showing as much income as possible on their financial statements probably prevents these corporations from hiding foreign-source income from the Internal Revenue Service. See Roin, supra note 10, at 602 n.194.

145. See supra Parts I, II and IV.

146. See Graetz, supra note 4, at 314. There have been assertions that exchange of information between countries is unacceptable where the purpose is to enforce residence country taxation of foreign-source income. See Letter from Congressman Dick Armey to Treasury Secretary Paul O'Neill (Mar. 16, 2001); Dan Mitchell, Center for Freedom and Prosperity Strategic Memorandum (June 11, 2001); Mastromarco, supra note 29, at 1625. This view assumes that worldwide income taxation is improper. By now, it is abundantly clear that we respectfully and strongly disagree.

X. CONCLUDING OBSERVATIONS: WEIGHING THE FACTORS

A. *Why Not Do as Others Do?*

With respect to deferral, a leading tax lawyer has recently stated that "[w]e often hear tax reformers scream about the evils of deferring taxes on foreign earnings, but if other countries do the same with their companies it is hard to see why we should treat our companies less favorably."[147] As the analysis in Part VII has indicated, deferral is a device that effectively allows taxpayers to elect out of the U.S. worldwide taxation system and into the close economic equivalent of an exemption system.[148] Thus, exemption system advocates are inclined to broaden the preceding quotation and ask why, if some other countries directly confer the advantages of an exemption system on their residents, should the United States treat its residents less favorably by holding to a worldwide system?[149] The answer is that we might choose to treat our companies less favorably than companies resident in exemption-system countries because we give a higher priority to fairness in the design of our income tax rules than is implied by the choice of an exemption system.

To be specific, the U.S. income tax is heavily grounded on a fairness notion–that taxpayers should contribute to the cost of government in relationship to their comparative economic well being or ability-to-pay.[150] It is clear, however, that in constructing or reforming an income tax, the goals of simplicity, economic neutrality/efficiency and economic growth must also be taken into account and may require that fairness concerns be somewhat circumscribed.

With respect to simplification, exemption system proponents argue that an exemption regime would advance the goal of reducing complexity in the tax system.[151] After all, what could be simpler than not taxing foreign-source income at all?

Adoption of an exemption regime might, indeed, simplify the U.S. system for taxing its residents' foreign-source income, but the amount of simplification to be gained by the switch from a worldwide approach is uncertain and may not be great. This is largely due to the fact that adoption of a regime that provides an explicit zero rate of tax for foreign-source income will heighten the importance of those elements of the system dealing with the distinction between U.S.-source and foreign-source net income. Thus, the sourcing rules, transfer pricing rules and expense-allocation rules will

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147. An Interview with Peter L. Faber, News, Commentary and Analysis, 87 Tax Notes 349 (2000).

148. See supra text accompanying notes 100-104.

149. See National Foreign Trade Council, supra note 6, at 6-28 to 6-29.

150. See authorities cited in supra note 3.

151. See Chorvat, supra note 9, at 850-53.

inevitably assume a greater role under an exemption regime than under the present worldwide system. We should expect that these rules would all be tightened in the exemption context, thereby becoming more complex and more productive of controversy between taxpayers and the IRS.[152]

Moreover, to mitigate fairness and economic efficiency/neutrality concerns, some countries exclude both passive income and low-taxed foreign-source business income from their exemption systems (indeed, most countries exclude passive income from their exemption systems) and employ a worldwide system (with a foreign tax credit) for this excluded income.[153] If the United States went down this road and preserved its worldwide system (with its complex foreign tax credit) for passive and low-taxed foreign-source income, the simplification gains from an exemption system could be slim indeed.[154]

In addition, some exemption countries have determined that although a resident's foreign-source income should be excluded from the tax base, it should, nevertheless, be taken into account for purposes of determining the progressive tax rate that applies to the resident's domestic-source income. This principle is generally referred to as exemption-with-progression.[155] If the United States were to adopt this approach, the issue of whether or not to recognize unrepatriated controlled foreign corporation income when implementing exemption-with-progression would be critically important and might well result in the preservation of the Subpart F and the passive foreign investment company regimes for this purpose. If so, the simplification gains from converting to an exemption system would be significantly reduced.

An exemption system is also a highly distortionary departure from the goal of economic neutrality. At its worst, an exemption system can cause an investment in a low-tax foreign country to be preferred to a U.S. investment even though the U.S. investment has a higher before-tax rate of return and is, therefore, economically superior.[156] It is difficult to see how the economic well-

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152. See generally Michael J. McIntyre, Thoughts on the IRS's APA Report and More Territorial Taxation, 87 Tax Notes 445, 446 (2000); Merrill, supra note 14, at 103; Peroni, supra note 20, at 985; Tillinghast, supra note 14, at 211-12; see also Grubert & Mutti, Dividend Exemption, supra note 10, at 7.

153. See Ault, supra note 16, at 402-06, 411-12; Woellner, Barkoczy & Murphy, supra note 7, at 1336-37, 1340-64; Chorvat, supra note 9, at 855-59; Graetz, supra note 4, at 324, 329; see also Rosenbloom, supra note 36, at 1549-50; Tillinghast, supra note 14, at 209-10.

154. See Kingson, supra note 14, at 53-54; Peroni, supra note 20, at 986. Although Australia generally employs an exemption regime for foreign-source income, it taxes certain foreign-source income under a worldwide system that features an anti-deferral regime described as "probably the most complex tax legislation which this country has seen." See Woellner, Barkoczy & Murphy, supra note 7, at 1347.

155. See Ault, supra note 16, at 402; Roin, supra note 13, at 1761-62 n.27.

156. See supra text accompanying notes 79-80; Avi-Yonah, supra note 10, at 1604 n.132; see also Jane G. Gravelle, Foreign Tax Provisions of the American Jobs Act of 1996, 72 Tax Notes 1165, 1166 (1996); Grubert & Mutti, Where U.S. Corporations Invest, supra note 10,

being of the United States is furthered by distorting taxpayer decisions in this manner.

With respect to economic growth, exemption advocates contend that exemption systems create greater worldwide economic well-being than do worldwide taxation systems.[157] The empirical and theoretical support for this proposition is, however, so mixed and debatable that the claimed economic growth virtues of the exemption approach must be regarded as speculative at best.[158]

Likewise, the claims that adoption of an exemption system by the United States is necessary to keep American businesses on a competitive footing in foreign markets are rendered dubious, at best, by the extensive overseas success of American businesses.[159] Advocates of the competitiveness view have failed to provide convincing empirical evidence for their claims that worldwide taxation undermines the ability of U.S. individuals and corporations to compete in the global marketplace.[160]

In addition to the preceding points, Parts VIII and IX have discussed ways to overcome objections to worldwide taxation that are based on a desire to accommodate the tax competition strategies of poor countries and a concern for the enforceability of residence taxation.[161]

Thus, it is quite rational for Americans to conclude that when the significance of the ability-to-pay fairness principle is weighed against an exemption system's distortionary effects, uncertain simplification benefits and speculative economic growth consequences, and against the strong competitive performance of American businesses abroad, worldwide taxation is the preferred option. This holds true regardless of the fact that other countries, with other ideas regarding the relative importance of fairness, countenance generous deferral of foreign-source income or employ exemption systems.[162]

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at 835; Mitchell, supra note 9, at 804; Peroni, supra note 20, at 983; Robert J. Peroni, Deferral of U.S. Income Tax on International Income: End It, Don't Mend It–Why Should We be Stuck in the Middle with Subpart F?, 79 Tex. L. Rev. 1609, 1613-14 (2001).

157. See, e.g., Gary Clyde Hufbauer, U.S. Taxation of International Income: Blueprint for Reform 57-59 (1992).

158. See, e.g., Joint Comm., Overview, supra note 14, at § IV.D; U.S. Treas. Dep't, Deferral, supra note 7, at 25-54; Altshuler, supra note 10, at 1585; Hines, supra note 14, at 401-02; Rousslang, supra note 10, at 595-97.

159. See U.S. Treas. Dep't, Deferral, supra note 7, at 56.

160. See U.S. Treas. Dep't, Deferral, supra note 7, at 56-57, 61.

161. See supra text accompanying notes 108-146.

162. See Reuven S. Avi-Yonah, Tax, Trade, and Harmful Tax Competition: Reflections on the FSC Controversy, 21 Tax Notes Int'l 2841, 2843 (2000) (arguing that an exemption system, as typically constructed, is a prohibited export subsidy under the General Agreement on Tariffs and Trade). For a more cautious view on this point, see Westin & Vasek, supra note 10, at 341-44.

B. *Ending Deferral*

As indicated previously, however, the feeble U.S. anti-deferral provisions allow U.S. residents to effectively elect out of the U.S. worldwide system and into the close equivalent of an exemption system by taking advantage of generous opportunities to defer recognition of foreign-source income.[163] The deferral privilege allows U.S. residents to achieve the approximate tax results of an exemption system[164] but only if these residents engage in economically wasteful business arrangements.[165] Thus, the deferral privilege is a poorly designed quasi-exemption system that is available only to well-advised taxpayers.

For the same reasons set out above in relation to an exemption system, we believe that the ability-to-pay criterion supports ending deferral of U.S. tax on foreign income earned through a foreign corporation. The current system of deferral distorts investment decisions, is unbearably complex and has not been shown to improve U.S. economic growth. When the ability-to-pay fairness principle is taken into account, it furnishes yet another basis on which to prefer current taxation of worldwide income with no deferral privilege.[166]

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163. See supra Part VII.

164. See U.S. Treas. Dep't, Deferral, supra note 7, at 46; Altshuler, supra note 10, at 1588-93; Grubert & Mutti, Dividend Exemption, supra note 10, at 4.

165. See Peroni, Fleming & Shay, supra note 10, at 458-59, 501-04.

166. If the United States cannot summon the political will to circumscribe the deferral loophole in its worldwide taxation regime, the second-best alternative may be to abandon worldwide taxation cum deferral and adopt an explicit exemption system. As suggested above, however, in order to prevent the exemption system from eroding U.S. taxing jurisdiction over U.S.-source income, an explicit exemption system would require enhanced transfer pricing, source-of-income and expense-allocation rules. Moreover, to restrain the exemption system from providing a strong incentive for U.S. taxpayers to shift highly mobile passive income to low-tax foreign countries, a properly designed exemption system would exclude passive income from the exemption regime and handle it under a worldwide system with a foreign tax credit. Finally, concerns about fairness and economic efficiency would probably dictate that low-taxed foreign-source business income be excluded from the exemption system and taxed under a worldwide system. When an exemption regime having all of these characteristics is presented in fully-developed form, much of the attractiveness that exemption possesses as an abstract concept may disappear. Certainly, much of an exemption system's simplification potential is lost if significant amounts of foreign-source income remain subject to a worldwide system, unless a "rough justice" approach is adopted under which international double taxation is mitigated by allowing only a deduction for foreign taxes borne by passive income or low-taxed business income remaining in the worldwide system. See Rosenbloom, supra note 36, at 1549-50. (Because the source country rate of tax on passive income would usually be low, there is little or no double taxation problem and, consequently, much to be said for confining U.S. taxpayers to a deduction, instead of a credit, for foreign taxes on foreign-source passive income. This approach would avoid many of the complexities of a foreign tax credit. See Graetz, supra note 4, at 332-34; Rosenbloom, supra note 36, at 1549-50.) In other words, the simplification potential of an exemption system depends heavily on achieving substantial repeal of the foreign tax credit provisions, including the complex basket limitation rules. See IRC § 904(d). Conversely, the simplification goal is defeated to the

It seems useful at this juncture to emphasize that a repeal of deferral could be accompanied by a counterbalancing cut in the corporate, or individual, tax rates so that the repeal would be revenue neutral. Indeed, our advocacy for repealing deferral is based on concerns regarding fairness and distortion, not on the hope that federal revenues will be increased. Thus, we would urge the elimination of deferral regardless of whether Congress used any resulting revenue increase to enlarge government spending or pay for a general tax cut.

C. *The Preferred Alternative*

Although the application of the ability-to-pay fairness principle to international income taxation is complicated by the presence of foreign taxpayers, by income earned through C corporations and by the claims of other governments to tax cross-border income, it is nonetheless possible, and indeed important, to analyze international tax policy in terms of fairness. As the foregoing discussion demonstrates, we believe that the fairness criterion supports the conclusion that taxing worldwide income and ending the deferral privilege provides a tax regime that is superior to either the current system or the adoption of an exemption system.

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extent that concerns about perverse incentives and fairness lead to the adoption of a system that is a hybrid of the exemption and credit approaches. We intend to explore these matters in a future article.